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Prudence is key for India's bank hopefuls

By Kunal Kumar Kundu

NEW DELHI - Will a severely under-banked country like India, where financial inclusion has been more of a utopia (what with virtually half of India's population not having any bank accounts), see a change for the better? Don't count on it now, though the Reserve Bank of India (RBI) has, after years of deliberations, laid down norms for granting new banking licenses. However, what is important to note here is that pragmatic policy making (I would resist myself from calling every policy initiative as reform) is finally back in the limelight.

India's banking sector is dominated by as many as 27 state-run banks, which control approximately 75% of the country's gross credit. Only recently have some foreign banks and a handful of private banks, like ICICI Bank, HDFC Bank and Axis Bank, emerged as important players in the segment, as RBI continued to be extra cautious in providing entry to the private sector so as to ensure stability of the financial system.

Over the past two decades, the RBI has allowed only 12 new banks, and that in two phases, with the most recent license being issued to Yes Bank Ltd in May 2004.

Last Friday, RBI came out with its much-awaited final guidelines on the New Banking License, approximately three years after the announcement in this regard made in the Budget speech of 2010-2011 by the then Finance Minister, Pranab Mukherjee.

Some of the key final guidelines for the licensing of new banks in the private sector are as follows:

- All companies or groups, whether private or public sector entities, are eligible to set up a bank, though only through a wholly owned non-operative financial holding company (NOFHC). With this provision, the bank's business would not be impacted by the company's or group's existing business.
- The entity or group should have a past record of sound credentials and integrity. The company should also have a healthy financial track record of 10 years. Further, the RBI may also investigate the above matter and check the veracity of the claims. With this, only companies that have a good financial track record, excellent management team and good corporate governance would be eligible for a license.
- The minimum capital required to start up is 5 billion rupees (US$93 million), of which the NOFHC shall hold a minimum voting stake of 40% of the paid-up equity capital that will be locked in for a period of 5 years. Going ahead, its stake shall be bought down to 15% within 12 years. Also, the aggregate foreign holding in the new bank shall not exceed 49% in the first five years. Further, the bank's shares should be listed on the stock exchange within three years of the commencement of its business. This clause would result in better efficiency in the management's working and their decision-making abilities.

- At least 50% of the bank's board should be independent directors. And, if a promoter and its group were from a non-banking background, then the independent directors would serve as the most important people on the board.
- The NOFHC and the bank should not have any exposure to the promoter group and its other entities. This would insulate the bank from various other risks that are associated with other businesses and check the practice of giving concessions or incentives to the promoter group in case they are in need of funds. This is the crucial part of the guideline.
- The bank shall open at least 25% of its branches in unbanked areas (population of up to 9,999 as per the latest census data) and comply with the priority sector lending targets (40% of total advances) and respective sub-targets (agriculture, small and medium-sized enterprises etc) as applicable to the existing domestic banks. This would further strengthen the overall aim of financial inclusion in the country.
- Existing non-banking financial companies, if eligible, may be permitted to promote new banks or convert themselves into banks. Similarly, state-owned enterprises can also apply for banking licenses.

Clearly, the RBI seems to believe that there should be level playing field for any aspirant, irrespective of their current line of business. Interestingly, in January, the International Monetary Fund in its report on India, "Financial System Stability Assessment Update", felt that India, given the international experience, would be better off not allowing industrial houses from promoting and owning banks.

Even the RBI's final guideline differed from the draft guideline circulated by it in August 2011 when it said that it was not in favor of allowing companies that earned at least 10% of their revenues from real estate and broking business to apply for new bank licenses.

The final guideline issued by the RBI should be lauded, as it is practical, non-discriminatory (ie any existing business can get the license if it adheres to all the laid down norms) and has enough checks and balances in place to ensure prudence. This guideline will ensure that the financial services businesses of the banks and their promoters are shielded from the risks emanating from the group entities of promoters.

It is also important to note that although the guidelines have been laid down, granting of licenses will still remain subjective and not every corporate entity that follows the guidelines will get a license. In fact, the final guidelines mention that, "promoter/promoter groups' business model and business culture should not be misaligned with the banking model and their business should not potentially put the bank and the banking system at risk on account of group activities such as those which are speculative in nature or subject to high asset price volatility".

This means that the RBI is well aware of the systemic ricks involved and would prefer to play it safe. The entry criteria, as laid down by them, which include the number of years of existence with a financially sound and successful track record along with the capital structure to be followed, would mean that not many aspirants can meet the criteria. And, even if they do, the check on the business model and culture would further help in narrowing down the list.

The government has for long been nudging the RBI to allow new entrants to the banking system. The primary goal is to push for financial inclusion as the success of the government's cash transfer scheme crucially hinges on financial inclusion. The cash transfer scheme allows direct transfer of cash directly to the subsidy beneficiaries (that is, those who are entitled to the subsidized products) rather than supplying subsidized products. Selling subsidized products leads to leakage due to faulty targeting as well as corruption in delivering the subsidized goods.

However, instant and widespread banking sector penetration should not be expected in the wake of this guideline. With the rumblings of the global financial crisis still reverberating across the world, the RBI (which must be complemented for being able to shield India's banking sector admirably from being impacted by the crisis) is justified in being cautious to the point of being paranoid. It is better to be safe than sorry.

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