

Technical Paper on Differentiated Bank Licences

I. Introduction

Financial sector reforms have been introduced in a calibrated and well-sequenced manner since the early 1990s and have resulted in a competitive, healthy and resilient financial system. There has been financial deepening: the deposits/ GDP ratio rose from 16.4 per cent in 1971-75 to 36.1 per cent in 1989-90 and further to 60 per cent in 2004-05. Bank credit to commercial sector increased from 15.6 per cent to 30.3 per cent of GDP in 1989-90 and 48 per cent in 2005-06.

The Annual Policy Statement for the year 2007-08 by Governor, Reserve Bank of India at para 185 states that “ with a view to directing the resources of banks to their niche areas and to sustain efficiency in the banking system, a graded approach of licensing may be appropriate which can be equally applicable to both domestic and foreign banks. A technical paper on this subject will be placed on website inviting comments/suggestions from the public”

Accordingly, an internal study in RBI covered the background on banking regulation, licensing of banks under Banking Regulation Act, 1949, extant policy relating to bank licensing, both Indian and foreign banks international experience and practice on limited bank licensing.

II. Statutory background- Banking Regulation Act, 1949

2.1 Background

Prior to the enactment of Banking Regulation Act, 1949 which aims to consolidate the law relating to banking and to provide for the nature of transactions which can be carried on by banks in India, the provisions of law relating to banking companies formed a part of the general law applicable to companies and were contained in Part XA of the Indian Companies Act, 1913. These provisions were first introduced in 1936, and underwent two subsequent modifications, which proved inadequate and difficult to administer.

Moreover, it was recognised that while the primary objective of company law is to safeguard the interests of the share holder, that of banking legislation should be the protection of the interests of the depositor. It was therefore felt that a separate legislation was necessary for regulation of banking in India. With this objective in view, a Bill to amend the law relating to Banking Companies was introduced in the Legislative Assembly in November, 1944 and was passed on 10th March, 1949 as the Banking Companies Act, 1949. By Section 11 of the Banking Laws (Application to Cooperative Societies) Act, 1965, the nomenclature was changed to the Banking Regulation Act, 1949.

2.2 Indian banking system

The Indian financial system currently consists of commercial banks, co-operative banks, financial institutions and non-banking financial companies (NBFCs). The commercial banks can be divided into categories depending on the ownership pattern, viz. public sector banks, private sector banks, foreign banks. While the State bank of India and its associates, nationalised banks and Regional Rural Banks are constituted under respective enactments of the Parliament, the private sector banks are banking companies as defined in the Banking Regulation Act. The cooperative credit institutions are broadly classified into urban credit cooperatives and rural credit cooperatives.

2.3 Powers and responsibilities of RBI in respect of regulation of banks

The Reserve Bank of India has been entrusted with the responsibility under the Banking Regulation Act, 1949 to regulate and supervise banks' activities in India and their branches abroad. While the regulatory provisions of this Act prescribe the policy framework to be followed by banks, the supervisory framework provides the mechanism to ensure banks' compliance with the policy prescription.

2.4 General Framework of Regulation

The existing regulatory framework under the Banking Regulations Act 1949 can be categorised as follows :

- a) Business of Banking Companies
- b) Licensing of banking companies
- c) Control over Management
- d) Acquisition of the Undertakings of banking companies in certain cases
- e) Restructuring and Resolution including winding up operation
- f) Penal Provisions

2.5 Licensing of banks

In terms of Sec 22 of the B.R.Act, no company shall carry on banking business in India, unless it holds a licence issued in that behalf by Reserve Bank and any such licence may be issued subject to such conditions as the Reserve Bank may think fit to impose.

Before granting any licence, RBI may require to be satisfied that the following conditions are fulfilled:

- i) that the company is or will be in a position to pay its present or future depositors in full as their claims accrue;
- ii) that the affairs of the company are not being , or are not likely to be, conducted in a manner detrimental to the interests of its present or future depositors;
- iii) that the general character of the proposed management of the proposed bank will not be prejudicial to the public interest or the interest of its depositors;
- iv) that the company has adequate capital structure and earning prospects;
- v) that having regard to the banking facilities available in the proposed principal area of operations of the company, the potential scope for expansion of banks already in existence in the area and other relevant factors the grant of the licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth;

2.6 Business of banking

As per Section 5 (b) of Banking Regulation Act, 1949 “ banking” means the accepting , for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise.

2.7 Permissible Activities of a Banking Company

Section 6 of B.R. Act, 1949 gives the details of forms of business in which a banking company may engage. However, it is a long list and banks may carry out one or more activities permitted in the section.

III. Policy of issuing licence to banks in India

The policy framework for issuing licences to private sector and foreign banks are discussed below:

3.1 Private sector banks

- The guidelines for licensing of new banks in the private sector were issued by the Reserve Bank of India (RBI) on January 22, 1993. The revised guidelines for entry of new banks in private sector were issued on January 3, 2001. The foreign investment limit from all the sources in private banks was raised from a maximum of 49 per cent to 74 per cent in March 2004. In consultation with the Government of India, the Reserve Bank released a roadmap on February 28, 2005, detailing the norms for the presence of foreign banks in India. The Reserve Bank also issued comprehensive guidelines on Ownership and Governance in private sector banks. The broad principles underlying the policy framework were to ensure that the ultimate ownership and control of private sector banks is well diversified. Further, the fit and proper criteria have to be the over-riding consideration in the path of ensuring adequate investments, appropriate restructuring and consolidation in the banking sector. No single entity or group of related entities would have shareholding or control, directly or indirectly, in any bank in excess of 10 per cent of the paid up capital of the private sector bank. Any higher level of acquisition will be with the prior approval of RBI and in accordance with guidelines issued by RBI for grant of

acknowledgement for acquisition of shares. These measures were intended to further enhance the efficiency of the banking system by increasing competition.

- The initial minimum paid-up capital for a new bank was kept at Rs. 200 crore. The initial capital was required to be to Rs.300 crore within three years of commencement of business. The aggregate foreign investment in private banks from all sources (FDI, FII, NRI) cannot exceed 74 per cent.
- Mergers and amalgamations are a common strategy adopted for restructuring and strengthening banks internationally. Although the consolidation process through mergers and acquisitions of banks in India has been going for several years it gained momentum in late 1990s. With increased liberalisation, globalisation and technological advancement, the consolidation process of Indian banking sector is likely to intensify in the future, thereby imparting greater resilience to the financial system. The Reserve Bank ensures that mergers and amalgamation enhance the stability of the banking system. Thus, the guidelines issued by RBI on May 11, 2005 laid down the process of merger and determination of swap ratio.

3.2 Licensing of foreign banks

India issues a single class of banking licence to banks and hence does not place any undue restrictions on their operations merely on the ground that in some countries there are requirements of multiple licences for dealing in local currency and foreign currencies with different categories of clientele. Banks in India, both Indian and foreign, enjoy full and equal access to the payments and settlement systems and are full members of the clearing houses and payments system.

Procedurally, foreign banks are required to apply to RBI for opening their branches in India. Foreign banks' application for opening their maiden branch is considered under the provisions of Sec 22 of the BR Act, 1949. Before granting any licence under this section, RBI may require to be satisfied that the Government or the law of the country in which it is incorporated does not discriminate in any way against banks from India. Other conditions as enumerated in para 2.5 above are required to be fulfilled.

Unlike the restrictive practices of certain foreign countries, India is liberal in respect of the licensing and operation of the foreign bank branches as illustrated by the following :

- India issues a single class of banking licence to foreign banks and does not place any limitations on their operations. All banks can carry on both retail and wholesale banking.
- Deposit insurance cover is uniformly available to all foreign banks at a non-discriminatory rate of premium.
- The norms for capital adequacy, income recognition and asset classification are by and large the same. Other prudential norms such as exposure limits are the same as those applicable to Indian banks.

3.3 Opening of branches in India by Foreign banks

The policy for approving foreign banks applications to open maiden branch and further expand their branch presence has been incorporated in the 'Roadmap for presence of Foreign banks in India' indicated in the Press Release dated February 28, 2005 as well as in the liberalized branch authorisation policy issued on September 8, 2005. The branch authorisation policy for Indian banks has been made applicable to foreign banks subject to the following:

- Foreign banks are required to bring an assigned capital of US \$25 million up front at the time of opening the first branch in India.
- Existing foreign banks having only one branch would have to comply with the above requirement before their request for opening of second branch is considered.
- Foreign banks may submit their branch expansion plan on an annual basis.
- In addition to the parameters laid down for Indian banks, the following parameters would also be considered for foreign banks :
 - Foreign bank's and its group's track record of compliance and functioning in the global markets would be considered. Reports from home country supervisors will be sought, wherever necessary.
 - Weightage would be given to even distribution of home countries of foreign banks having presence in India.
 - The treatment extended to Indian banks in the home country of the applicant foreign bank would be considered.
 - Due consideration would be given to the bilateral and diplomatic relations between India and the home country.

- The branch expansion of foreign banks would be considered keeping in view India's commitments at World Trade Organisation (WTO). Licences issued for off-site ATMs installed by foreign banks are not included in the ceiling of 12.

In terms of India's commitment to WTO, as a part of market access, India is committed to permit opening of 12 branches of foreign banks every year. As against these commitments, Reserve Bank of India has permitted upto 17- 18 branches in the past. The Bank follows a liberal policy where the branches are sought to be opened in unbanked/under-banked areas. Off-site ATMs are not counted in the above limit. Including off-site ATMs, foreign banks are having (as on October 15, 2007) place of business at 933 locations (273 branches + 660 off site ATMs).

The procedure regarding approval of proposals for opening branches of foreign banks in India has been simplified and streamlined for the sake of expeditious disposal.

A licence under the provisions of B.R. Act, 1949 enables the foreign banks to carry out any activity which is permissible to a bank in India. This is in contrast with practices adopted in many countries, where foreign banks can carry out only a limited menu of activities.

As against the requirements of achieving 40 per cent of net bank credit as target for lending to priority sector in case of domestic banks, it has been made mandatory for the foreign banks to achieve the minimum target of 32% of net bank credit for priority sector lending. Within the target of 32%, two subtargets in respect of advances (a) to small scale sector (minimum of 10%), and (b) exports (minimum of 12%) have been fixed. The foreign banks are not mandated for targeted credit in respect of agricultural advances. There is no regulatory prescription in respect of foreign banks to open branches in rural and semi-urban centres.

IV. Differentiated Bank Licensing- Examining Pros and Cons

A. Arguments in Favour of Adopting a Differentiated bank Licensing

4.1 With the broadening and deepening of financial sector, it is observed that banks are slowly migrating from a situation in the past where the number of banking services offered by the banks was limited and all banks provided all the services to a situation where banks are finding their niche areas and mainly providing services in their chosen areas. Many banks keep the plain vanilla banking as a small necessary adjunct. It is widely recognized that banks providing services to retail customers have different skill sets and risk profiles as compared to banks which mainly deal with large corporate clients.

The present situation where every bank can carry out every activity permissible under Section 6 of Banking Regulation Act, 1949 has the following implications, relevant to the subject under consideration :

- For a wholesale bank dealing with corporate clients only, it becomes a costly adjunct to maintain a skeleton retail banking presence. Moreover it becomes difficult for such a bank to meet priority sector obligations and obligations for doing inclusive banking.
- Retail banks may have to create risk management and regulatory compliance structures which are more appropriate to wholesale banks, thus resulting in non-optimal use of resources.
- Similar supervisory resources are devoted to banks with different business profiles. This may also result in non-optimal use of supervisory resources.
- The priority sector lending regime for foreign banks indicated in paragraph 3.3 has been causing some discomfort for some of the foreign banks. For example, some of the foreign banks find it difficult to fulfil even the less rigorous target of 32 per cent in respect of priority sector advances.
- Some banks find it difficult to provide “no frills” facility to economically disadvantaged. For them the more liberal licensing regime causes a different set of problems.

It appears that given an opportunity, some of the banks may like to follow a niche strategy rather than competing as full service all purpose banks.

4.2 On the other hand, there are some factors which point towards desirability of continuing with the existing system of universal banking:

- In India, the penetration of banking services is very low. Less than 59 % of adult population has access to a bank account and less than 14 % of adult population has a loan account with a with a bank. Under such circumstances, it would be incorrect to create a regime where banks are allowed to choose a path away from carrying banking to masses.

- Priority sector lending is important for banks. The revised guidelines on priority sector lending have rationalized the components of priority sector. For the first time, investments by banks in securitised assets, representing loans to various categories of priority sector, shall be eligible for classification under respective categories of priority sector (direct or indirect) depending on the underlying assets, provided the securitised assets are originated by banks and financial institutions and fulfil the Reserve Bank of India guidelines on securitisation. This would mean that the banks' investments in the above categories of securitised assets shall be eligible for classification under the respective categories of priority sector only if the securitised advances were eligible to be classified as priority sector advances before their securitisation. These measures would make it easier to comply with the priority sector lending requirements by those banks which had faced some difficulties in this regard.

- The business model adopted by such 'niche' banks depends heavily on ample inter-bank liquidity. Any shock leading to liquidity crunch can translate into a run on the bank. This situation has been clearly illustrated recently in UK in the case of Northern Rock Bank.

V. International experience and practice

International experience and practices of licensing procedure followed in major jurisdictions by the respective regulators have been studied and we have grouped them into two viz limited banking licence - equally applicable both for domestic and foreign banks and limited bank license-different for domestic and foreign banks. In addition, there are countries where different licences are issued for commercial banking, savings bank, rural banks or credit unions . In certain countries no distinction is made between domestic and foreign banks. Thus, there is no widely accepted recommended model available internationally.

VI. Way forward

It may be seen that one of the major objectives of banking sector reforms has been to enhance the efficiency and productivity of the banking system through competition. It is also aim of authorities to provide banking services to maximum number of people. To enable the banking system to operate at optimum efficiency, and in the interest of financial inclusion, it is necessary that all banks should offer certain minimum services to all customers, while they may be allowed sufficient freedom to function according to their own business models. Thus, it will be prudent to continue the existing system for the time being. The situation may be reviewed after a certain degree of success in financial inclusion is achieved and Reserve Bank is more satisfied with the quality and robustness of the risk management systems of the entire banking sector.