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Article

RBI revises banking license guidelines

By **Sonali Kapoor**

The banking system in India has been constantly evolving with the government and the Reserve Bank of India (the RBI) making changes in the banking policies, as and when required. The RBI grants licenses to entities proposing to establish new banks and enter the industry, and also governs terms of the same.

For nearly two decades, during 1970s – 1990s, no banks were allowed to be set up in the private sector. In 1993, consequent to liberalization of economy, the guidelines for licensing of new banks in the private sector were formulated for the very first time (1993 Guidelines) and the same were revised in 2001 (2001 Guidelines).

The RBI has issued the revised guidelines for licensing of new banks in the private sector on 22 February 2013 (2013 Guidelines). Applications for grant of licenses under the 2013 Guidelines have to be submitted with the RBI by 1st July 2013, and once the license is granted, the banks have to be set up within one year of receipt of the in-principle approval. Salient features of the 2013 Guidelines in comparison with the 1993 and 2001 Guidelines are discussed in the following paragraphs.

Eligible promoters

Under the 1993 Guidelines individuals, corporate groups and financial institutions were eligible to set up banks. This position was amended by the 2001 Guidelines so as to enable individuals and financial institutions to set up banks, large industrial houses being made ineligible to promote new banks. However, individual companies (directly or indirectly) connected with large industrial houses could participate in the equity of a new private sector bank up to a maximum of 10%. Now, the 2013 Guidelines have thrown the field open to all types of private entities and corporate groups (owned and controlled by residents), entities in the public sector and existing Non-Banking Financial Companies (NBFCs) to apply for banking licenses. The RBI has also introduced the "fit and proper" criterion which provides that the promoter should have a past record of sound credentials, be financially sound and have a successful track record of running the business for at least 10 years. Interestingly, entities in the real estate and insurance sectors are also eligible under the 2013 Guidelines to promote new banks, even though the RBI had shown skepticism in relation to the same earlier.

Corporate structure

Under the 1993 and 2001 Guidelines new banks had to be registered as public limited companies under the Companies Act, 1956. However, under the 2013 Guidelines, new banks can be set up by promoters *only* through wholly owned Non-Operative Financial Holding Companies (NOFHCs). The NOFHC shall be registered as an NBFC with the RBI.

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Promoters' control

The 1993 Guidelines did not mention any cap on promoters' holding. The 2001 Guidelines introduced a condition stating that promoters' contribution had to be a minimum of 40% of the paid-up equity capital of the bank *at any point of time* and the initial capital shall be locked in for a period of 5 years. Similarly, under the 2013 Guidelines, the NOFHC shall hold a minimum of 40% of the paid-up *voting* equity capital of the bank which shall be locked in for a period of 5 years. However, additional conditions have now been added in respect of promoters' contribution. Any shareholding beyond 40% is to be brought down to the 40% within 3 years from date of commencement of business. Shareholding of NOFHC has to be reduced to 20% of the paid-up voting equity capital within 10 years and to 15% within 12 years from date of commencement of business.

Foreign shareholding

The 2001 Guidelines stated that non-resident participation in the equity of a new bank was to be a maximum of 40%, and in case a foreign banking/finance company acted as a technical collaborator or a co-promoter, its equity participation was to be restricted at 20% within the ceiling of 40%. Under the 2013 Guidelines, non-resident shareholding from FDI, FIIs and NRIs has been capped at 49% for the first 5 years from date of licensing of the bank.

Voting rights

As per the 1993 Guidelines voting rights of an individual shareholder were capped at 1% of total voting rights. The 2013 Guidelines state that no single entity or group related entities will hold shareholding/control, directly or indirectly, in excess of 10% of the paid-up voting equity capital of the bank.

Ring-fenced structure

The 1993 and 2001 Guidelines were silent on this subject. The 2013 Guidelines provide that the banking company and financial services companies (regulated by the RBI or any other financial sector regulator) under the control of the NOFHC have to be ring-fenced and kept separate from the other commercial, industrial and financial activities (not regulated by the financial sector regulators) of the NOFHC and further, the bank should be ring-fenced from the other regulated financial activities of the group. Thus, only non-financial services companies and non-operative financial holding company in the group and individuals belonging to the promoter group will be allowed to hold shares in the NOFHC. Financial services entities whose shares are held by the NOFHC cannot be shareholders of the NOFHC.

The RBI has clarified that no financial services entity held by the NOFHC would be allowed to engage in any activity that a bank is permitted to undertake departmentally. Thus, activities such as insurance, mutual funds, stock broking, etc., that are required to be conducted through a separate subsidiary/joint venture and activities such as credit cards, hire purchase, factoring, etc., that can be conducted both in-house and through separate entities, have to now be carried out through separate financial entities under the NOFHC.

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Listing on stock exchange

The 1993 Guidelines required new banks to be listed on the stock exchange without any time limit being stipulated for the same. The 2013 Guidelines require new banks to be listed on the stock exchange within 3 years of commencement of business.

Directors

Similar to the 2001 Guidelines, the 2013 Guidelines also provide that no director of the NOFHC shall be on the board of directors of another NOFHC or a bank, other than a banking company under it. Further, at least 50% of the directors of the NOFHC shall be totally independent of the promoter or promoter group entities and their major customers and major suppliers as per the current Guidelines.

Further, NOFHCs will be required to comply with the prudential norms for classification, valuation and operation of investment portfolio and for income recognition and asset classification, as issued by RBI. Also, NOFHCs will have to maintain a reserve fund and transfer to such fund a sum equal to minimum of 25% of the profits every year, before declaration of any dividend. Investments may be made by banks in financial and non-financial entities outside the promoter group up to a limit of, lesser of, 10% of the investee's paid-up share capital or 10% of the bank's paid-up share capital and reserves. The 2013 Guidelines also provide for conversion of existing NBFCs into banks subject to certain conditions pertaining to activities of the NBFCs permitted to be carried on by banks departmentally.

The present guidelines, apart from being exhaustive in terms of structure and governance of the new units, also lay emphasis on corporate governance and transparency of operations. The NOFHCs have to ensure that there are efficient policies in place for ascertaining fit and proper criterion for appointment of directors and their maintainability on the board. The new guidelines have been welcomed by many large industrial houses even though they have been released years after the government announced that revised guidelines would be introduced enabling private sector entities to set up shop in the market.

The 2013 Guidelines, like the 2001 Guidelines, state that at least 25% of the branches of the new banks have to be opened in unbanked rural centers with a population lower than 10,000 and mandate it for banks to use modern infrastructural facilities to provide effective customer services. However, half the population in India does not hold bank accounts or have access to banking facilities till date. The emphasis should be on the improvisation of existing entities and consolidation of the same rather than on establishment of new banks. In the past many banks have deviated from conventional banking policies in lending, deposits and treasury functions with little positive impact on their performance. One reassuring factor is that RBI's procedure for granting licenses is going to be selective and emphasis will be on impeccable track record of the applicants, who are likely to conform to the best international and domestic standards of customer service and efficiency.

[The author is an Associate, Corporate Practice, Lakshmikumaran & Sridharan, New Delhi]

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Notifications & Circulars

Infrastructure Debt Funds - SEBI (Mutual Funds) Regulations, 1996 amended: The Securities and Exchange Board of India has amended the SEBI (Mutual funds) Regulations 1996. As per Circular No. CIR / IMD / DF / 7 / 2013, dated 23-4-2013, issued to clarify the amendments, private placement to less than 50 investors is now allowed as an alternative to the New Fund Offer to the public in cases of Infrastructure Debt Funds. For this purpose, a placement memorandum with SEBI would have to be filed by the mutual funds instead of a Scheme Information Document and a Key information Memorandum according to the given format. The memorandum will be uploaded on the websites of the asset management companies after the allotment of units as well as on the website of the recognized stock exchange where it is proposed to be listed. The universe of strategic investor has also been expanded to include *inter alia*, FIIs subject to their existing investment limits. Further investments in bank loans as per Regulation 49P(1) of the SEBI (Mutual Funds) Regulations, 1996, can only be made through the securitization mode.

Overseas Direct Investment – RBI permission for financial products linked to Indian Rupee: Any entity established outside India having direct or indirect equity participation of Indian entities and offering financial products linked to Indian Rupee (e.g. non-deliverable trades involving foreign currency, rupee exchange rates, stock indices linked to Indian market, etc.) shall not offer such products without specific approval of Reserve Bank of India. RBI's A.P. (DIR Series) Circular No. 100, dated 25-4-2013 issued in this regard notes that such products may have an impact on the exchange rate management of the country since Indian Rupee is not fully convertible.

Gold import restriction on nominated banks: Reserve Bank of India (RBI) has restricted import of gold on consignment basis by nominated banks only for the purpose of catering to the genuine needs of gold jewellery exporters. As per A.P. (DIR Series) Circular No.103, dated 13-5-2013 issued for the purpose, these restrictions have been made on the recommendations of Working Group on Gold to align gold import regulations with other imports.

News Nuggets

RBI set to demystify definition of 'control': The Reserve Bank of India (RBI) has recently submitted draft norms on the definition of 'control' under the Foreign Direct Investment (FDI) policy to the Cabinet Committee on Economic Affairs for approval. As per the draft norms, RBI wishes to align the definition of 'control' in the FDI Policy with the definition of 'control' in the Companies Bill, 2012 presently pending with the Rajya Sabha. If the draft norms are accepted, a company will be treated as controlled by

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the domestic or foreign entity who has the right to appoint a majority of the directors or to control the management or policy decisions of the controlled company. At present, the definition of control is highly debated since the Companies Act, 1956 is silent on the issue. Clarity on the issue would drastically affect calculation of indirect foreign investment in Indian entities under the FDI policy.

Motor accident claims – Apex Court issues guidelines for compensation: The Supreme Court of India has on 2-4-2013 clarified the position regarding the application of the 'multiplier' in the Second Schedule of the Motor Vehicles Act, 1988 to claims for compensation filed under Section 166 of the Act. The task before the three judge bench was to remove discrepancies which may arise between applications filed under Section 166 and those filed under Section 163A of the Motor Vehicles Act. Section 163A allows compensation claims to be filed and provides for calculation of such compensation on the basis of the Second Schedule. The multiplier mentioned in the schedule is a numerical value used for calculating the final quantum of compensation. The discrepancy arose from the fact that Section 166 also allows compensation to be sought but there is no formula given for calculating such compensation, nor is there any reference to the 'multiplier' in the Second Schedule. Stressing the importance of having a standard method of selection of multiplier, the Bench approved the a prior decision given in the *Sarla Verma* case and held that in cases of compensation claims, the table given in the said case as well as certain paragraphs of the judgment are to be followed.

Multi level Marketing (MLM) Companies – Distinction from other companies under study: The inter-ministerial committee to draft model rules to regulate MLM companies and on the prohibited schemes under the Prize Chits and Money Circulation Schemes (Banning) Act, 1978 has been granted more time to consider afresh the distinction of MLM companies from those undertaking money circulation activities, after the direct selling industry pointed out certain discrepancies in the draft guidelines issued by the committee. Earlier, the Department of Financial Services had constituted the committee in July, 2012 and its draft guidelines presently provide that MLM companies should not have startup cost and further also define pyramid schemes involving money churning activities but are ambiguous whether all MLM companies fall within the purview of this definition. MLM companies in India, operating by only engaging sales personnel for network marketing, direct selling or referral marketing, currently do not come within the ambit of any Indian regulatory body. Many players in this market segment are said to have legitimate business operations but the government wishes to ensure that the MLM companies are not illegally pooling funds from the investors and exposing the investors to risk.

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Ratio Decidendi

FDI policy in multi brand retail upheld by SC: A three judge bench of the Supreme Court has dismissed the petition challenging the FDI policy in multi brand retail. The challenge was on the ground that the policy by the Department of Industrial Policy and Promotion (DIPP) was without the authority of law. It was contended that the Central Government has no power to make policies regarding FDI as such prerogative rests with the Reserve Bank of India as per the Foreign Exchange Management Act 1999. The Court, while dismissing the petition, held that DIPP is empowered to frame policies regarding FDI. According to the order, the Court will not interfere with policy matters unless they are unconstitutional, contrary to statutory provisions, arbitrary or in abuse of power. It was noted that the FDI policy is only an enabling policy and the State Governments and the Union Territories are free to take their own decisions. [*Manohar Lal Sharma* v. *UOI*, Order dated 1-5-2013 in Writ Petition (C) No. 417 of 2012].

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