Banking Amendment

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The UPA's second stab at paving the way for an expanded presence of domestic and foreign private capital in the banking sector and the dilution of government ownership of public sector banks has moved one step forward, though after a compromise. The Lok Sabha has passed a revised version of the draft Banking Laws (Amendment) Bill, 2011 in which clauses allowing banks to engage in commodity futures trading and exempting the banking sector from scrutiny by the Competition Commission of India (CCI) have been dropped. But there is much else that remains controversial in the bill, against which bank employees and officers had decided to strike work on December 20. In fact, when the Finance Minister sought to take up discussions on the bill in Parliament on December 11, the opposition stalled proceedings and demanded that it be referred back to Standing Committee on Finance the views and recommendations of which had been largely ignored in the draft. This occurred despite the fact that in an effort to 'neutralise the opposition', Finance Minister P. Chidamabaram had met and solicited the support of the two leaders of the opposition, Sushma Swaraj and Arun Jaitley, neither of whom has displayed a strong distaste for banking liberalisation.

Much of the opposition, while crossing swords with the UPA on this issue for political reasons, does not oppose the essential objective of the bill, which is to pave the way for consolidation in the banking sector under the aegis of a few domestic and foreign entities. There are a number of crucial changes relating to bank ownership and control that the amendment bill proposes. First, the draft amendment bill as introduced in Parliament seeks to drop completely Section 12 (2) of the Banking Regulation Act 1949, which states: "No person holding shares in a banking company shall, in respect of any shares held by him, exercise voting rights on poll in excess of ten per cent of the total voting rights of all the shareholders of the banking company." Scrapping this ceiling of 10 per cent on individual voting rights would permit those shareholders holding a stake in excess of 10 per cent to exercise voting rights proportionate to their shareholding. Because of opposition to the clause the bill as finally passed has decided to move one step forward, while retaining a restriction on voting rights that is below the ceiling on equity ownership. It states, "in sub-section (2), the following proviso shall be inserted, namely:— 'Provided that the Reserve Bank may increase, in a phased manner, such ceiling on voting rights from ten per cent to twenty-six per cent.'"

This may seem altogether appropriate. But the original clause has served to ensure diversified ownership in private sector banks, which is crucial since a bank is set up with minimal equity when compared with the deposits it mobilises from the public at large. Expanded equity ownership would allow powerful shareholders with a small absolute stake to control a bank's operations and use depositors' money to advance their own interests or engage in speculation. It was only with liberalisation, especially during the years since 2005, that individual or groups of related shareholders have been permitted to acquire significantly more than 10 per cent of total equity in private banks.

Second, the amendment bill seeks to revise a similar provision relating to public sector banks under the Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970 and 1980. As per Section 2E of that Act no shareholder in a public sector bank, other than the Central Government, "be entitled to exercise voting rights in respect of any shares held by him in excess of one per cent of the total voting rights of all the shareholders." The amendment bill seeks to raise this voting right limit to ten per cent.

Third, the amendment bill seeks to render subject to RBI approval such acquisition of shares by any person acting by "himself or acting in concert with any other person, shares of a banking company or voting rights therein, which acquisition taken together with shares and voting rights, if any, held by him or his relative or associate enterprise or person acting in concert with him, makes the applicant to hold five per cent." While giving the RBI the right of approval the bill makes the process of acquisition of an influential stake in a bank transparent, it also provides the central bank the right to permit such acquisition on a range of grounds varying from public interest or the requirements set by international best practices. Without legislative limits a policy of permitting private majority ownership would be easy to implement when decided on by the government.

Finally, the earlier draft version of the bill had proposed that when mergers and acquisitions occur, resulting in combination and possible consolidation, the process should be kept outside the purview of the Competition Commission. According to the original amendment bill, "nothing contained in the Competition Act, 2002 shall apply to any banking company… in respect of the matters relating to amalgamation, merger, reconstruction, transfer, reconstitution or acquisition." In essence, if as a result of approvals granted by the RBI (whether influenced by the Finance Ministry or not) a process of consolidation begins, that would be unstoppable. Fortunately this change has been blocked and the clause dropped, though the effort to allow mergers without scrutiny is bound to continue given the UPA's obsession with creating two or three banks comparable in size to leading global banks.

The implication of these moves is clear. While the revisions discussed above are embedded in an amendment bill that also seeks to strengthen the RBI's regulatory control over cooperative banks and such other institutions, the former rather than any other revisions being proposed define the principal objective of the bill. This is indeed a major shift in policy reflecting the victory of the liberalisers in government over the regulator (the RBI). It is important to recall here the earlier view of the Reserve Bank. The RBI's Report on Trend and Progress of Banking in India, 2003-04 (Chapter VIII: Perspectives) states, "The concentrated shareholding in banks controlling substantial amount of public funds poses the risk of concentration of ownership given the moral hazard problem and linkages of owners with businesses. Corporate governance in banks has therefore, become a major issue. Diversified ownership becomes a necessary postulate so as to provide balancing stakes."

An instance that illustrates the conflict between the RBI and the government in the past is the saga surrounding a relatively small bank, the Catholic Syrian Bank (CSB). In 1994, Surachan Chansri Chawla and his Bangkok-based Siam Vidhya Group, had acquired 36.18 per cent equity in Catholic Syrian Bank. This private transaction between Chawla and the bank was subsequently approved by the bank's board. The proposal for the acquisition of a stake in CSB by the non-resident Chawla was also approved by the Foreign Investment Promotion Board (FIPB) and the Cabinet Committee on Foreign Investment in early 1997. However, the RBI rejected the Siam Vidhya group's request to transfer the bank's shares to its name. This was because, under the bank ownership norms of the regulator, no single entity can hold more than 10 per cent of total equity in any Indian bank. They were then held in "trust" by the bank and Chawla challenged the decision in court. After much litigation, the Supreme Court had directed the RBI to grant permission for the transfer of shares to the group subject to the condition that it would divest 26.18 per cent shares, after retaining about 10 per cent with it, on or before August 1, 2008. Following the directions of the Supreme Court, the group did divest its excess stake after some delay.

In recent years the government has in a number of cases allowed the acquisition of equity in excess of 10 per cent by single investors in some private banks such as ING Vysya. The amendment being proposed would thus serve multiple purposes. One would be to legitimise prior holdings of more than 10 per cent equity and permit these investors in private banks to exercise voting rights proportionate to their stake. The second would be to permit acquisition of other private banks by new investors, domestic and foreign, on the grounds that these banks need to mobilise capital to strengthen their capital base, to meet the revised Basel III capital adequacy norms. And, the third would be to gradually apply the same principle to the public banks, in whose case spokespersons from both the government and the RBI have declared that they need to go to market to raise additional capital. In sum, the objective of the bill is clearly to permit new entry, consolidation and expanded foreign presence in a sector that is the repository of much of household saving in the country.

For the government the process of freeing entry and control in the banking sector has been a long and painfully slow process. It began as far back as 2004 when the Ministry of Commerce announced a set of decisions with reference to foreign investment in the banking sector, which set the cap on foreign equity in Indian banks at 20 per cent in the case of public sector banks and 74 per cent in the case of private banks.

Consequent to the Ministry of Commerce announcement, the Reserve Bank of India issued a comprehensive set of policy guidelines on ownership of private banks on 2nd July 2004. These guidelines stated among other things that no single entity or group of related entities would be allowed to hold shares or exercise control, directly or indirectly, in any private sector bank in excess of 10 per cent of its paid-up capital. Recognising that the earlier 5th March notification by the Union Government had hiked foreign investment limits in private banking to 74 per cent, the guidelines sought to define the ceiling as applicable on aggregate foreign investment in private banks from all sources (FDI, Foreign Institutional Investors, Non-Resident Indians).

However, in the interests of diversified ownership the 2004 guidelines had declared that no single foreign entity or group could hold more than 10 per cent of equity. There was also a 10 per cent limit set for individual FIIs and an aggregate of 24 per cent for all FIIs, with a provision that this can be raised to 49 per cent with the approval of the Board or General Body. Finally, the 2004 guidelines set a limit of 5 per cent for individual NRI portfolio investors with an aggregate cap for NRIs of 10 per cent, which can be raised to 24 per cent with Board approval. In keeping with its more cautious policy, however, the RBI decided to retain the stipulation under the Banking Regulation Act, Section 12 (2), that in the case of private banks the maximum voting rights per shareholder will be 10 per cent of the total voting rights. The 10 per cent ceiling on equity ownership by a single foreign entity was partly geared to aligning ownership guidelines with the rule on voting rights. Moreover, there is a cap on voting rights for individual investors set at 10 per cent for private banks and 1 per cent for public banks.

This is the policy that the government has sought to change since 2005 and to legislate into law. It has now partially succeeded. The BJP through its former Finance Minister Yashwant Sinha found a rather less significant and dilatory reason to demand the return of the bill to the Committee on Finance. The bill if passed, he argued, will allow banks to trade and speculate in commodity futures markets. But that is hardly the main thrust of the proposed amendments to the banking regulation act of 1949. So the government partly relented and dropped a couple of clauses, in order to push through a bill that would substantially liberalise regulation of the banking sector.

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