



Draft Guidelines for New Bank Licences: *Watchful Advancement by RBI*

Analyst Contact:

Vibha Batra

vibha@icraindia.com
+91-124-4545302

Karthik Srinivasan

karthiks@icraindia.com
+91-22-3047 0028

The August 29, 2011-released draft Reserve Bank of India (RBI) guidelines for licensing of new privately-owned banks propose to open up the banking sector to corporate entities and non-banking financial companies (NBFCs) while safeguarding the stability of the financial sector and mitigating concerns over interconnected lending. The suggested stability-ensuring measures include exclusion of business groups with extensive real estate and broking operations, while the problem of interconnected lending is sought to be overcome via stricter approval processes, tighter concentration norms, and higher disclosure requirements.

The proposal that promoter shareholding in a new private bank should not go below 40% during the first five years, in ICRA's view, should ensure that promoters retain significant economic interest in the bank during the crucial start-up period. Similarly, the proposal on compulsory reduction in promoter shareholding over the longer term should ensure eventual diversification of shareholding, according to ICRA.

In ICRA's view, while the suggested condition that 25% of the branches of new private banks be opened in new areas could compel them to spread out into smaller towns and improve their market share there, the stipulation could also have adverse implications for their profitability. As for urban and metropolitan areas, ICRA thinks that the entry of new banks here would increase competition in these areas significantly; as on March 31, 2010, private banks and foreign banks together had an 18% share of deposit accounts and 67% share of credit accounts in urban and metropolitan areas.

ICRA believes the suggestion that a new private bank have a separate unleveraged non-operating holding company (NOHC) would ensure that the RBI can effectively control and monitor the NOHC (registered as an NBFC) and the banking subsidiary, while also preventing double leveraging. However, the stipulations requiring the NOHC to lower its equity stake in the bank to 40% and the bank to get listed on the stock exchanges within two years of receipt of the banking licence could prove to be a challenge, given the time taken to actually commence banking operations post-receipt of licence and the restrictions imposed by the RBI on non-promoter shareholding. Besides, the capital market environment prevailing at the time of listing could also be adverse.

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ICRA's assessment of some of the key clauses in the draft guidelines issued by the RBI for the licensing of new banks in the private sector is presented in the following sections.

Measures seeking to ensure stability

- Entities/groups in the private sector owned and controlled by residents are eligible to promote banks
- Promoter groups should have diversified ownership, sound credentials and integrity, besides a minimum 10-year successful track record in their business
- Entities/groups with more than 10% of their income or assets from real estate, construction and broking are not eligible to promote banks
- A minimum capital adequacy of 12% (compared with 9% for other banks) will have to be maintained for the first three years of operations

ICRA's comments

While these criteria could make some aspirants ineligible for banking licence (there may still be enough aspirants for fresh banking licences), the restrictions could impart stability to the proposed banks and make supervision simpler and more effective. Further, a higher capital adequacy could offer some cushion to deposit-holders against volatilities faced by the bank during the start-up phase.

Measures allaying some concerns over entry of corporate entities

- All financial services operations (including the proposed new bank) will have to be held by a wholly-owned NOHC
- The NOHC will have to be registered as an NBFC with the RBI, and the NOHC will not be permitted to raise debt for investing in its operating subsidiaries
- No financial entity under the NOHC will be allowed to engage in any activity that a bank is allowed to undertake; all such activities will have to be undertaken by the bank
- The additional considerations for promoter groups with 40% or more assets/income from non-financial business are as follows:
 - Exposure to any promoter group entity and others¹ to be kept within 10% (20% for promoter group exposures) of paid up capital and reserves of the bank
 - Minimum security cover on such exposures to be 150%
 - Quarterly audited reports on all such exposures in excess of Rs. 1 crore mandatory
 - Prior approval required from the RBI for raising fresh equity
 - All exposures to promoter group entities to be approved by the the Bank's Board
 - The RBI to have final authority on defining "group" entity
 - Five-year lock-in for NOHC shareholding in the bank, after which shareholding to be brought down to 20% within 10 years and 15% within 12 years

ICRA's comments

ICRA believes that the requirement of a separate unleveraged NOHC (registered as an NBFC) will allow the RBI better monitor and control the NOHC and the banking subsidiary, and also prevent double leveraging. Further, the requirement of a minimum 40% promoter shareholding for the first five years should ensure that the promoter concerned retains significant economic interest in the bank during the crucial start-up phase; also, the compulsory reduction in promoter shareholding over the longer term paves the path for a diversified shareholding. The stricter approval processes, tighter concentration norms and higher disclosure requirements envisaged, in ICRA's view, could reduce the risk of interconnected lending significantly. At the same time, the requirement of RBI approval for issue of fresh equity should ensure compliance with the various clauses related to ownership.

Considering the larger issues of financial stability and a level playing field for all players, ICRA thinks there may be a case for realignment of guidelines for capital market and real estate activities for existing private banks; for the shareholding of existing promoters who continue to hold over 15% in existing private banks; and for the consolidation of operations of the existing groups that continue to operate via non-banking routes.

¹ To their business associates, major suppliers and customers

Measures to strengthen governance structure

- At least 50% of the Directors of the NOHC should be totally independent of the promoter/promoter group entities, their business associates, and their customers and suppliers
- The RBI will have to be satisfied on ring fencing of financial services offered by the NOHC from other activities, and it should be able to supervise the bank and the NOHC on a consolidated basis
- Ownership and management should be separate and distinct in the promoter/promoter group entities that own or control the NOHC; the management should be professional and corporate governance standards adequate
- The source of promoters'/promoter groups' equity in the NOHC should be transparent and verifiable

ICRA's comments

The stronger corporate governance structure envisaged may serve to further mitigate some of the concerns associated with the entry of corporate entities in the banking sector, in ICRA's view. However, greater clarity required in some of the provisions mentioned.

Measures on ownership and listing

- Applicants will have to list group companies undertaking key business activities on the stock exchange
- The private bank will have to get its shares listed on the stock exchanges within two years from getting the licence
- The NOHC will have to reduce its shareholding in the bank to 40% within two years of receipt of the bank licence
- The NOHC will not be permitted to set up any new financial services entity for two years from getting the licence
- Foreign shareholding in the new bank will be capped at 49% for the first five years. Subsequent shareholding will be in accordance with the extant policy. No non-resident shareholder, directly or indirectly, individually or in groups, will be permitted to hold 5% or more of the paid-up capital of the bank
- The promoters, their group entities, the NOHC and the bank will be subject of consolidated supervision by the RBI
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ICRA's comments

ICRA is of the view that the proposed guideline requiring corporate entities to list their key group companies on the stock exchange may deter some of them from applying for banking licences, as some of the other businesses may not be mature for listing. Additionally, the restriction on establishing any new financial services entity for the first three years may also prove to be a constraining factor. Further, the requirement to bring down the promoter shareholding to 40% and have the bank listed on the stock exchange within two years of receipt of the banking licence could be a challenge, given that it would take some time post-receipt of licence to commence banking operations while managing teething problems and that capital market conditions prevailing at the time may not be conducive. Also, considering the restrictions on non-promoter shareholding (at 5% for non resident / 10% for resident Indians), it will be difficult to dilute the promoter stake to 40% within the first two years. As for supervision of non-financial entities by the RBI, this may be difficult to implement. Overall, ICRA is of the view that the ownership and listing related conditions proposed are somewhat onerous.

Measures to improve banking penetration

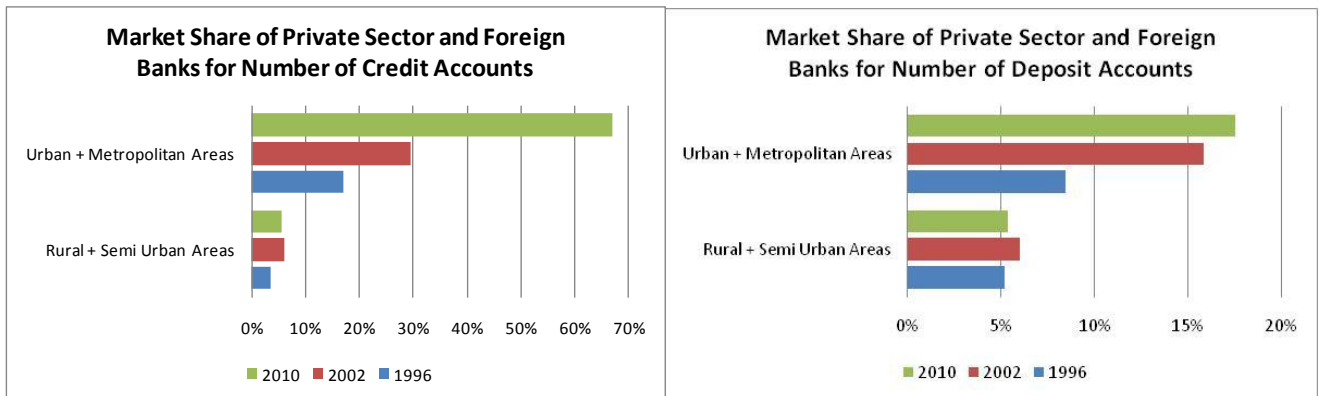
- Banks will have to focus on financial inclusion and draw up realistic business plans
- At least 25% of the bank's branches will have to be in under-banked rural centres

ICRA's comments

ICRA is of the opinion that the requirement of having to open branches in under-banked areas may lead to some improvement in the market share of private banks; till date, it is largely the public sector banks that have been serving these areas(94-95% credit/deposit account holders in rural/urban areas are served by PSBs).

To scale up their business, private sector banks have so far been tapping the urban and metropolitan areas, in which they have seized significant market share from their public sector counterparts. Expansion

by private banks into rural and semi-urban areas has been limited till date, and the little that they have done on this front has been to just about maintain their low market share. As the charts show, the market share of private banks by the number of deposits in rural and semi-urban areas has remained stagnant at 5-6% over the 14 years even as their share in the urban and metropolitan areas has increased rapidly from 8% in 1995-96 to 18% in 2009-10. The growth is starker in the case of credit accounts, for which their market share has risen from 4% to just 6% in rural and semi-urban areas during the period 1995-96 to 2009-10, while spurring from 16% to 67% in urban and metropolitan areas over the same period. Given the more profitable nature of urban/metropolitan operations, the entry of new private banks is likely to intensify competition further in these areas. At the same time, the requirement of having to open branches in under-banked areas could exert pressures on the profitability of the new banks in the short term even as the stipulation could bring in some improvement on the financial inclusion front.





ICRA Limited

An Associate of Moody's Investors Service

REGISTERED OFFICE

Kailash Building, 11th Floor, 26, Kasturba Gandhi Marg, New Delhi 110001
Tel.: +(91 11) 2335 7940-50; Fax: +(91 11) 2335 7014

CORPORATE OFFICE

Building No. 8, 2nd floor, Tower A, DLF Cyber City, Phase II, Gurgaon - 122002
Tel.: + (91 124) 4545300; Fax: +(91 124) 4545350
Email: icrainfo@icraindia.com, Website: www.icra.in

Branches: **Mumbai:** Tel.: + (91 22) 24331046/53/62/74/86/87, Fax: + (91 22) 2433 1390 □ **Chennai:** Tel + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294, Fax + (91 44) 2434 3663 □ **Kolkata:** Tel + (91 33) 2287 0450, 2240 6617/8839, 2280 0008, Fax + (91 33) 247 0728 □ **Bangalore:** Tel + (91 80) 2559 7401/4049 Fax + (91 80) 2559 4065 □ **Ahmedabad:** Tel + (91 79) 2658 4924/5049/2008, Fax + (91 79) 2658 4924 □ **Hyderabad:** Tel +(91 40) 2373 5061/7251, Fax + (91 40) 2373 5152 □ **Pune:** Tel + (91 20) 2552 0194/95/96, Fax + (91 20) 2553 9231

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