Banking Laws Balance Between Corporate Democracy And Governance

While the hitherto conservative banking sector is also undergoing liberalisation, our over regulated past continues to cast its shadow on the path ahead. Only time will tell if this tightrope walk has been achieved successfully

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As India moves towards the second generation of legislative reforms by liberalising various sectors and regimes, the erstwhile conservative banking sector is also undergoing change. However, the direct fallout of any liberalisation scheme is its impact on corporate governance issues. This becomes even more important in the case of banks, owing to their inherent public money exposure and systemic risk threat.

The regulatory regime governing the Indian banking sector has seen two major changes over the last few months - first, the much-awaited Banking Laws (Amendment) Act, 2012 ("Banking Amendment"), which amended certain provisions of the Banking Regulation Act, 1949 ("BR Act"); and second, the introduction of the Guidelines for Licensing of New Banks in the Private Sector issued by Reserve Bank of India on February 22, 2013 ("New Bank Guidelines"). In this article, we have briefly discussed from an investor's standpoint, impact of these changes on corporate governance concerns relating to the voting rights and share capital.

The Banking Amendment has introduced the much-awaited increase in ceiling for shareholder voting rights. Voting caps have been increased from 1% to 10% for private investors in public sector banks, though there is no cap on the exercise of voting rights by the Central Government. Similar changes have also been made for private sector banks, whereby the Reserve Bank of India ("RBI") has been empowered to increase, at its discretion, the present cap of 10% to 26% in a phased manner. Though the increase in voting power is a welcome move, the industry's demand was to make it proportionate to the shareholding of an investor. The low voting caps had limited the role played by private investors in public sector banks and made investment in private sector banks unattractive to foreign investors.

Under the New Bank Guidelines, new banks to be set up by the private sector will be held by a Non-Operating Financial Holding Company ("NOFHC"), which shall hold at least 40% of the paid-up voting equity capital of the bank, and this shareholding will need to be gradually reduced to 15% over a period of 12 years from the commencement of business. Further restrictions on the voting rights have been placed at the NOFHC level, including restrictions on the voting capital held by individuals, entities and their related parties within the promoter group. According to New Bank Guidelines, the capital structure of the NOFHC should be such that:

(a) An individual belonging to the promoter group, along with his relatives and entities in which he and his

relatives hold at least 50% of the voting shares, shall not hold more than 10% of the total voting equity shares of the NOFHC.

(b) Companies within the promoter group in which the public hold atleast 51% of the voting equity shares, will be required to hold at least 51% of the voting equity shares of the NOFHC.

Given the above requirements, it would be interesting to see how the cap on voting rights in existing banks would play out against the more l beral approach taken for NOFHCs and banks held by them.

Also, while the cap on voting rights has seen some liberalisation, the Banking Amendment continues to give RBI the reigns to control the acquisition of more than 5% of shares or voting rights of Indian banks. Pursuant to the Banking Amendment, prior approval of RBI will be required by a person who, along with persons acting in concert, intends to acquire shareholding of a bank, where pursuant to the acquisition, such person along with his relatives (as per the Companies Act, 1956) or associate enterprises or persons acting in concert hold more than 5% of shares or voting rights of a bank. Expectedly, the RBI has wide powers to specify the criteria for acquisition of shares and voting rights depending on the percentage stake intended to be acquired by an investor.

An approval may be accorded after verifying the 'fit and proper criteria' of the acquirer, for which following would be considered; (a) public interest; (b) interest of banking policy; (c) effective management of affairs of the bank; (d) international best practices and emerging trends in banking; (e) interest of Indian banking and financial system. Accordingly, the criteria for 'fit and proper' person under the Banking Amendment has undergone a shift from focus on the credentials of the applicant (such as integrity, financial track record of the applicant, source of funds etc.), as laid down in the Guidelines for Acknowledgement of Transfer/Allotment of Shares in Private Sector banks dated February 3, 2004, to a broader and arguably more subjective concept of public interest and interest of the banking industry and policy. Having said that, as determination of 'fit and proper' is not an objective exercise and under the Banking Amendment, RBI has the power to seek additional information, it appears l kely that the criteria specified under the aforesaid 2004 guidelines would continue to apply. It is relevant to note that the 'fit and proper' criteria prescribed by the New Bank Guidelines for the promoter/ promoter group of new private sector banks rightly concentrate on the credentials of the applicants but it is unclear whether macro-economic and fiscal criteria pertaining to public interest etc would apply to a promoter setting up the bank. The criteria prescribed by the New Bank Guidelines include:

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Parag Srivastava

Member

Nishith Desai Associates

(a) Past record of sound credentials and integrity;

(b) Financial soundness and a track record of running their business for at least 10 years;

(c) Alignment of the business of the promoter group with the banking model; and

(d) Insulation of the bank from any speculative activities of the promoter group.

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Another area to consider is the type of share capital that banks can issue. Issuance of preference shares by public sector banks was permitted vide the Banking Companies (Acquisition and Transfer of Undertakings) and Financial Institutions Laws (Amendment) Act, 2006 and pursuant to the subsequent guidelines issued by the RBI, private sector banks were proh bited under the BR Act, from issuing preference shares as part of their capital. With the amendment to Section 12 (1) (ii), the Banking Amendment has permitted private sector banks to issue preference shares subject to guidelines issued by RBI. In this regard, RBI, in 2007, had prescr bed guidelines for banks to issue preference shares in order to meet the capital adequacy norms under the then applicable Basel II norms. However, this creates an exception to the provisions applicable to Indian companies (vide the Companies Act, 1956) since the Banking Amendment prescribes that preference shares will not be entitled to exercise voting rights with respect to any resolution if any dividend is unpaid for a period of more than 2 years.

It is also pertinent to note that foreign institutional investors are permitted to subscribe to the preference shares issued by the banks subject to the limits specified therein.

Clearly, the issue of preference shares by banks and the ability of foreign institutional investors to subscribe to the same helps in raising capital for banks, without equity dilution. Further, this will also assist banks in meeting the capital adequacy requirements prescr bed under the now applicable Basel III norms. For investors too, the subscription to preference shares appears to be an attractive and tax efficient proposition, to draw preferred returns. However, the enthusiasm of investors towards subscription to preference shares will have to be watched, especially in the light of limited preferential share allotments by public sector banks, thus far. It would also be interesting to watch the traction towards the use of preferential shares by the new private sector banks to be promoted by corporate houses under the New Bank Guidelines.

Though the reforms suggested are definitely a step in the right direction of having a free banking regime, our over regulated past continues to cast its shadow on the path ahead. As it has always been the case in the financial sector, only time would tell if the right chords have been struck to balance the divide between governance and free economy and if enough impetus has been provided to fuel investments in this sector.

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