

Reserve Bank of India

Draft Guidelines for Licensing of “Small Banks” in the Private Sector

July 17, 2014

I. Preamble

The Reserve Bank of India (RBI) last came out with a set of guidelines for licensing of new banks in the private sector on February 22, 2013. The process of licensing culminated with the announcement by the RBI vide its [Press Release dated April 2, 2014](#) that it would grant “in-principle” approval to two applicants who would set up new banks in the private sector within a period of 18 months.

While preparing these guidelines, the Reserve Bank recognized the need for an explicit policy on banking structure in India keeping in view the recommendations of the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham) (1998), Committee on Financial Sector Reforms (Chairman: Dr. Raghuram G. Rajan) (2009) and other viewpoints.

Accordingly, the Reserve Bank came out with a policy discussion paper on *Banking Structure in India – The Way Forward* on August 27, 2013. One of the observations in the discussion paper was that in India, where extending banking services to the underserved and unserved sections of the population is a challenge, there is merit in considering access to bank credit and services through expansion of small banks in unbanked and under-banked regions.

In the Union budget 2014-2015 presented on July 10, 2014, the Hon’ble Finance Minister announced that:

“After making suitable changes to current framework, a structure will be put in place for continuous authorization of universal banks in the private sector in the current financial year. RBI will create a framework for licensing small banks and other differentiated banks. Differentiated banks serving niche interests, local area banks, payment banks etc. are contemplated to meet credit and remittance needs of small businesses, unorganized sector, low income households, farmers and migrant work force”.

It may be mentioned that India did experiment with small banks following an announcement made by then Finance Minister in the Union Budget in August 1996 and the RBI issued guidelines for setting up of Local Area Banks (LABs) vide its Press Release dated August 24, 1996. The LABs were conceived as low cost structures which would provide efficient and competitive financial intermediation services in a limited area of operation, i.e., primarily in rural and semi-urban areas. LABs were required to have a minimum capital of Rs. 5 crore and an area of operation comprising three contiguous districts. Presently, four LABs are functioning satisfactorily.

Taking into account the above and that small local banks can play an important role in the supply of credit to micro and small enterprises, agriculture and banking services in unbanked and under-banked regions in the country, the RBI has decided to allow new “small banks” in the private sector. While permitting small banks, however, the issues relating to their size, capital requirements, area of operations, exposure norms, regulatory prescriptions, corporate governance and resolution need to be suitably addressed in the light of experience gained.

Accordingly, the following guidelines for licensing of small banks in the private sector have been formulated. The guidelines for continuous authorisation of universal banks will be issued separately.

II. Guidelines

1. Registration, licensing and regulations

The small bank shall be registered as a public limited company under the Companies Act, 2013. It will be licensed under Section 22 of the Banking Regulation Act, 1949 and governed by the provisions of the Banking Regulation Act, 1949, Reserve Bank of India Act, 1934, Foreign Exchange Management Act, 1999, Payment and Settlement Systems Act, 2007, Credit Information Companies (Regulation) Act, 2005, other relevant Statutes and the Directives, Prudential Regulations and other Guidelines/Instructions issued by RBI and other regulators from time to time, including the regulations of SEBI regarding public issues and other guidelines applicable to listed banking companies.

2. Objectives

The objectives of setting up of small banks will be for furthering financial inclusion by (i) provision of savings vehicles to underserved and unserved sections of the population, and (ii) supply of credit to small business units, small farmers, micro and small industries, and other unorganised sector entities, in their limited areas of operations, through high technology-low cost operations.

3. Eligible promoters

Resident individuals/professionals with 10 years of experience in banking and finance, Companies and Societies will be eligible as promoters to set up small banks. Existing Non-Banking Finance Companies (NBFCs), Micro Finance Institutions (MFIs), and LABs can also opt for conversion into small banks after complying with all legal and regulatory requirements from various authorities if they conform to these guidelines. Preference will be given to professionals from banking / financial sector, NBFCs and MFIs to set up small banks, if they meet the “fit and proper” criteria. Local focus and the ability to serve smaller customers will be a key criterion in licensing such banks. Thus this may be a more appropriate vehicle for local players.

Promoters/ Promoter Groups as defined in the SEBI (Issue of Capital & Disclosure Requirements) Regulations, 2009 should be ‘fit and proper’ in order to be eligible to promote small banks. RBI would assess the ‘fit and proper’ status of the applicants on the basis of their past record of sound credentials and integrity; financial soundness and successful track record of running their businesses, etc. for at least a period of five years.

4. Scope of activities

The area of operations of the small bank will normally be restricted to contiguous districts in a homogenous cluster of States/Union Territories so that the bank has the “local feel” and culture. However, if considered necessary, the bank will be allowed to expand its area of operations beyond contiguous districts in one or more States with reasonable geographical proximity. Its branch expansion plan for the initial three years would need prior approval of RBI after which, based on experience, RBI may consider relaxing this condition.

In the initial five years, the small bank shall further the objectives for which it is set up. Therefore, the small bank shall primarily undertake basic banking activities of acceptance of deposits and lending to small farmers, small businesses, micro and small industries and unorganised sector entities. It can also undertake other simple financial services activities with the prior approval of the RBI. It cannot set up subsidiaries to undertake non-banking financial services activities.

The other financial and non-financial services activities of the promoters, if any, should be kept distinctly ring-fenced and not comingled with the banking business. After the initial stabilisation period of five years, and after a review, RBI may liberalize the scope of activities of the small banks.

5. Capital requirement

The minimum paid up voting equity capital for small banks shall be Rs. 100 crore. Any additional voting equity capital to be brought in will depend on the business plan of the promoters. In view of the inherent risk of a small bank, it shall be required to maintain a minimum capital adequacy ratio of 15 per cent of its risk weighted assets (RWA) on a continuous basis, subject to any higher percentage as may be prescribed by RBI from time to time. However, as small banks are not expected to deal with sophisticated products, the capital adequacy ratio will be computed under simplified Basel I standards.

6. Promoters' contribution

The promoters' minimum initial contribution to the paid up voting equity capital of such small bank shall at least be 40 per cent which shall be locked in for a period of five years from the date of commencement of business of the bank. Shareholding by promoters in the bank in excess of 40 per cent shall be brought down to 40 per cent within three years from the date of commencement of business of the bank. Further, the promoter's stake should be brought down to 30 per cent of the paid-up voting equity capital of the bank within a period of 10 years, and to 26 per cent within 12 years from the date of commencement of business of the bank. Proposals having diversified shareholding and a time frame for listing of the bank will be preferred.

7. Foreign shareholding

The foreign shareholding in the bank would be as per the extant FDI policy.

8. Voting rights and transfer/acquisition of shares

As per Section 12 (2) of the Banking Regulation Act, 1949, the voting rights in private sector banks are capped at 10 per cent, which can be raised to 26 per cent in a phased manner by the RBI. Further, as per Section 12B of the Act *ibid*, any acquisition of 5 per cent or more of voting equity shares in a private sector bank will require prior approval of RBI.

9. Prudential norms

The newly set up small banks should ensure that they put in place a robust risk management framework.

The small bank will be subject to all prudential norms and regulations of RBI as applicable to existing commercial banks including requirement of maintenance of CRR and SLR. However, in view of concentration of its area of operations, the small bank will be required to have a well diversified portfolio of loans and advances spread over its area of operations. The maximum loan size and investment limit exposure to single/group borrowers / issuers would be restricted to 15 per cent of its capital funds. At least 50 per cent of its loan portfolio should constitute loans and advances of size upto Rs. 25 lakh in order to extend loans primarily to micro enterprises.

In addition to the restrictions placed on banks' loans and advances to its directors and the companies in which its directors are interested under Section 20 of the Banking Regulation Act, 1949, the small bank is precluded from having any exposure to its promoters, major shareholders (who have shareholding of 10 per cent of voting equity shares in the bank), the relatives [as defined in Section 2 (77) of the Companies Act, 2013 and Rules made there under] of the promoters as also the entities in which they have significant influence or control (as defined under Accounting Standards AS 21 and AS 23).

10. Additional conditions for NBFCs/MFIs/LABs converting into a bank

An existing NBFC/MFIs/LAB, if it meets the conditions under these guidelines, could apply to convert itself into a small bank, after complying with all legal and approval requirements from various authorities. In such a case, the entity shall have a minimum net worth of Rs. 100 crore.

11. Business plan

The applicants for small bank licences will be required to furnish their business plans along with project reports with their applications. The business plan will have to address how the bank proposes to achieve the objectives behind setting up of small banks. The business plan submitted by the applicant should be realistic and viable. In case of deviation from the stated business plan after issue of licence, RBI may consider restricting the bank's expansion, effecting change in management and imposing other penal measures as may be necessary.

12. Corporate governance

- i. The Board of the small bank should have a majority of independent Directors.
- ii. The bank should comply with the corporate governance guidelines including 'fit and proper' criteria for Directors as issued by RBI from time to time.

13. Other conditions

- i. Entities other than the promoters will not be permitted to have shareholding in excess of 10 per cent of the voting equity capital of the bank.
- ii. The small bank shall comply with the priority sector lending targets and sub-targets as applicable to the existing domestic banks. For this purpose, the bank should build its priority sector lending portfolio from the commencement of its operations.
- iii. While submitting its branch expansion plan to RBI for prior approval for the initial period of three years as indicated in para 4 above, the small bank shall

- plan to open at least 25 per cent of its branches in unbanked rural centres (population up to 9,999 as per the latest census). After three years of operations, depending on its performance, general permission for opening of branches in its area of operations would be considered, subject to extant guidelines on branch opening.
- iv. The operations of the bank should be technology driven from the beginning.
 - v. The bank should have a high powered Customer Grievances Cell to handle customer complaints.
 - vi. The compliance of terms and conditions laid down by RBI is an essential condition of grant of licence. Any non-compliance will attract penal measures including cancellation of licence of the bank.

14. Procedure for application

In terms of Rule 11 of the Banking Regulation (Companies) Rules, 1949 applications shall be submitted in the prescribed form (Form III). In addition, the applicants should furnish the requisite information in support of its business plan, shareholding pattern in the proposed bank, financial statements, income tax returns and credit reports for last three years, names and addresses of banks from which credit facilities are availed, etc. Applications for setting up of small banks in the private sector, along with other details as mentioned above, should be addressed to:

The Principal Chief General Manager,
 Department of Banking Operations and Development,
 Reserve Bank of India, Central Office,
 13th Floor, Central Office Building,
 Shahid Bhagat Singh Road,
 Mumbai - 400001

Applications will be received at the above address till the close of business as on -----.
 After experience gained in dealing with small banks, applications will be received on a continuous basis. However, these guidelines are subject to periodic review and revision.

15. Procedure for RBI decisions

- i. The applications will be initially screened by RBI to ensure *prima facie* eligibility of the applicants. RBI may apply additional criteria to determine the suitability of applications, in addition to the prescribed 'fit and proper' criteria.
- ii. Thereafter an External Advisory Committee (EAC) comprising eminent professionals like bankers, chartered accountants, finance professionals, etc. will evaluate the applications. The names of the professionals in EAC will be placed on RBI's website.
- iii. The External Advisory Committee will reserve the right to call for more information as well as have discussions with any applicant/s and seek clarification on any issue as may be required by it. The EAC will submit its recommendations to RBI for consideration. The decision to issue an in-principle approval for setting up of a bank will be taken by RBI. RBI's decision in this regard will be final.
- iv. The validity of the in-principle approval issued by RBI will be one year from the date of granting such in-principle approval and would thereafter lapse automatically.

Therefore, the bank will have to be set up within one year of grant of in-principle approval.

- v. After issue of the in-principle approval for setting up of a bank, if any adverse features are noticed subsequently regarding the promoters or the companies/entities with which the promoters are associated and the group in which they have interest, the RBI may impose additional conditions and if warranted, it may withdraw the in-principle approval.
 - vi. In order to ensure transparency, the names of applicants for bank licences will be placed on the RBI website on receipt of the applications. The names of successful applicants will also be placed on the RBI website.
 - vii. Banking being a highly leveraged business, licences shall be issued on a very selective basis to those who conform to the above requirements, who have an impeccable track record and who are likely to conform to the best standards of customer service and efficiency. Therefore, it may not be possible for RBI to issue licences to all the applicants meeting the eligibility criteria prescribed above. RBI will adopt a cautious approach in licensing small banks in the initial years, and with experience gained, may suitably revise the approach.
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