

Rakesh Mohan: Ownership and governance in private sector banks in India

Address by Dr Rakesh Mohan, Deputy Governor of the Reserve Bank of India, at the Conference on Ownership and Governance in Private Sector Banking organised by the Confederation of Indian Industries, Mumbai, 9 September 2004.

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I am grateful to the Confederation of Indian Industries to arrange a seminar on a subject of great importance today. This gives me an opportunity to discuss the issues with various stakeholders.

On July 2, 2004, RBI issued draft guidelines on ownership and governance in private sector banks in India. These guidelines were placed in the public domain for wider debate and feedback. The RBI is to put out a second draft and then finalise the policy taking into account the feedback received. The intention is to continue strengthening the Indian Banking System and keep moving towards international best practice through a consultative process.

If the importance of the issue of ownership and governance in banks is to be gauged by the number of responses received to any public document issued by RBI then I would say that it is overwhelmingly important!

We had said in the guidelines that banks are special. Several responses have been received asking us what we mean by 'special'. Banks are financial intermediaries critical for mobilising public savings and for deploying them to provide safety and return to the savers. They thus have fiduciary responsibility. The deployment of funds mobilized through deposits involves banks in financing economic activity and providing the lifeline for the payments system. The banking system is something that is central to a nation's economy; and that applies whether the banks are locally- or foreign-owned.

The owners or shareholders of the banks have only a minor stake and considering the leveraging capacity of banks (more than ten to one) it puts them in control of very large volume of public funds of which their own stake is miniscule. In a sense, therefore, they act as trustees and as such must be fit and proper for the deployment of funds entrusted to them. The sustained stable and continuing operations depend on the public confidence in individual banks and the banking system. The speed with which a bank under a run can collapse is incomparable with any other organisation. For a developing economy like ours there is also much less tolerance for downside risk among depositors many of whom place their life savings in the banks. Hence from a moral , social, political and human angle, there is a more onerous responsibility on the regulator. Millions of depositors of the banks whose funds are entrusted with the bank are not in control of their management.

Thus, concentrated shareholding in banks controlling huge public funds does pose issues related to the risk of concentration of ownership because of the moral hazard problem and linkages of owners with businesses. Hence diversification of ownership is desirable as also ensuring fit and proper status of such owners and directors. At the same time with diversified ownership, there is, perhaps, even greater concern over corporate governance and professional management, in view of this, apart from ensuring fit and proper considerations, in order to safeguard depositors interest and ensure systemic stability, the regulatory and supervisory framework has to ensure that banks have adequate capital to cushion risks that are inevitable in their operations, follow prudent and transparent accounting practices and are managed in accordance with the best practices for risk management. Seen from this standpoint, great responsibility is imposed on the regulator.

The issue has been raised as to why now- what is new that these concerns are being raised now? After nationalisation of major banks in 1969 and in 1980, in a sense, being government owned the issue did not arise till recently. As part of financial sector reform and keeping in view the growth needs of the economy it is expected that the significance and share of the private sector banks will increase as also public shareholding in the public sector banks within the current policy framework. The banks are expected to grow with the economy. There is also opening up of the economy and increasing integration with the global economy. As this happens, the regulator has to ensure that the banking system is strong, healthy and resilient to withstand shocks. We also want to ensure that transparency improves and want to move to international best practices in regulation, supervision, risk management while at same time calibrating the suitability to the domestic conditions and needs at the current stage of development

Key features of the guidelines

To begin with, let me enumerate the salient features of the guidelines.

1. All shareholding of 5 per cent and above representing important shareholding will have to meet the 'fit and proper' tests of competence, reputation, track record, integrity, satisfactory outcome of financial vetting, source of funds and so on. Where the applicant is a body corporate, fit and proper would include 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.
2. In the interest of diversified ownership of banks, the objective will be to ensure that no single entity or group of related entities 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 the guidelines of February 3, 2004. These guidelines state that 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. In addition as indicated in the July draft, where the investing entity is a corporate entity, it will be seen whether there is diversified shareholding of the investing entity. For acquisition or investment exceeding the level of 30 percent the criteria will also take into account but will not be limited to whether (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.
3. The main difference between the February guidelines and the July draft is that the latter requires prior approval for shareholding above 10 per cent and is also applicable for existing shareholding above such level. The criteria laid down in the guidelines will be applicable equally for higher level of acquisitions as also for time bound plan for continuance or reduction in cases where the limits exceed those indicated.
4. Minimum of Rs 300 crore of net worth is perceived as being desirable on grounds of optimal operations and systemic stability. Banks with net worth lower than Rs 300 crore will be encouraged to increase it to this level through organic or inorganic growth within a reasonable period.
5. In case of new licenses, promoter's shareholding will normally be expected to be brought down to 10 per cent in a period of three years even if higher to begin with.
6. Large industrial houses as per existing policy will be permitted strategic investment in banks up to 10 per cent subject to fulfilling the other criteria.
7. While guidelines have already been issued to banks and Fis in India to minimize cross holding to 5 per cent, symmetrically, the draft guidelines require foreign banks operating in India to restrict their acquisition (*either directly or through any entity in the group*) of shareholding in Indian banks to 5 per cent .
8. The maximum limits for portfolio investment through stock exchanges by individual NRIs and FIIs at 5 per cent and 10 per cent respectively and aggregate limits at 10 per cent (can be raised to 24 per cent through special resolution of general body) and 24 per cent (can be raised to 49 per cent through special resolution of general body) respectively, currently permissible, as reiterated in the GOI press note of March 5, 2004, have been retained in the draft guidelines. These will be subject to government's policy in this regard. All cases of acquisition or holding of 5 per cent and above, in case of FIIs, will require acknowledgment by RBI as per February 3, 2004 guidelines. Where the investing entity is a 'sub account', full details of the investor/s and other particulars required for due diligence will be called for.

9. While most of the elements of the draft guidelines in case of directors have been implemented already, the provision relating to the desirable practice of having not more than one member of family close relative or associate on the Board of a bank is yet to be introduced.
10. All transition arrangements for compliance with the guidelines for existing holdings will be subject to submission of time bound action plans by the concerned banks. The intention as already indicated will be to move towards the desired objectives in as non-disruptive a manner as possible.
11. Continuing compliance of 'fit and proper' criteria for shareholders and directors will have to be ensured by the bank on an ongoing basis subject to independent verification by RBI where felt necessary.

How did we come to devise these guidelines? Apart from an internal review, we scanned international practice.

International approaches

Internationally, the regulatory/supervisory approach has been evolving into cohesive and inclusive regulatory paradigm involving three different monitoring perspectives on the overall functioning of banks -

- an enabling and proactive regulatory and supervisory oversight,
- internal control through a vibrant and professional Board and
- market discipline

All three in isolation have their limitations and are effective differentially based on the overall systemic contexts such as the level of maturity of the economy, and hence the markets, the efficacy of the legal system and the resolution mechanisms in place, the prevalent business culture etc. Market discipline may not be very effective till transparent disclosure requirements are put in place. Even then the ability of the market to discipline the constituents would depend on its own structural strength as well as the economic setting in which it operates. Therefore a significant level of reliance has to be placed on internal control effected through Board oversight.

An important factor, in this context, that defines the business culture is what has come to be termed as "corporate governance". It is a nebulous concept whose essential elements were part of the business ethos in all societies but which has in recent times come under sharp focus and acquired a heightened significance partly due to the process of globalization and the increasingly overarching role of business on the society at large.

From a banking industry perspective, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management, affecting how banks¹:

- set corporate objectives (including generating economic returns to owners);
- run the day-to-day operations of the business;
- consider the interests of recognised stakeholders;
- align corporate activities and behaviours with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations;
- protect the interests of depositors.

The two major concerns that arise in context of corporate governance in banks and need to be addressed are (i) the concentration of ownership and (ii) the type of people who control the bank. Diversified ownership becomes a necessary postulate as it provides balancing stakes which may not be possible otherwise, even in the case of voting right limits. A related concern is the 'quality' of control over the functioning of banks manifest in the credentials of the various stakeholders.

¹ Basel Committee on Banking Supervision, 'Enhancing Corporate Governance in Banking Organisations', 1999.

A survey of the regulatory regimes in major countries brings out that most of the regimes address these two concerns through a set of restrictions on the ownership of bank stock on the following parameters:

- quantum of ownership by single person/associated persons
- ownership restrictions for domestic entities based on nature of entity
- non-bank financial firms
- non-financial entities
- other banks
- ownership restrictions for foreign entities

Major inferences that can be drawn from the international practices are as follows :

In most of the countries, **ownership concentration is regulated through a layered threshold structure** as per which any person wishing to acquire/increase shareholding in a bank beyond those thresholds would be required to seek regulatory approval . The qualifying threshold level in most countries is 10%. Most of the countries though **do not have an explicit cap** on the maximum shareholding by a single person/entity. The above structure applies to **direct as well as indirect control** by a person **singly or jointly** through a group of associates or related parties.

The regulators give **approvals on a case to case basis** subject to a number of considerations including the overall sectoral impact of the transaction and the satisfaction of **'fit and proper' principles** by the person(s) acquiring the stake.

Acquirers of shares beyond thresholds need to **provide comprehensive information** to the authorities for their approval including the intent of purchase, terms and conditions, if any, manner of acquisition, source of funds etc.

In terms of the nature of the entity, **non-banking financial firms and non-financial firms are permitted to acquire shares in banks** subject to the overall ceilings in respect of single entity in most countries albeit **with regulatory approval in most cases**. The non-discriminative treatment of the two classes of entities is reflected in dovetailing of the restrictive clauses, wherever applicable, with the norms on ownership by single entity.

Crossholding amongst banks i.e., **acquiring shares in a bank by another bank**, directly or indirectly, is subject to regulatory approval in most of the regimes and the thresholds, in some cases, are lower than those for non-bank entities.

Background for the draft guidelines

Having dealt with the international approaches , I would like to highlight some facts and developments which should serve as a background information for this seminar.

- Unlike in many other countries, the various laws relating to banking in India [Banking Regulation Act 1949, Banking Companies (Acquisition and Transfer of Undertakings Act, 1970 and 1980, the State Bank of India Act 1955, the State Bank of India (Subsidiary Banks) Act 1959] do not provide for prior approval of the regulator for acquisition of significant ownership in banks - either in the public sector or in the private sector. There is, therefore, a need for an articulation of policy in public interest and depositor's interest.
- On February 3, 2004, the Reserve Bank came out with the guidelines for acknowledgment for acquisition and transfer of shares in private sector banks. These guidelines took into account the emerging trends in banking and international practices. For the first time, it was spelt out that the term 'holding' will refer to both direct and indirect, beneficial or otherwise and will be computed with reference to the holding of the applicant, relatives and associates.
- On 5 March 2004, press note 4 was issued by Government of India covering foreign investment in banking. The operational guidelines are yet to be issued. Hence the draft guidelines do not cover the policy in regard to investment by foreign banks or form of presence of foreign banks for which there will be separate guidelines. Before issuing these, it

is felt necessary to streamline the national policy for ownership, domestic and foreign, and governance.

- On June 25 2004, 'fit and proper' criteria for directors of private sector banks were spelt out by RBI based on qualification, expertise, track record and integrity of persons to be appointed as directors of banks. The process of due diligence is to be undertaken by the bank at time of appointment and renewal.
- On July 6 2004, banks / FIs were advised that they should not acquire any fresh stake in a bank's equity shares, if by such acquisition, the investing bank's/FI's holding exceeds 5 per cent of the investee bank's equity capital.

Why are the guidelines being made applicable for existing banks?

The banking sector is already quite large and widespread. There are several banks of varying sizes, composition of shareholding and directors. The issues of size and governance are extremely important from point of view of financial stability. This draft policy is in consonance of treating banks as special and is setting upfront a road map in a transparent manner for the existing investors to align their policies and potential investors to make informed decisions. The intention of the policy is to ensure adequate capital and consolidation in the banking industry with the regulator being aware of the intention of existing and potential shareholders. Since one of the fundamental presumption in the policy is that any shareholding above 10 per cent would have to satisfy the regulator of the fit and proper status and sound governance principles on a continuing basis, it is necessary that the same principles are applicable to existing owners but done so in a non-disruptive and consultative fashion. In regard to banks permitted recently or rehabilitated recently on the basis of specific approvals, the commitments made as part of the approval process would undoubtedly be taken into account as also continuing compliance with 'fit and proper' and sound governance. The same criteria as applicable for higher level of ownership as articulated in the February 3, 2004 would form the basis for dealing with the cases under transition as well.

The discussion paper is an illustration to the consultative process that has been increasingly adopted in the policy making by the Reserve Bank. As far as banking business is concerned, we appreciate the role of promoters in general and strategic investors in particular; although the distinction between them is often blurred in practice. The comments on the first draft of this discussion paper will definitely enable us to fine tune the policy for the better.