February 28, 2005

Guidelines on 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 they also leverage such funds through credit creation. The banks 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, co-operation, 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 declaration and undertaking by directors, etc., were issued by RBI on June 20, 2002 and June 25, 2004, 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 were issued in the interest of transparency by RBI on February 3, 2004.

(iv) Foreign investment in the banking sector is governed by 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. While diversified ownership minimises the risk of misuse or imprudent use of leveraged funds, it is no substitute for effective regulation.

Further, the fit and proper criteria, on a continuing basis, has to be the over-riding consideration in the path of ensuring adequate investments, appropriate restructuring and consolidation in the banking sector. The pursuit of the goal of diversified ownership will take account of these basic objectives, in a systematic manner and the process will be spread over time as appropriate.

(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' as indicated in circular dated June 25, 2004 and observe sound corporate governance principles.

(iv) Private sector banks have minimum capital/net worth for optimal operations and systemic stability.

(v) 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, 2001, 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. The banks which are yet to achieve the required level of net worth will have to submit a time-bound programme for capital augmentation to RBI. Where the net worth declines to a level below Rs.300 crore, it should be restored to Rs. 300 crore within a 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 well established regulated entity, widely held, publicly listed and enjoys good standing in the financial community.

(iv) Banks (including foreign banks having branch presence in India)/FIs 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 as indicated in RBI circular dated July 6, 2004.

(v) As per existing policy, large industrial houses will be allowed 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. Furthermore, such a limitation will also be considered if appropriate, in regard to important shareholders with other commercial affiliations.

(vi) In case of restructuring of problem/weak banks or in the interest of consolidation in the banking sector, RBI may permit a higher level of shareholding, including by a 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 fulfil the criteria under corporate governance norms provided by the Ganguly Committee and they also fulfil the criteria applicable for determining 'fit and proper' status of Important Shareholders (i.e., shareholding of 5 per cent and above) as laid down in RBI Circular dated June 25, 2004.

(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 in respect of 'Fit and Proper' criteria for directors of banks by RBI circular dated June 25, 2004 in accordance with the recommendations of the Ganguly Committee on Corporate Governance. For this purpose a declaration and undertaking is required to be obtained from the proposed / existing directors

(iv) Being a Director, the 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 an application to RBI for approval of appointment of Chairman/CEO.

7. Foreign investment in private sector banks

In terms of the Government of India press note of March 5, 2004, the aggregate foreign investment in private banks from all sources (FDI, FII, NRI) cannot exceed 74 per cent. At all times, at least 26 per cent of the paid up capital of the private sector banks will have to be held by resident Indians.

7.1 Foreign Direct Investment (FDI) (other than by foreign banks or foreign bank group)

(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 per cent either individually or as a group will have to comply with the criteria indicated in the aforesaid guidelines and get RBI acknowledgement for transfer of shares.

(ii) To enable assessment of 'fit and proper' the information on ownership/beneficial ownership as well as other relevant aspects will be extensive.

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 requires RBI's acknowledgement for acquisition/transfer of shares of 5 per cent and more of a private sector bank by FIIs based upon the policy guidelines on acknowledgement of acquisition/transfer of 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 which can be raised to 24 per cent with the approval of Board/General Body. Further, 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 were prescribed have 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 fulfil the minimum net worth requirement of Rs.300 crore required for a new entry. Hence any bank with net worth 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 fulfilment 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. While considering such cases, RBI will also take into account the terms and conditions of the banking licences.

(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 per cent 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 before appointment of directors and Chairman/CEO on the 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 a family, or close relatives or associates on the Board will be required to ensure compliance with these requirements 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 acknowledgement 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.

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