Duvvuri Subbarao: Banking structure in India – looking ahead by looking back

Speaking notes by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the FICCI–IBA (Federation of Indian Chambers of Commerce & Industry – Indian Banks' Association) Annual Banking Conference, Mumbai, 13 August 2013.

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1. For the fifth year on a trot, you have given me the privilege of inaugurating this prestigious and influential FICCI–IBA Annual Banking Conference. In my fifth year as Governor of RBI, I have the Governor's annual schedule firmly ingrained in my mind. I have come to expect, even look forward to, this event in September every year. I am aware that the organizers have advanced the schedule by a month to extend to me the honour of inaugurating this conference before I demit office next month. I am deeply touched.

Banking structure

2. What should be the focus of my remarks today? At earlier conferences, I focussed on narrow themes within the banking domain. Should I pick another narrow theme for this year's conference as well? I deliberated on it quite a bit. Since I will be laying down office as Governor of the Reserve Bank in about 4 weeks' time, I determined that it may be most appropriate if I loosened the constraint and addressed a broader topic. And the topic I have chosen is to look ahead to the appropriate banking structure for India.

3. When we issued the guidelines for licencing of new banks in the private sector in February this year, the Reserve Bank said that it will come out with a Discussion Paper on the Banking Structure in India. That paper is in the final stages and will be released shortly. The issues that I will address today will inevitably overlap with some of the issues that will be covered in the Discussion Paper but there need be no presumption that the coverage and nuancing of the issues will be similar.

Indian financial sector – the big picture

4. In order to look ahead to issues on the way forward, it may be instructive to look at a snap shot of the Indian financial system as it is today and review the evolution of the banking system over the last 20 years of economic reforms. Let me do that quickly and briefly so as to set the context for the issues that I will address.

Table - I

Indian Financial System - Share by Asset Size - 2012

Segment	Market Share of Financial Assets (Percentage)
Banks	 63
Insurance Companies	 19
Non-banking Financial Institutions	 8
Mutual Funds	 6
Provident and Pension Funds	 4
Total	100

- Banks dominate the Indian financial system.

Table - II

Indian Banking System - Share by Asset Size

Institution	Market Share of Total Banking Assets (2012) (Percentage)
Scheduled Commercial Banks	.... 92.4
of which:	
Public Sector Banks	*... ... ... 67.2*
Private Sector Banks	*... ... ... 18.7*
Foreign Banks	*... ... ... 6.5*
Regional Rural Banks	.... 2.7
Rural and Urban Co-operative Banks	.... 3.4
Local Area Banks	.... 1.5
Total	100.0

- The banking system is dominated by commercial banks.

Table - III

Share in the Banking Space

Type of Banks	Number of Banks	Number of Branches	Percentage Share of Number of Branches	Market Share of Assets (Percentage)
Public Sector	26	67,466	83.0	72.8
Private Sector	20	13,452	16.6	20.2
Foreign Banks	41	323	0.4	7.0
Total	**87**	**81,241**	**100.0**	**100.0**

- Public sector banks have more branch presence relative to their share of assets.

What do the above data tell us about the big picture?

- Within the banking system, public sector banks (PSB) continue to dominate with 73% of market share of assets and 83% of branches.
- Rural and urban co-operatives banks have a relatively small share in the banking system. However, given their geographic and demographic outreach, they play a key role in providing access to financial services to low and middle income households in both rural and urban areas.
- Similarly, RRBs play a key role in promoting financial inclusion. The Government is pursuing branch expansion and capital infusion plans for the RRBs.

Table - IV

Expansion of Banking Since Nationalization

Year	1969	1991	2007	2012
No. of Commercial Banks (incl. RRBs and LABs)	73	272	182	173
No. of Bank Offices	8,262	60,570	74,563	1,01,261
of which Rural and semi-urban bank offices	5,172	46,550	47,179	62,061
Population per office	64,000	14,000	15,000	13,000
Per capita Deposit of Scheduled Commercial Banks (SCBs)	₹88	₹2,368	₹23,382	₹51,106
Per capita Credit of SCBs	₹68	₹1,434	₹1,7541	₹39,909

- Since nationalisation of 14 major commercial banks in 1969, followed by nationalisation of another 6 banks in 1980, Indian banking system has expanded rapidly.
- The number of bank offices increased from about 8,000 in 1969 to over 100,000 by 2012.
- The average population per branch office has sharply declined from 64,000 in 1969 to 13,000 today.
- Both per capita deposit and per capita credit have expanded about 600 times. Even accounting for inflation, this is significant expansion.

Major banking sector reforms since 1991

The economic reforms initiated in 1991 also embraced the banking system. Following are the major reforms aimed at improving efficiency, productivity and profitability of banks.

- New banks licenced in private sector to inject competition in the system. 10 in 1993 and 2 more in 2003. Another lot of new banks will be licenced in the next few months.
- FDI+FII up to 74% allowed in private sector banks
- Listing of PSBs on stock exchanges and allowing them to access capital markets for augmenting their equity, subject to maintaining Government shareholding at a minimum of 51%. Private shareholders represented on the Board of PSBs.
- Progressive reduction in statutory pre-emption (SLR and CRR) to improve the resource base of banks so as to expand credit available to private sector. SLR currently at 23% (38.5% in 1991) and CRR at 4% (15% in 1991).
- Adoption of international best practices in banking regulation. Introduction of prudential norms on capital adequacy, IRAC (income recognition, asset classification, provisioning), exposure norms etc.
- Phased liberalisation of branch licensing. Banks can now open branches in Tier 2 to Tier 6 centres without prior approval from the Reserve Bank.
- Deregulation of a complex structure of deposit and lending interest rates to strengthen competitive impluses, improve allocative efficiency and strengthen the transmission of monetary policy.
- Base rate (floor rate for lending) introduced (July 2010). Prescription of an interest rate floor on savings deposit rate withdrawn (October 2011).
- Functional autonomy to PSBs.
- Use of information technology to improve the efficiency and productivity, enhance the payment and settlement systems and deepen financial inclusion
- Strengthening of Know Your Customer (KYC) and Anti-money Laundering (AML) norms; making banking less prone to financial abuse.
- Improvements in the risk management culture of banks.

Post-crisis regulatory reforms around the world

- The financial crisis exposed the risk posed by the Global Systemically Important Financial Institutions (G-SIFIs) as these were “too big to fail”.

- Post-crisis, US, UK, European Union took initiatives (Paul A Volcker in US, Sir John Vickers Independent Commission on Banking in UK, Erkki Liikanen in the European Union) to recommend as structural reforms in the banking sector to build safeguards against instability.
- The Volcker Rule and the Dodd-Frank Act Wall Street Reform and Consumer Protection Act have brought significant changes to the US financial system.
- The Volcker Rule separates investment banking, private equity and proprietary trading (hedge fund) sections of financial institutions from their consumer lending arms. Banks are not allowed to simultaneously enter into an advisory and creditor role with clients, such as with private equity firms. The Volcker Rule aims to minimize conflicts of interest between banks and their clients through separating the different types of business practices financial institutions engage in.
- The Independent Commission on Banking (Vickers Report) in UK has *inter alia* recommended ring fencing of UK banks, such that the ring fenced banks would be permitted to extend only retail and commercial banking services to limited clients including individuals and small and medium-sized organizations (SMEs) in UK.
- The Liikanen Report for the EU concluded that risky financial activities need to be separated from deposit-taking banks within the banking group, with the objective of making banking groups (mainly deposit-taking and providing financial services to the non-financial sectors in the economy) safer and less connected to trading activities.

Issue No. 1: public vs private ownership of banks

- Abstracting from ideology, from a pragmatic perspective, both public and private banks have respective advantages and disadvantages. Private ownership brings competition, professionalism and operational efficiency. Public ownership makes it easier to pursue social objectives such as mass banking, financial inclusion etc.
- Private banks have comparatively greater freedom in terms of recruitment, salary and compensation. On the other hand, PSBs are perceived to offer more job security, and consequently, employee turnover is lower.
- PSBs dominate the banking sector in India and will continue to be dominant in the foreseeable future. However, these banks require substantial capital to support growth.
- The critical question is whether the Government, given its limited fiscal space, can meet the enhanced capital needs of public sector banks under the Basel III capital regulations.
- Reserve Bank has made an estimate of the additional capital requirements of domestic banks for full Basel III implementation till March 2018. These estimates are based on two broad assumptions: (i) increase in the risk weighted assets of 20% p.a.; (ii) internal accrual of the order of 1% of risk weighted assets.
- The estimates suggest that the Indian banks will require an additional capital (on top of internal accruals) to the tune of ₹4.95 trillion; of this, non-equity capital will be of the order of over ₹3.30 trillion, while equity capital will be of the order of ₹1.65 trillion.
- Specific to public sector banks, the estimates suggest that public sector banks would require an additional capital to the tune of ₹4.15 trillion; of which equity capital will be of the order of ₹1.43 trillion, while non-equity capital will be of the order of ₹2.72 trillion. The Government's contribution to the equity capital of PSBs would be of the order of ₹900 billion at the existing level of shareholding of the Government.

The Government's contribution will come down to approximately ₹660 billion if its shareholding comes down to 51%.

- Finally, how should the Government enforce its rights and obligations as the owner of PSBs? Through the Board or through other means of interaction?

Table - V

Additional[1] Common Equity Requirements of Indian Banks under Basel III

(Amount in ₹ billion)

	Public Sector Banks	Private Sector Banks	Total
Additional Equity Capital Requirements under Basel III	1430	220	1650
Additional Non-equity Capital Requirements under Basel III	2720	580	3300
Of Additional Equity Capital Requirements under Basel III for Public Sector Banks			
Total	4150	800	4950
Government Share (at the present level of shareholding pattern)	900	-	-
Government Share (if shareholding is brought down to 51 per cent)	660	-	-

[1] Over and above internal accruals

- Over the last five years, the Government has infused ₹477 billion in the PSBs. An additional amount of ₹140 billion is proposed to be invested during the current year.
- Currently, government shareholding in public sector banks ranges from 55% to 82%. There is sufficient headroom available to the Government for dilution of its stake in a number of public sector banks.
- Given its fiscal constraints, should the Government dilute its shareholding in PSBs to 51% or should the Government go further and acquiesce in reducing its shareholding to below 51%, but build in some safeguards for retaining requisite management control?

- Possible options other than the budgetary support available to the Government:
  - Issuance of shares with differential voting rights or non-voting shares.
  - Reduction in the Government shareholding and insertion of protective clause to protect Government's control over public sector banks.
  - Formation of Holding Companies for PSBs.
- Need for a debate on the ideal capital structure of public sector banks such that they can best serve the demands of inclusive growth of the economy.

Issue No. 2: consolidation of banks

- Consolidation assumed significance after the introduction of financial sector reforms starting early nineties.
- Gained momentum after the Narasimham Committee – I (1991) put forward the broad pattern of the banking sector [3 or 4 large banks, 8 to 10 national banks, local banks and rural banks].
- Reiterated by the S.H. Khan Committee (1997), Narasimham Committee – II (1998), Raghuram Rajan Committee (2009), Committee on Financial Sector Assessment (CFSA) (2009) and Committee on Fuller Capital Account Convertibility (2006).
- All Committees viewed that restructuring of the banking system should be market-driven based on viability and profitability considerations and brought about through a process of Mergers & Amalgamations.
- Since the first round of nationalization of banks in 1969, there have been a total of 41 mergers and amalgamations. Of these, 17 happened before the onset of reforms in 1991 and 24 after that.
- The nature of M&As has been as follows:

	Number of cases
Public sector bank with public sector bank	3
Private bank with public sector bank	24
Private bank with private bank	14
Total	41

Arguments in support of consolidation

- Higher capital base after consolidation will facilitate increased lending activity and faster GDP growth.
- Boost infrastructure financing from the perspective of enhanced exposure limits for single and group borrowers.
- Meet the banking service demands of Indian corporates, both at home and globally.

- Cost benefits for banks due to economies of scale and economies of scope such as centralised back office processing, elimination of branch overlap and duplication of administrative infrastructure, better manpower planning, optimum funds management, consolidation of operations, savings in IT and other purchases.
- Consolidation will afford focused supervision.
- Larger size means wider and richer experience in financial inclusion. Possible to bring larger collective experience to identify successful models.
- International acceptance and recognition.
- Better risk management.

Arguments against consolidation

- Lead to complexity and Too-Big-To-Fail (TBTF) or Too-Connected-To-Fail (TCTF) moral hazards with adverse impact on financial stability.
- Regulatory issues: Significant big banks could resort to monopolistic practices that may result in unequal competition and distortive and even predatory behaviour in the market. Such practices could also blunt the monetary transmission and market mechanism for efficient allocation of resources.
- Could pose problems such as technology migration issues, customer attrition, implementation costs, HR issues (viz. seniority, salary, transfers, promotion, parity in perks etc.) and litigation, will not be able to provide personalized services provided by small banks.

Criteria for consolidation/merger

- Presently, significant skewness in the size of banks. The second largest bank in the system is almost one-third the size of the biggest bank. This creates a monopolistic situation. The task is to ensure that there are at least 4–5 banks of comparable size at all times to ensure that consolidated banks do not acquire monopolistic market power, adopt predatory behaviour and force smaller banks into unviable models.
- Organic merger or inorganic merger?

Issue No. 3: large and small banks

An issue related to the debate on consolidation in banking sector is the merits and demerits of large and small banks.

In support of large banks

- Large banks can exploit economies of scale and scope leading to economic efficiency.
- Large banks will have the capacity, resilience and innovative zeal to pursue financial inclusion. They will bring diverse experience to bear on local initiatives.
- Large banks can potentially become significant global players and thereby give a global reach to Indian corporates.
- Large banks with huge capital base can better meet the huge funding requirements of the infrastructure sectors.

Against large banks

- Large banks can become too-big-to fail, leading to moral hazard problems.
- Proliferation of non-core activities, either in the books of the bank or through off-balance sheet vehicles such as investment banking, securitisation, derivatives trading, etc. could pose significant systemic risk because of their complexity and opacity.
- Large banks can use power derived from their information monopoly to suppress competing institutions and markets.
- Large banks may dilute the benefits of competition.

In support of small banks

- Small banks have a comparative advantage in the supply of credit to small business units, small farmers and other unorganized sector entities, thereby furthering the cause of financial inclusion.
- Small local banks are more nimble and flexible. They can effectively cater to unbanked areas and meet localised needs. Can be more efficient in financial inclusion.
- Small banks with limited area of operation would require less infrastructure, staff and hence the operational expenses would be low.
- Failure of a small bank will not have any systemic impact and resolution would be easier.

Against small banks

- Small banks are potentially vulnerable to sector concentration risk. For instance, community banks in the US suffered losses due to their excessive reliance on lending to commercial real estate.
- Small banks are vulnerable to geographic concentration risk from the local economy and hence require higher level of CRAR.
- Small banks are not big enough to finance big investments, including infrastructure.
- Small banks are prone to local influence capture.
- A large number of small banks put pressure on the supervisory resources of the central bank.

Our experience with LABs /UCBs /RRBs

- Out of six LABs licensed by RBI, 2 were closed down, inter alia, due to mismanagement and only 4 are functioning. The overall performance of functioning LABs is less than satisfactory as they have become high cost structures.
- The LAB model has inherent weaknesses owing to its small size and concentration risk resulting in unviable and uncompetitive cost structures, adverse selection, constraints in attracting and retaining professional staff /management due to locational disadvantage.
- UCBs suffer from mismanagement, growing NPAs, state intervention, politicization and poor resource base. There have been 111 mergers and amalgamations among the UCBs with the number of UBCs placed at 1,618 as at end March 2012.

- Experience with RRBs is similar. Over the years, the number of RRBs has come down from 196 to 62.

Issues with encouraging large banks in India

- What is our definition of a large bank? By large bank, do we mean a bank with large asset size or a bank with global foot print? Some of the Chinese banks fit well into the first definition. They are large in terms of their assets, but they are not global in the sense that they have no global presence. Some of the American or European banks may not be large in terms of assets, but they have presence in many jurisdictions.
- What type of largeness should Indian banks attempt? Large banks like the Chinese banks or large banks with global presence? Note that it will take several years for our banks to achieve the status of a large global bank. Our biggest bank is ranked at about 60 in the global league of large banks. It may take years for our banks to become global players by way of organic growth. However, we should aspire to have a few Indian multinational banks in the near future by selective acquisition.

Issues with small banks in India

- Merely encouraging small banks without addressing the disadvantages of being small?
- Small banks are prone to fail frequently, and we have to develop the political and financial resilience to accept failures of small banks.
- There is a need for a faster and more effective framework for resolution and settlement of deposit insurance claims in the event of failure of a bank.
- When small banks become successful, they naturally want to expand and grow. Should we allow a smooth transition from small to big? But if we do that, aren't we defeating the very rationale for such banks viz. that they will be nimble and flexible and meet local demands?

Issue No. 4: licensing policy

- The RBI issues bank licences under section 22 of the Banking Regulation Act, 1949. The licence enables the bank to do banking and other financial services activities listed in the Banking Regulation Act.
- India follows a universal bank licensing regime.

Licensing policy for domestic private sector banks

- Pursuant to the recommendations of Narasimham Committee I in 1991, guidelines on new banks were released in 1993 with a minimum capital requirement of ₹1 billion. 10 new private sector banks were licensed
- Pursuant to Narasimham Committee II (April 1998) on Banking Sector Reforms, a new set of guidelines were issued in 2001 with a capital requirement of ₹3 billion. 2 new private sector banks were licensed.
- In February 2013, fresh guidelines for licensing of new banks were issued, inter alia permitting business/industrial houses to promote banks with a capital requirement of ₹5 billion.

Licensing policy for foreign banks

- At present, foreign banks operate in India as branches of the parent bank. Currently, permission for opening of branches by foreign banks in India is guided by India's commitment to WTO to allow 12 new branches in a year.

Development financial institutions

- Development Financial Institutions (DFIs) do not require a banking licence.
- Post-Independence, DFIs were established mainly to meet the demand for long-term finance by the industrial sector.
- They had the benefit of low-cost funds through Long Term Operation (LTO) funds from RBI at concessional rates, funds from multilateral and bilateral agencies duly guaranteed by the Government. They were also allowed to issue bonds, which qualified for SLR status. For deployment of funds, they faced little competition as the banking system concentrated largely on working capital finance and almost totally yielded the term finance space to DFIs.
- Post-financial sector reforms in the 1990s, the privileged access to low-cost funds was withdrawn forcing DFIs to raise resources at market-related rates. On the other hand, they had to face competition in the term finance space from banks offering lower rates. The change in operating environment, combined with high accumulation of non-performing assets, due to a combination of factors put financial stress on DFIs. Today, DFIs are very marginal players in the financial sector.
- Pursuant to the recommendations of the Khan Working Group on Harmonizing the Role and Operations of DFIs and banks, a Discussion Paper was prepared outlining the issues.
- A broad policy framework was outlined in the Mid-Term Review of Monetary and Credit Policy of 1999–2000 of RBI indicating that the desired path was towards universal banking. DFIs were given the option to transform into a bank. The operational guidelines for enabling a DFI to convert to a universal bank were issued in 2001.
- Is it necessary now to review our commitment to universal banking? Should we go in for differentiated licensing?

Differentiated licensing

- In October 2007, Reserve Bank prepared a Discussion Paper on Differentiated Bank Licensing which said that the case for differentiated licensing will be reviewed after a certain degree of success in financial inclusion is achieved and the Reserve Bank is satisfied with the quality and robustness of the risk management systems of the entire banking sector.
- Time to reevaluate this issue of Differentiated Licensing?

Arguments in support of differentiated licensing

- Specialized entities have expertise in risk assessment and structuring of infrastructure finance.
- Core competency could be better harnessed leading to enhanced productivity in terms of reduced intermediation cost, better price discovery and improved allocative efficiency.

- With differentiated licences, we can get around issues of conflict of interest that arise when a bank performs multiple functions.
- Customised application of supervisory resources according to the banking type could result in optimisation of scarce resources.

Argument against differentiated licensing

- Given the extent of financial exclusion in India, is it advisable to create a regime where some banks are freed of the obligation of financial inclusion?
- A universal bank will be able to cross subsidise across sectors to optimize utilization of resources and ensure better profitability of banks.
- Will specialized banks be prone to concentration risk because of narrower business models?

The critical issue on the way forward

- Differentiated licensing for various banking activities (retail, wholesale, trading in securities, mortgage lending, infrastructure financing, micro lending, etc.) with differentiated regulatory requirements depending upon the risks involved?
- If we accept Differentiated Licensing in principle, a special category of banks that will come up for consideration, is Investment Banks. Let me now discuss licensing of pure Investment Banks.

Issue No. 5: investment banking

- Post sub-prime crisis, the US investment banking sector collapsed due to high leverage and severe maturity mismatches.
- Soon after, leading investment banks such as Morgan Stanley and Goldman Sachs converted themselves into bank holding companies.

Investment banking in India: current regulatory framework

- The term investment bank is not legally defined in India, and no entities are registered as such with SEBI.
- "Investment Banking" is commonly used to define entities that are into asset management, capital raising, trading in securities, portfolio management, merchant banking, underwriting, broking and those offering business and financial advisory services.
- Pure investment entities which do not have presence in the lending or banking business are regulated primarily by the capital market regulator (SEBI).
- Banks are subject to regulatory restrictions on their investments.

Why and how of investment banks

- Pure investment banks have a comparative advantage in corporate structuring and raising capital from the market. As Indian corporate go global, do we need pure investment banks in India to serve their sophisticated financial needs and advisory services?
- Will exclusive investment banks militate against development goals – priority sector lending, financial inclusion?

- Is Investment Banking under the proposed Non-Operative Financial Holding Company (NOFHC) a possible option?
- Need for more extensive debate on the pros and cons of exclusive investment banks in India.

Issue No. 6: Financial Sector Legislative Reforms Commission (FSLRC)

- FSLRC was constituted by the Government "with a view to rewriting and cleaning up the financial sector laws to bring them in tune with the current requirements". FSLRC submitted its Report to the Government in March 2013.
- The Commission proposes shifting from rule based to principle based regulation. The logic is that the principles will be enshrined in the law and the law need not change to reflect changes over time and changes in technology.
- As per FSLRC, The new financial regulatory architecture will comprise:
  – Unified Financial Authority (UFA)
  – RBI
  – Financial Sector Appellate Tribunal
  – Resolution Corporation
  – Financial Redressal Agency
  – Financial Sector Development Council
  – Public Debt Management Agency
- Today RBI has the following regulatory and supervisory responsibilities:
  – Regulator of banks & non-banks ie all deposit taking and credit institutions
  – Regulator of Payment Systems
  – Regulator of Markets (viz., money, forex & g-sec)
  – Major responsibility for financial stability, macro-prudential regulations & supervision of financial conglomerates
  – Deposit Insurance and Credit Guarantee (through its subsidiary)
  – Customer Grievance Redressal relating to banks
- FSLRC recommends that RBI should eventually (within 5–10 years) focus on monetary policy and traditional central banking activity only, and shed all other regulatory and supervisory functions.
- In the interim, FSLRC recommends that
  – The Reserve Bank will be the regulator for banking and payment systems.
  – The Unified Financial Authority will be the regulator for all financial services other than banking and payment systems.
  – RBI will share responsibility for financial stability with FSDC and other regulators.
- Further, RBI to be free of responsibilities relating to Public Debt Management, Customer Grievance Redressal relating to banks, and deposit insurance.

Why RBI should regulate both banks and non-banks?

- One of the major causes of the 2008 financial crisis was that credit intermediation activities were conducted by non-banks (the so called shadow banks) which were primarily outside the regulatory purview. This raised serious concerns of regulatory arbitrage, requirements for similar regulation of entities performing similar activities and issues of commonality of risks and synergies of unified regulation for such entities.
- Strong interlinkages between banks and NBFCs. Unified regulation by the same regulator essential for financial stability.
- For Monetary Policy to be effective, credit creation (i.e. by banks and credit institutions like NBFCs) should be regulated by the central bank.
- Post-crisis, the trend has been to entrust more, not less, regulation to central banks.

Issue No. 7: Non-Operative Financial Holding Companies (NOFHC)

- There are three types of banking models prevalent around the world.
- Europe has adopted Universal Banking model. In the US, the predominant model is Bank Holding Company (BHC) or Financial Holding Company (FHC). Most other jurisdictions follow the Bank-Subsidiary model.
- India adopted Bank-Subsidiary model till the early 90s, and then moved on to the Universal Banking model.
- RBI had constituted a Working Group, under former Deputy Governor Shyamala Gopinath, in June 2010 to study the different holding company structures internationally and to indicate a roadmap for adoption of the holding company structure in India.
- The Working Group felt that a holding company structure would better enable oversight of financial groups from a systemic perspective.
- The Working Group had also recommended that there should be a separate statute for regulation of financial holding companies.
- New banks in the private sector would be set up under a Non-Operative Financial Holding Company (NOFHC).
- The objective of NOFHC is that the holding company will ring fence the regulated financial services entities of the promoter group, including the bank, from other activities of the group i.e., commercial, industrial and financial activities not regulated by financial sector regulators. The objective is also that the bank should be ring-fenced from other regulated financial activities of the Group.
- NOFHC will be registered as a non-banking financial company (NBFC), but regulated like a bank.
- For the PSBs, a High Level Committee set up by the Government has recommended formation of a non-operating financial holding company (HoldCo) under a special Act of Parliament to act as an investment company for the Government; to hold a major portion of the Government's shareholdings in all PSBs; to raise long-term debt from domestic and international markets to infuse equity into PSBs.
- Need for debate on whether a holding company structure is suited to the Indian banking and financial system.

Issue No. 8: subsidiarisation of foreign banks

- At present, foreign banks operate in India as branches of the parent banks.
- Post crisis lessons support domestic incorporation of foreign banks i.e. subsidiarisation
- Main advantages of local incorporation are:
  - Ring fenced capital within the host country
  - Easier to define laws of which jurisdiction apply
  - Better corporate governance, local board of directors
  - Effective control in a banking crisis and enables host country authorities to act more independently as against branch operations
  - Regulatory comfort
- Potential down side risk could be domination of the domestic financial system by Wholly Owned Subsidiaries (WOS) of foreign banks.
- There were certain taxation and other issues which needed to be resolved in consultation with Govt. of India. The Income Tax Act has since been amended to exempt foreign bank from payment of capital gains tax on subsidiarisation. The Banking Laws (Amendment) Bill, 2012 amended the Indian Stamp Act, 1899 whereby conversion of branch/es of a foreign bank into WOS as per the scheme or guidelines of RBI shall not be liable to duty under the Indian Stamp Act, 1899 or any other law for the time being in force.
- Apart from taxation issues, there are a few other important issues in conversion of foreign bank branches into wholly owned subsidiaries, mainly of a legal nature, like transfer of rights and liabilities, finality of transfer, etc. which need to be addressed. These issues are under examination of the Reserve Bank. After resolution of all these issues comprehensive guidelines on subsidiarisation of foreign banks in India will be issued.

Conclusion

- I have raised some issues relevant in the context of thinking through a banking structure for India that best promotes our aspiration for fast and inclusive growth.
- I am conscious I raised issues without necessarily giving the Reserve Bank’s views. That is deliberate. The Reserve Bank needs the benefit of larger and informed debate on these issues.
- I trust you will engage on these issues when the Reserve Bank’s Discussion Paper comes out in a few days.
- My best wishes for the success of this Conference.
- Thank you once again for inviting me.

Annex

Indicators of Impact of Financial Sector Reforms

	1990-91 (pre-reform)	2007-08 (post-reform, preceding global crisis)	Current position (2011-12)
Gross Domestic Saving Rate (% of GDP)	22.9	36.8	30.8
Gross Domestic Investment Rate (% of GDP)	26.0	38.1	35.0
Bank Credit / GDP (%)	20.4	47.4	50.60
Broad Money / GDP (%)	46.7	82.9	83.21
Spread (return on funds-cost of funds) (%)		2.9	3.62
Net Interest Income to Total Assets (%)	1.95	3.0	2.9
Return on Assets (%)		1.13	1.08
BSE Market Capitalisation (% of GDP)	16	103	70.2
Primary Market Resource Mobilisation (₹ billion)	43.1	636.4	3087.5