

A comprehensive policy framework for Ownership and governance in private sector banks

Introduction

Banks are “special” as they not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity, but also they leverage such funds through credit creation. They are also important for smooth functioning of the payment system. In view of the above, legal prescriptions for ownership and governance of banks laid down in Banking Regulation Act, 1949 have been supplemented by regulatory prescriptions issued by RBI from time to time. The existing legal framework and significant current practices in particular cover the following aspects:

- (i) The composition of Board of Directors comprising members with demonstrable professional and other experience in specific sectors like agriculture, rural economy, cooperation, SSI, law, etc., approval of Reserve Bank of India for appointment of CEO as well as terms and conditions thereof, and powers for removal of managerial personnel, CEO and directors, etc. in the interest of depositors are governed by various sections of the B. R. Act, 1949.
- (ii) Guidelines on corporate governance covering criteria for appointment of directors, role and responsibilities of directors and the Board, signing of deed by covenants by directors, etc., was issued by RBI on June 20, 2002, based on the recommendations of Ganguly Committee and a review by the BFS.
- (iii) Guidelines for acknowledgement of transfer / allotment of shares in private sector banks was issued in the interest of transparency by RBI on February 3, 2004 (Annexure).
- (iv) Foreign investment in the banking sector is governed vide Press Note dated March 5, 2004 issued by the Government of India, Ministry of Commerce and Industries.

- (v) The earlier practice of RBI nominating directors on the Boards of all private sector banks has yielded place to such nomination in select private sector banks.

2. Against this background, it is considered necessary to lay down a comprehensive framework of policy in a transparent manner relating to ownership and governance in the Indian private sector banks as described below.

3. The broad principles underlying the framework of policy relating to ownership and governance of private sector banks would have to ensure that:

- (i) The ultimate ownership and control of private sector banks is well diversified.
- (ii) Important Shareholders (i.e., shareholding of 5 per cent and above) are 'fit and proper', as laid down in the guidelines dated February 3, 2004 on acknowledgement for allotment and transfer of shares.
- (iii) The directors and the CEO who manage the affairs of the bank are "fit and proper" and observe sound corporate governance principles.
- (iv) To avoid conflict of interest, RBI will not appoint its nominee on the Boards of private sector banks unless there are exceptional circumstances.
- (v) Private sector banks have minimum capital / net worth for optimal operations and systemic stability.
- (vi) The policy and the processes are transparent and fair.

4. Minimum capital

The capital requirement of existing private sector banks should be on par with the entry capital requirement for new private sector banks prescribed in RBI guidelines of January 3, 2002, which is initially Rs.200 crore, with a commitment to increase to Rs.300 crore within three years. In order to meet with this requirement, 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.

5. Shareholding

- (i) The RBI guidelines on acknowledgement for acquisition or transfer of shares issued on February 3, 2004 will be applicable for any acquisition of shares of 5 per cent and above of the paid up capital of the private sector bank.
- (ii) In the interest of diversified ownership of banks, the objective will be to ensure that no single entity or group of related entities has 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 the guidelines of February 3, 2004 for grant of acknowledgement for acquisition of shares.
- (iii) Where ownership is that of a corporate entity, the objective will be to ensure 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 the objective will be to ensure that it is a widely held entity, publicly listed and a well established regulated financial entity in good standing in the financial community.
- (iv) In respect of a new license for private sector banks, promoter shareholding may be allowed to be higher to start with as at present, but will be required to be brought down to the limit of 10 per cent in a time bound manner normally within a period of three years.
- (v) As per existing policy, large industrial houses will not be allowed to set up banks but will be permitted to acquire by way of strategic investment shares not exceeding 10 per cent of the paid up capital of the bank subject to RBI's prior approval.
- (vi) Any private sector bank will be allowed to hold shares in any other private sector bank only upto 5 per cent of the paid up capital of the

investee bank. On the same analogy, any foreign bank with presence in India will be allowed to hold shares in any other private bank only upto 5 per cent of the paid up capital of the investee bank.

6. Directors and Corporate Governance

- (i) The recommendations of the Ganguly Committee on corporate governance in banks have highlighted the role envisaged for the Board of Directors. The Board of Directors should ensure that the responsibilities of directors are well defined and the banks should arrange need-based training for the directors in this regard. While the respective entities should perform the roles envisaged for them, private sector banks will be required to ensure that the directors on their Boards representing specific sectors as provided under the B. R. Act, are indeed representatives of those sectors in a demonstrable fashion, they fulfill the criteria under corporate governance norms provided by the Ganguly Committee and they also fulfill the criteria applicable for determining 'fit and proper' status of Important Shareholders (i.e., shareholding of 5 per cent and above).
- (ii) As a matter of desirable practice, not more than one member of a family or a close relative (as defined under Section 6 of the Companies Act, 1956) or an associate (partner, employee, director, etc.) should be on the Board of a bank.
- (iii) Guidelines have been provided by the Ganguly Committee on Corporate Governance according to which a covenant has to be signed by all the directors on the Boards of the banks. All directors will be required to sign the covenant in "public interest".
- (iv) Being a Director, CEO should satisfy the requirements of the "fit and proper" criteria applicable for directors. In addition RBI may apply any additional requirements for the Chairman and CEO. The banks will be required to provide all information that may be required while

making application to RBI for approval of appointment of Chairman /CEO.

7. Foreign investment in private sector banks

In terms of the recent GOI press note of March 5, 2004, the aggregate foreign investment in private banks from all sources (FDI, FII, NRI) cannot exceed 74 per cent. The limit of 74 per cent will be reckoned by taking the direct and indirect holding. At all times, at least 26 per cent of the paid up capital of the private sector bank will have to be held by residents.

7.1 Foreign Direct Investment (FDI)

- (i) The policy already articulated in the February 3, 2004 guidelines for determining fit and proper status of shareholding of 5 per cent and above will be equally applicable for FDI. Hence any FDI in private banks where shareholding reaches and exceeds 5 percent either individually or as a group will have to comply with the criteria indicated in the aforesaid guidelines.
- (ii) In the interest of diversified ownership, the percentage of FDI by single entity or group of related entities may not exceed 10 percent.

7.2 Foreign Institutional Investors (FIIs)

- (i) Currently there is a limit of 10 per cent for individual FII investment with the aggregate limit for all FIIs restricted to 24 per cent which can be raised to 49 per cent with the approval of Board / General Body. This dispensation will continue.
- (ii) The present policy of RBI's acknowledgement for acquisition/ transfer of shares of 5 percent and more of a private sector bank by FIIs will continue and will now be based upon the policy guidelines on acknowledgement of acquisition/transfer for shares

issued on February 3, 2004. For this purpose RBI may seek certification from the concerned FII of all beneficial interest.

7.3 *Non Resident Indians (NRIs)*

Currently there is a limit of 5 per cent for individual NRI portfolio investment with the aggregate limit for all NRIs restricted to 10 per cent but can be raised to 24 per cent with the approval of Board / General Body. This dispensation will continue. But, the policy guidelines of February 3, 2004 on acknowledgement for acquisition/transfer will be applied.

8. Due diligence process

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

9. Transition arrangements

- (i) The current minimum capital requirements for entry of new banks is Rs. 200 crore to be increased to Rs. 300 crore within three years of commencement of business. A few private sector banks which have been in existence before these capital requirements are prescribed are having less than Rs.200 crore net worth. In the interest of having sufficient minimum size for financial stability, all the existing private banks should also be able to fulfill the minimum net worth requirement of Rs. 300 crore required for new entry. Hence any bank falling below this level will be required to submit a time bound programme for capital augmentation to RBI 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 February 3, 2004 guidelines will 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 will 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 will be required to indicate a time bound plan for reduction in such investments to the permissible limit. The parent of any foreign bank having presence in India, having shareholding directly or indirectly through any other entity in the banking group in excess of 5% in any other bank in India will be similarly required to indicate a time bound plan for reduction of such holding to 5 per cent.
- (v) Banks will be required to undertake due diligence of directors and Chairman / CEO on basis of criteria that will be separately indicated and provide all the necessary certifications/ information to RBI.
- (vi) Banks having more than one member of family, close relative or associate on the Board will be required to ensure compliance with this requirement at the time of considering any induction or renewal of terms of such directors.
- (vii) Action plans submitted by private sector banks outlining the milestones for compliance with the various requirements for ownership and governance will be examined by RBI for consideration and approval.

10. Continuous monitoring arrangements

- (i) Where RBI acknowledgment has already been obtained for transfer of shares of 5 per cent and above, it will be the bank's responsibility to ensure continuing compliance of the fit and proper criteria and provide an annual certificate to the RBI of having undertaken such continuing due diligence,
- (ii) Similar continuing due diligence on compliance with the fit and proper criteria for directors/CEO of the bank will have to be undertaken by the bank and certified to RBI annually,

(iii) RBI may, when considered necessary, undertake independent verification of fit and proper test conducted by banks through a process of due diligence as described in paragraph 8.

11. On the basis of such continuous monitoring, RBI will consider appropriate measures to enforce compliance.

**Guidelines for acknowledgement of transfer / allotment
of shares in private sector banks**

The Reserve Bank has issued the following guidelines on the grant of acknowledgement for acquisition and transfer of shares in private banks after a review of the operation of existing instructions and recent developments. These guidelines build on the existing policy and clarify and streamline existing procedures for obtaining acknowledgement to remove uncertainties for potential investors, both domestic and foreign, in regard to allotment and transfer of shares in private banks. The guidelines also take into account the use of demat shares, emerging trends in banking and international best practices.

Current status

2. As per the existing policy of RBI, any allotment or transfer of shares which will take the aggregate shareholding of an individual or a group to equivalent of five percent and more of the paid-up capital of the bank requires acknowledgement of RBI before the bank can effect the allotment or transfer of shares. The bank is required to approach the Reserve Bank of India with all the relevant details for acknowledgement of transfer/allotment of shares after the Board makes a review. The bank is required to await the Reserve Bank's acknowledgement, for approving the registration of the transfers in their books. Such measures are necessary to protect depositors interest and the integrity of the financial system.

Proposed Guidelines for grant of acknowledgement

3. In order to streamline the procedures for obtaining acknowledgement by removing uncertainties for investors including foreign investors (FDI, FII and NRI) in regard to the allotment or transfer of shares and indicate in a transparent manner the broad criteria followed by RBI for the purpose, the following decisions have been taken.

4. As hitherto, acknowledgement from RBI for acquisition/transfer of shares will be required for all cases of acquisition of shares which will take the aggregate holding of an individual or group to equivalent of 5 percent or more of the paid-up capital of the bank. RBI while granting acknowledgement may require such acknowledgement to be obtained for subsequent acquisition at any higher threshold as may be specified.

5. The term "holding" in paragraph 4 above refers to both direct and indirect holding, beneficial or otherwise. The holdings will be computed with reference to the holding of the applicant, relatives (where the applicant is a natural person) and associated enterprises.

"relative" has the same meaning as assigned under section 6 of the Companies Act, 1956.

"associate enterprise" has the same meaning as assigned under Section 92A of the Income Tax Act 1991

6. The term "applicant" in these guidelines denotes the applicant, relatives and associate enterprises as indicated in paragraph 5 above.

7. In deciding whether or not to grant acknowledgement, RBI may take into account all matters that it considers relevant to the application, including ensuring that shareholders whose aggregate holdings are above specified thresholds meet the fitness and propriety tests. The application of such tests is a common regulatory mechanism adopted internationally to ensure that the banks are operated in a sound and prudent manner. In this context, the RBI may call for additional information and documents including shareholder agreements while considering the requests for grant of acknowledgement.

Illustrative criteria for acknowledgement of transfer of shares

8. In determining whether the applicant (including all entities connected with the applicant) is fit and proper to hold the position of a shareholder, RBI may take into account all relevant factors, as appropriate, including, but not limited to

- 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 as enumerated above.

9. Where acquisition or investment takes the shareholding of the applicant to a level of 10 percent or more and up to 30 percent, the RBI will also take into account other factors including but not limited to the following: (a) 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, (b) the business record and experience of the applicant including any experience of acquisition of companies, (c) the extent to which the corporate structure of the applicant will be in consonance with effective supervision and regulation of the bank; and (d) 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.

10. Acknowledgement for transfer of acquisition or investment exceeding the level of 30 percent will be considered keeping the above criteria in view and also taking into account but not limited to the following (a) the acquisition is in public interest, (b) the desirability of diversified ownership of banks, (c) the soundness and feasibility of the plans of the applicant for the future conduct and development of the business of the bank; and (d) shareholder agreements and their impact on control and management of the bank

Compliance with other regulations

11. As hitherto, the RBI acknowledgement will be subject to compliance by the applicant with other applicable laws and regulations such as those issued by SEBI, DCA and IRDA.

Constitution of Independent Advisory Committee.

12. The RBI will constitute an independent Advisory Committee which will make appropriate recommendations to RBI for dealing with applications for grant of acknowledgement as indicated in paragraph 4 above.

Voting Rights etc

13. Voting rights restrictions and other related provisions of the B.R.Act will continue to be applicable as appropriate.

Applicability and effective date

14. As stated in paragraph 3, these guidelines are applicable to acknowledgement of acquisition of shares by residents and non-residents above the specified thresholds in private banks. These guidelines will be effective from the date of issue.