RBI's IWG Recommendations

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Why in news?

An Internal Working Group (IWG) of the RBI constituted to “review extant ownership guidelines and corporate structure for Indian private sector banks” recently submitted its report.

How is the Indian banking system's performance?

- India’s banking system has changed a lot since Independence.
- Back then, banks were owned by the private sector, resulting in a “large concentration of resources in the hands of a few business families”.
- The government resorted to the nationalisation of banks in 1969 (14 banks) and again in 1980 (6 banks) to -
  1. achieve a wider spread of bank credit
  2. prevent its misuse
  3. direct a larger volume of credit flow to priority sectors
  4. make it an effective instrument of economic development
- But with economic liberalisation in the early 1990s, the economy’s credit needs grew and private banks re-entered the picture.
- This had a notable impact on credit growth.
- However, even after three decades of rapid growth, the total balance sheet of banks in India still constitutes less than 70% of the GDP.
  - This is much less compared to global peers such as China, where this ratio is closer to 175%.
- Moreover, domestic bank credit to the private sector is just 50% of GDP.
  - In economies such as China, Japan, the US and Korea it is upwards of 150%.
- In other words, India’s banking system has been struggling to meet the credit demands of a growing economy.
- There is only one Indian bank in the top 100 banks globally by size.
- Further, Indian banks are also one of the least cost-efficient.
- Clearly, India needs to strengthen its banking system to grow at a fast pace.

- In this regard, it is crucial to note that public sector banks have been steadily losing ground to private banks.
- Private Banks are not only more efficient and profitable but are also ready to take risks.
- It was against this backdrop that the RBI constituted the IWG to suggest reforms.

What was the IWG tasked to?

- Given the above, the IWG was asked to suggest changes that not only boost private sector banking but also make it safer.
- The terms of reference of the IWG inter alia included -

1. a review of the eligibility criteria for individuals/entities to apply for banking license
2. examination of preferred corporate structure for banks and harmonisation of norms in this regard
3. review of norms for long-term shareholding in banks by the promoters and other shareholders

What are the key recommendations?

- **Promoter's cap** - The IWG has proposed to raise the cap on promoters' stake in private banks from the current 15% to 26% in 15 years.
- As regards non-promoter shareholding, a uniform cap of 15% of the paid-up voting equity share capital of the bank is prescribed for all types of shareholders.
- **Corporates as banks** - IWG has recommended that large corporate or industrial houses may be allowed as promoters of banks.
    - Large corporates refer to business houses having total assets of Rs 5,000 crore or more.
    - Here, the non-financial business of the group accounts for more than 40% in terms of total assets or gross income.
- However, this move will be rolled out only after making amendments to the Banking Regulation Act, 1949.
    - This is to deal with connected lending and exposures between the banks and other financial and non-financial group entities.
- The IWG also made a case for strengthening of the supervisory mechanism for large conglomerates, including consolidated supervision.
- **New Banks** - IWG recommended that the <u>minimum initial capital requirement</u> for licensing new banks should be enhanced -
    i. from Rs. 500 crore to Rs. 1,000 crore for universal banks

ii. from Rs. 200 crore to Rs. 300 crore for small finance banks

- **NBFCs** - The panel suggested well run large NBFCs with an asset size of Rs. 50,000 crore and above, including those owned by a corporate house, may be considered for conversion into banks.
- This is however subject to completion of 10 years of operations and meeting due diligence criteria and compliance with additional conditions specified.
- **Payments Banks into SFBs** - The panel has proposed a reduction in the time-frame needed for payments banks to convert into small finance banks (SFB) to 3 years from 5 years.
- A change has also been suggested in the listing criterion for SFBs and payment banks.
- They may list -
    i. within 6 years from the date of reaching the net worth equivalent to prevalent entry capital requirement prescribed for universal banks (or)
    ii. 10 years from the date of commencement of operations, whichever is earlier

- **NOFHC -** Non-operative Financial Holding Company (NOFHC) should continue to be the preferred structure for all new licenses to be issued for universal banks.
    - [NOFHC is a category of non-banking finance company (NBFC), registered as an NBFC with the RBI.
    - It is governed by a separate set of directions issued by RBI.
    - The objective is to separate several financial activities carried out by the same holding company.]
- However, it should be mandatory only in cases where the individual promoters / promoting entities/ converting entities have other group entities.
- Banks licensed before 2013 may move to an NOFHC structure at their discretion.
    - However, once the NOFHC structure attains a tax-neutral status, all banks licensed before 2013 shall move to the NOFHC structure within 5 years from announcement of tax-neutrality.
- The concerns about banks undertaking different activities through subsidiaries joint ventures (JVs)/associates should be addressed through suitable regulations till the NOFHC structure is made feasible and operational.
- Banks currently under NOFHC structure may be allowed to exit from such a structure if they do not have other group entities in their fold.
- **Licensing guidelines** - The panel called for the RBI to take steps to ensure harmonisation and uniformity in different licensing guidelines, to the extent possible.

What are the benefits of the recommendations?

- **Growth** - The RBI panel has suggested opening the field to new players.
- This may provide a wide choice to consumers in terms of products and pricing.
- By initial indications, 9 private sector and 5 state owned NBFCs may get qualified to set up, or turn into, banks adding to the present strength of 143 banks (June 2020).
- This is likely to expand the banking network that should help the economy reach its growth potential.
- **NBFCs** - The IWG's recommendation to allow conversion of large NBFCs into banks could increase the size of the banking system itself.
- With at least 10 years as shadow banks, they will have a different approach to credit appraisal; risk-based pricing, monitoring and recovery strategies.
- **NOFHC** - A non-operative finance holding company (NOFHC) structure to separate ownership and management control is expected to take care of the 'conflict of interest' issues.
- This is in line with the recommendations of the PJ Nayak Committee report reviewing 'Governance of Boards of Banks in India'.
- The committee even called for Public Sector Banks (PSBs) to separate government ownership and grant autonomy in their functioning.
- The transition of the ownership structure of existing private banks licensed before 2013 is also clearly outlined.

What are the challenges before the RBI?

- With expansion of number of banks and non-banks, the onus of the RBI to oversee the orderliness, sustainability and compliance standards will increase.
- Fintech companies, peer-to-peer lenders and neo-banks add to the challenges of the supervisory system.
- Cooperative banks and housing finance companies are already added to the list of regulated entities of the RBI.
- So, the RBI has to plan and reorient its human resources and draw in new talent to oversee the rapidly expanding banking system.
- It must especially track signs of stress and ensure that there is no systemic threat.

Sources: The Indian Express, RBI, BusinessLine