

CREDIT INFORMATION REVIEW



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POLICY

Draft Policy Framework for Ownership and Governance in Private Sector Banks

The Reserve Bank on July 2, 2004 placed in public domain a draft policy framework for ownership and governance in private sector banks. The draft is for discussion before finalisation.

Objective

The objective of the policy framework is to ensure good corporate governance in private sector banks. Banks are "special" as they not only accept and deploy large amount of uncollateralised public funds in fiduciary capacity, but they also leverage such funds through credit creation. They are also important for smooth functioning of the payment system.

The legal prescriptions for ownership and governance of banks laid down in the Banking Regulation Act, 1949 have been supplemented by regulatory prescriptions issued by the Reserve Bank from time to time. Recently, the Reserve Bank has laid down a comprehensive policy framework relating to ownership and governance in Indian private sector banks. The broad principles underlying the policy framework would ensure that -

- The ultimate ownership and control of private sector banks is well diversified.
- Important shareholders (i.e., shareholding of 5 per cent and above) are 'fit and proper' (see box on page 4).
- The directors and the chief executive officer who manage the affairs of the bank are "fit and proper" and observe sound corporate governance principles.
- The Reserve Bank will not appoint its nominee on the boards of private sector banks unless the circumstances are exceptional.
- Private sector banks have minimum capital/net worth for optimal operations and systemic stability.
- The policy and the processes are transparent and fair.

Minimum Capital

All banks in private sector should have a net worth of Rs 300 crore at all times. Where the net worth declines to level below Rs 300 crore, it should be restored within reasonable time.

Shareholding

- The Reserve Bank's guidelines on acknowledgement for acquisition or transfer of shares of February 3, 2004 (see box on page 4) will be applicable for any acquisition of shares

of 5 per cent and above of the paid up capital of the private sector bank.

- In the interest of diversified ownership of banks, it would be ensured that no single entity or group of related entities has shareholding or control, directly or indirectly, in any private sector bank in excess of 10 per cent of the paid up capital of the bank.
- Where ownership is that of a corporate entity, it would be ensured that no single individual/entity has ownership and control in excess of 10 per cent of that entity. Where the ownership is that of a financial entity it would be ensured that it is a widely held entity, publicly listed and a well established regulated financial entity in good standing in the financial community.
- In case of a new licence for a private sector bank, promoter shareholding would be allowed to be higher to start with, but should be brought down to 10 per cent in a time bound manner normally within a period of three years.
- As per the existing policy, large industrial houses will not be allowed to set up banks but would be permitted to acquire by way of strategic investment, shares not exceeding 10 per cent

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of the paid up capital of the bank subject to the Reserve Bank's prior approval.

- (vi) Any private sector bank, including any foreign bank with presence in India, will be allowed to hold shares in any other private sector bank only up to 5 per cent of the paid up capital of the investee bank.

Directors and Corporate Governance

- The board of directors should ensure that the responsibilities of directors are well defined and they are provided need-based training.
- Not more than one member of a family or a close relative or an associate (partner, employee, director, etc.) should be on the board of a bank.
- All directors would be required to sign a covenant in "public interest".
- Being a director, the chief executive officer should satisfy the requirements of the "fit and proper" criteria applicable for directors.

Foreign Investment

As announced by the Government of India in March 2004, the aggregate foreign investment in private banks from all sources, i.e., foreign direct investment (FDI), foreign institutional investors (FIIs), non-resident Indians (NRIs) should not exceed 74 per cent. The limit of 74 per cent would be reckoned by taking into account the direct and indirect holding. In other words, at all times, at least 26 per cent of the paid up capital of a private sector bank would have to be held by residents.

FDI

- FDI in private banks where shareholding reaches and exceeds 5 per cent either individually or as a group would have to comply with the criteria indicated in the Reserve Bank's guidelines of February 3, 2004.
- The percentage of FDI by single entity or group of related entities should not exceed 10 percent.

FIIs

- Individual FII investment is limited to 10 per cent. The aggregate limit for all FIIs is restricted to 24 per cent but can be raised to 49 per cent with the approval of the board/general body.
- As earlier, FIIs would continue to obtain the Reserve Bank's acknowledgement for acquisition/transfer of shares of 5 per cent and more of a private sector bank.

NRIs

Individual NRI portfolio investment in banks is limited to 5 per cent and the aggregate limit for all NRIs is restricted to 10 per cent. It could, however, be raised to 24 per cent with the approval of the board/general body.

Due Diligence

The process of due diligence in all cases of shareholders and directors will involve reference to the relevant regulator, revenue authorities, investigation agencies and independent credit reference agencies.

Acknowledgement of Transfer/Allotment of Shares (February 3, 2004 Guidelines)

Any allotment or transfer of shares which will take the aggregate holding (direct and indirect) of an individual or group to equivalent of 5 per cent or more of the paid-up capital of a private sector bank would require the Reserve Bank's acknowledgement before the bank can effect the allotment/transfer of shares.

While deciding whether or not to grant acknowledgement, the Reserve Bank would take into account all matters that it considers relevant to the application, including ensuring that the shareholders whose aggregate holdings are above specified thresholds meet the fitness and propriety tests. The Reserve Bank may, if required, call for additional information and documents including shareholder agreements.

In determining whether the applicant (including all entities connected with the applicant) is fit and proper to be a shareholder of a private bank, the Reserve Bank may take into account all relevant factors, such as -

- The applicant's integrity, reputation and track record in financial matters and compliance with tax laws.
- Whether the applicant has been the subject of any proceedings of a serious disciplinary or criminal nature, or has been notified of any such impending proceedings or of any investigation which may lead to such proceedings.
- Whether the applicant has a record or evidence of previous business conduct and activities where the applicant has been convicted for an offence under any legislation designed to protect members of the public from financial loss due to dishonesty, incompetence or malpractice.
- Whether the applicant has achieved a satisfactory outcome as a result of financial vetting. This will include any serious financial misconduct, bad loans or whether the applicant was judged to be bankrupt.
- The source of funds for the acquisition.
- Where the applicant is a body corporate, its track record of reputation for operating in a manner that is consistent with the

standards of good corporate governance, financial strength and integrity in addition to the assessment of individuals and other entities associated with the body corporate.

Where acquisition or investment takes the shareholding of the applicant to a level of 10 per cent or more and up to 30 per cent, the Reserve Bank would also take into account other factors, such as -

- Source and stability of the funds for the acquisition and the ability to access financial markets as a source of continuing financial support for the bank
- Business record and experience of the applicant including any experience of acquisition of companies
- The extent to which the corporate structure of the applicant would be in consonance with effective supervision and regulation of the bank
- In case the applicant is a financial entity, whether the applicant is a widely held entity, publicly listed and a well established regulated financial entity in good standing in the financial community.

Acknowledgement for transfer of acquisition or investment exceeding the level of 30 per cent would be considered also taking into account that -

- The acquisition is in public interest;
- A diversified ownership of the bank is desirable;
- The applicant's plans for the future conduct and development of the bank's business are sound and feasible;
- Shareholder agreements and their impact on control and management of the bank.

The Reserve Bank's acknowledgement would be subject to the applicant's compliance with other applicable laws and regulations, such as, those issued by the Securities and Exchange Board of India, Department of Company Affairs and Insurance Regulatory and Development Authority.

Voting rights restrictions and other related provisions of the Banking Regulation Act would continue to be applicable as appropriate.

Transition

- (i) Existing private banks which do not fulfill the minimum net worth requirement of Rs. 300 crore would be required to submit a time bound programme for capital augmentation to the Reserve Bank for approval.
- (ii) Where any existing shareholding of any individual entity/group of entities is 5 per cent and above, due diligence outlined in the Reserve Bank's guidelines of February 3, 2004 would be undertaken to ensure fulfillment of fit and proper criteria.
- (iii) Where any existing shareholding by any individual entity/group of related entities is in excess of 10 per cent, the bank would be required to indicate a time table for reduction of holding to the permissible level.
- (iv) Any bank having shareholding in excess of 5 per cent in any other bank in India would be required to indicate a time bound plan for reduction in such investments to the permissible limit.
- (v) Banks would be required to undertake due diligence of directors and chairman/chief executive officer and provide all the necessary certifications/information to the Reserve Bank.
- (vi) At the time of considering any new induction or renewal of terms of directors, banks should ensure that not more than one member of family, close relative or associate is on the board.

'Fit and Proper' Criteria for Banks' Directors

Persons to be appointed as directors of private sector banks, would now be required to fulfill specific criteria prior to their appointment. Pursuant to the recommendations of Ganguly Group Report, the Reserve Bank has advised all private sector banks to-

- (i) Undertake a process of due diligence to determine the suitability of the person for appointment/continuing to hold appointment as a director on the Board, based upon qualification, expertise, track record, integrity and other 'fit and proper' criteria. Banks should obtain necessary information and declaration from the proposed/existing directors for the purpose in the prescribed format.
- (ii) Undertake the process of due diligence at the time of appointment/renewal of appointment of the directors.
- (iii) Constitute nomination committees to scrutinise the declarations.
- (iv) The nomination committees should, based on the information provided in the signed declaration, decide on the acceptance and make references, where considered necessary, to the appropriate authority/persons, to ensure their compliance with the requirements indicated.
- (v) Obtain annually as on March 31, a simple declaration that the information already provided has not undergone change and if there is any change, the requisite details would be furnished by the directors forthwith.
- (vi) Ensure in public interest that the nominated/elected directors execute the deeds of covenants every year as on March 31.

Capital Charge for Market Risks

With a view to ensuring smooth transition to Basel II norms, the Reserve Bank has advised banks to phase the implementation of capital charge for market risk over a two year period as under:

- a) Capital for market risks on securities included in the 'Held for Trading' category, open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures by March 31, 2005, and
- b) In addition to (a) above, capital for market risks on securities included in the 'Available for Sale' category by March 31, 2006.

With a view to ensuring smooth implementation of the guidelines, banks have been advised to nominate suitable official(s) who would be the contact point in the bank. Details of the nominated official(s), viz., name, designation, telephone number, fax number, e-mail-id and postal address should be conveyed to the Reserve Bank. The contact officials may also seek clarifications, if any, by e-mail from the Reserve Bank (dbodmrg@rbi.org.in).

The Basel Committee on Banking Supervision (BCBS) had issued the 'Amendment to the Capital Accord to incorporate market risks' containing comprehensive guidelines to provide explicit capital charge for market risks. In India, as an initial step towards prescribing capital charge for market risks, banks were advised to :

- assign an additional risk weight of 2.5 per cent on the entire investment portfolio;
- assign a risk weight of 100 per cent on the open position limits on foreign exchange and gold; and
- build up investment fluctuation reserve up to a minimum of five per cent of the investments held in 'held for trading' and 'available for sale' categories in the investment portfolio.

In April 2002, banks were advised to adopt the BCBS norm on capital charge for market risk. Banks were also advised to study the BCBS framework on capital for market risks and prepare themselves to follow the international practices in this regard. As a further step in this direction, Reserve Bank had issued draft guidelines on computing capital charge for market risks, on the lines of the Basel Committee framework, in May 2003, to select banks seeking their comments.

Wilful Defaulters

Pursuant to representations received from borrowers who have been classified as 'wilful defaulters', that the redressal mechanism should precede the classification as 'wilful defaulter', the Reserve Bank has clarified that the classification of borrowal accounts and the redressal mechanism are two distinct processes, comprising -

- (a) identification of default as 'wilful' with clear-cut reasons; and
- (b) advising the borrower about the proposal to classify him as wilful defaulter along with the reasons and providing him with an opportunity for making representation against such decision. The concerned borrower should be provided reasonable time (say 15 days) for making representation, if he so desires, to the Committee headed by the Chairman and Managing Director.

A final declaration as 'wilful defaulter' should be made after a view is taken by the Committee on the representation and the borrower should be suitably advised.

Import of Gold

The Ministry of Commerce and Industry has clarified that in terms of the EXIM Policy 2002-2007, export oriented units (EOUs) and special economic zones (SEZs) in the gem and jewellery sector are permitted to import gold directly. These units can also source gold through the existing nominated agencies. Accordingly, as per the extant guidelines in force, only nominated agencies, approved banks and EOUs/SEZ units in gems and jewellery sector can directly import gold.

Authorised dealers (ADs) have been advised that they may open letters of credit (L/Cs) and allow remittances on behalf of EOUs, units in SEZs in the gem and jewellery sector and nominated agencies, for direct import of gold, provided -

- (a) The import of gold is strictly in accordance with the EXIM Policy.
- (b) Suppliers' and buyers' credit, including the usance period of L/Cs opened for direct import of gold does not exceed 90 days.
- (c) Bankers' prudence is strictly exercised for all transactions pertaining to import of gold. ADs should ensure that due diligence is undertaken and all know your customer (KYC) norms and anti-money laundering guidelines, issued by the Reserve Bank are adhered to while undertaking such transactions. Any large or abnormal increase in the volume of business of the importer should be closely examined to ensure that the transactions are bonafide trade transactions. ADs should closely monitor such transactions in addition to carrying out the normal due diligence exercise. The credentials of the supplier should also be ascertained before opening of LCs. The financial standing, line of business and the net worth of the importer customer should be commensurate with the volume of business turnover. In case of such transactions, banks should also make discreet enquiries from other banks to assess the actual position. In order to establish audit trail of import/export transactions, all documents pertaining to such transactions must be preserved for at least five years.
- (d) Submission of the bill of entry by the importers is followed up.
- (e) Head offices/international banking divisions, of ADs undertaking gold import transactions should submit a monthly statement to the Trade Division, Foreign Exchange Department, Central Office, Reserve Bank of India, Fort, Mumbai. The statement should be submitted within ten days of the following month.

Banks' Investment in Mortgage Backed Securities

The Reserve Bank has advised all scheduled commercial banks that they may classify the investment made by them in mortgage backed securities (MBS) under direct lending to housing within the priority sector lending, provided -

- (i) the pooled assets are in respect of direct housing loans which satisfy the definition for inclusion under the priority sector;
- (ii) the securitised loans are originated by housing finance companies/banks; and
- (iii) the mortgage backed securities satisfy the conditions laid down in the Reserve Bank's circular of May 24, 2002.

BANKING

KYC Norms for Existing Accounts

With a view to ensuring that existing small account holders are not inconvenienced and the KYC procedure is completed in time, it has been decided that banks may limit the application of KYC procedures to existing accounts where the credit or debit summation for the financial year ended March 31, 2003 is more than Rs.10 lakh or where unusual transactions are suspected. This process may be completed by December 31, 2004.

Banks may, however, ensure that KYC procedures are applied to all existing accounts of trusts, companies, firms, religious/charitable organisations and other institutions or where the accounts are opened through a mandate or power of attorney.

RBI realigns jobs among its other Departments

In an attempt at job consolidation and job alignment, the Reserve Bank has merged the functions handled by its Industrial and Export Credit Department (IECD) with those of the other departments July 1, 2004, as under:

Function	Department to which the function has been allocated
(i) All matters relating to industrial and export credit including inter-bank guarantees, housing finance, bank lending to NBFCs, infrastructure financing and industrial rehabilitation (ii) Progress reports on relief packages for tea, coffee, tobacco and marine products submitted by banks.	Department of Banking Operations and Development, Central Office, Reserve Bank of India, Centre -1, World Trade Centre, Cuffe Parade, Colaba, Mumbai 400 005
(i) All matters relating to food credit (ii) All statements and returns relating to food credit submitted by the State Bank of India, state governments and union territories	Monetary Policy Department, Reserve Bank of India, Central Office Building, Fort, Mumbai 400 001
Returns relating to industrial and export credit, housing finance, infrastructure financing and industrial rehabilitation as below : (i) Form 'A' Return (ii) Export Credit Disbursement Return (iii) Fortnightly Export Credit Outstanding Return (iv) Annual Return on Sick and Weak Units (v) Return on Housing Finance (vi) Infrastructure Credit Return	Department of Banking Supervision, Central Office, Reserve Bank of India, Centre -1, World Trade Centre, Cuffe Parade, Mumbai 400 005
(i) Matters relating to commercial paper (ii) Returns : (a) Fortnightly returns relating to commercial paper (b) Data on sectoral deployment of credit	Monetary Policy Department, Reserve Bank of India, Central Office Building, Fort, Mumbai 400 001
Matters relating to National Housing Bank and Infrastructure Development and Finance Company including the nodal functions relating to the Reserve Bank's shareholding in these institutions and the secretarial services rendered to the Reserve Bank's nominee directors on their boards.	Department of Banking Supervision (Financial Institutions Division), Central Office, Reserve Bank of India, World Trade Centre, Cuffe Parade, Mumbai 400 005.