

Reserve Bank of India

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

November 27, 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 placed on its website on August 27, 2013 a policy [discussion paper](#) on *Banking Structure in India – The Way Forward*. 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 the 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 finance 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 licence new “small finance 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 draft guidelines for licensing of small banks in the private sector were formulated and released for public comments on July 17, 2014.](#) Based on the comments and suggestions received on the draft guidelines, the following guidelines for licensing of small finance banks in the private sector have been finalised.

II. Guidelines

1. Registration, licensing and regulations

The small finance 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; Deposit Insurance and Credit Guarantee Corporation Act, 1961; other relevant Statutes and the Directives, Prudential Regulations and other Guidelines/Instructions issued by RBI and other regulators from time to time. The small finance banks will be given scheduled bank status once they commence their operations, and found suitable as per Section 42 (6) (a) of the Reserve Bank of India Act, 1934.

2. Objectives

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

3. Eligible promoters

Resident individuals/professionals with 10 years of experience in banking and finance; and Companies and Societies owned and controlled by residents will be eligible as promoters to set up small finance banks. Existing Non-Banking Finance Companies (NBFCs), Micro Finance Institutions (MFIs), and LABs that are owned and controlled by residents can also opt for conversion into small finance banks after complying with all legal and regulatory requirements of various authorities and if they conform to these guidelines. However, joint ventures by different promoter groups for the purpose of setting up small finance banks would not be permitted. As local focus and the ability to serve smaller customers will be the key criteria in licensing such banks, this may be a more appropriate vehicle for local players or players who are focussed on lending to unserved / underserved sections of the society. Accordingly, proposals from large public sector entities and industrial and business houses, including from NBFCs promoted by them, will not be entertained.

Promoter / 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 finance 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 professional experience or of running their businesses, etc. for at least a period of five years.

4. Scope of activities

The small finance bank, in furtherance of the objectives for which it is set up, shall primarily undertake basic banking activities of acceptance of deposits and lending to unserved and underserved sections including small business units, small and marginal farmers, micro and small industries and unorganised sector entities. It can also undertake other non-risk sharing simple financial services activities, not requiring any commitment of own fund, such as distribution of mutual fund units, insurance products, pension products, etc. with the prior approval of the RBI and after complying with the requirements of the sectoral regulator for such products. The small finance bank can also become a Category II Authorised Dealer in foreign exchange business for its clients' requirements. It cannot set up subsidiaries to undertake non-banking financial services activities.

The annual branch expansion plans of the small finance banks for the initial five years would need prior approval of RBI. The annual branch expansion plans should be in compliance with the requirement of opening at least 25 per cent of its branches in unbanked rural centres (population upto 9,999 as per the latest census).

There will not be any restriction in the area of operations of small finance banks; however, preference will be given to those applicants who in the initial phase set up the bank in a cluster of under-banked States / districts, such as in the North-East, East and Central regions of the country. These applicants will not have any hindrance to expand to other regions in due course. It is expected that the small finance bank should primarily be responsive to local needs. After the initial stabilisation period of five years, and after a review, RBI may liberalize the requirement of prior approval for annual branch expansion plans and scope of activities of the small finance banks.

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.

The small finance bank will be required to use the words "Small Finance Bank" in its name in order to differentiate it from other banks.

5. Capital requirement

The minimum paid-up equity capital for small finance banks shall be Rs. 100 crore. In view of the inherent risk of a small finance 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. Tier I capital should be at least 7.5 per cent of RWAs. Tier II capital should be limited to a maximum of 100 per cent of total Tier I capital. As small finance banks are not expected to deal with sophisticated products, the capital adequacy ratio will be computed under Basel Committee's standardised approaches.

6. Promoter's contribution

The promoter's minimum initial contribution to the paid-up equity capital of such small finance bank shall at least be 40 per cent. If the initial shareholding by promoter in the bank is in excess of 40 per cent, it should be brought down to 40 per cent within a period of five years. The promoter's minimum contribution of 40 per cent of paid-up equity capital shall be locked in for a period of five 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 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 subject to the initial minimum shareholding of promoters and a time frame for listing of the bank will be preferred. However, after the small finance bank reaches the net worth of Rs.500 crore, listing will be mandatory within three years of reaching that net worth. However, small finance banks having net worth of below Rs.500 crore could also get their shares listed voluntarily, subject to fulfillment of the requirements of the capital markets regulator.

7. Foreign shareholding

The foreign shareholding in the small finance bank would be as per the Foreign Direct Investment (FDI) policy for private sector banks as amended from time to time. As per the current FDI policy, the aggregate foreign investment in a private sector bank from all sources will be allowed upto a maximum of 74 per cent of the paid-up capital of the bank (automatic upto 49 per cent and approval route beyond 49 per cent to 74 per cent). At all times, at least 26 per cent of the paid-up capital will have to be held by residents. In the case of Foreign Institutional Investors (FIIs) / Foreign Portfolio Investors (FPIs), individual FII / FPI holding is restricted to below 10 per cent of the total paid-up capital, aggregate limit for all FIIs / FPIs / Qualified Foreign Investors (QFIs) cannot exceed 24 per cent of the total paid-up capital, which can be raised to 49 per cent of the total paid-up capital by the bank concerned through a resolution by its Board of Directors followed by a special resolution to that effect by its General Body. In the case of NRIs, the individual holding is restricted to 5 per cent of the total paid-up capital both on repatriation and non-repatriation basis and aggregate limit cannot exceed 10 per cent of the total paid-up capital both on repatriation and non-repatriation basis. However, Non-Resident Indian (NRI) holding can be allowed upto 24 per cent of the total paid-up capital both on repatriation and non-repatriation basis provided the banking company passes a special resolution to that effect in the General Body.

8. Voting rights and transfer/acquisition of shares

As per Section 12 (2) of the Banking Regulation Act, 1949, any shareholder's voting rights in private sector banks are capped at 10 per cent. This limit 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 paid-up share capital in a private sector bank will require prior approval of RBI. This will also apply to the small finance banks.

9. Prudential norms

The newly set up small finance banks should ensure that they put in place a robust risk management framework. The small finance 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. No forbearance would be provided for complying with the statutory provisions.

In view of the objective for which small finance bank will be set up, it will be required to extend 75 per cent of its Adjusted Net Bank Credit (ANBC) to the sectors eligible for classification as priority sector lending (PSL) by RBI. While 40 per cent of its ANBC should be allocated to different sub-sectors under PSL as per the extant PSL prescriptions, the bank can allocate the balance 35 per cent to any one or more sub-sectors under the PSL where it has competitive advantage.

The maximum loan size and investment limit exposure to a single and group obligor would be restricted to 10 per cent and 15 per cent of its capital funds, respectively. Further, in order to ensure that the bank extends loans primarily to small borrowers, at least 50 per cent of its loan portfolio should constitute loans and advances of upto Rs.25 lakh.

After the initial stabilisation period of five years, and after a review, RBI may relax the above exposure limits.

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 finance bank is precluded from having any exposure to its promoters, major shareholders (who have shareholding of 10 per cent of paid-up 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/MFI/LAB, if it meets the conditions under these guidelines, could apply to convert itself into a small finance 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 or it shall infuse additional paid-up equity capital to achieve net worth of Rs. 100 crore. It may be noted that on conversion into a small finance bank, the NBFC / MFI will cease to exist and all its business which a bank can undertake should fold into the bank and the activities which a bank cannot statutorily undertake be divested / disposed of. Further, the branches of the NBFC / MFI should either be converted into bank branches or be merged / closed as per the business plan. The small finance bank and the NBFC / MFI cannot co-exist.

Banks are precluded from creating floating charge on their assets. For such NBFCs / MFIs, which succeed in obtaining licences to convert into small finance banks, if they have created

floating charges on their assets for secured borrowings which stand in their balance sheets on the day of conversion into a bank, RBI will permit grandfathering of such borrowings till their maturity, subject to imposition of additional capital charge in order to protect the interest of the depositors.

If the existing NBFCs / MFIs / LABs have diluted the promoters' shareholding to below 40 per cent, but above 26 per cent, due to regulatory requirements or otherwise, RBI may not insist on the promoters' minimum initial contribution as indicated in paragraph 6 of the guidelines.

11. Business plan

The applicants for small finance 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 finance banks and in the case of an NBFC / MFI applicant, how the existing business of NBFC / MFI will fold into the bank or divested / disposed of. 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 finance 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. If a promoter setting up a small finance bank desires to set up a Payments Bank, it should set up both types of banks under a Non-Operative Financial Holding Company (NOFHC) structure. However, a promoter will not be granted licences for both universal bank and small finance bank even if the proposal is to set them up under the NOFHC structure.
- ii. Individuals (including relatives) and entities other than the promoters will not be permitted to have shareholding in excess of 10 per cent of the paid-up equity capital of the bank. In case of existing NBFCs / MFIs / LABs converting into small finance bank, where there is shareholding in excess of 10 per cent of the paid-up equity capital by entities other than the promoters, RBI may consider providing time upto 3 years for the shareholding to be brought down to 10 per cent.
- iii. The small finance bank cannot be a Business Correspondent (BC) for another bank. However, it can have its own BC network.
- iv. The operations of the bank should be technology driven from the beginning, conforming to generally accepted standards and norms; while new approaches

- (such as for data storage, security and real time data updation) are encouraged, a detailed technology plan for the same should be furnished to RBI.
- v. The bank should have a high powered Customer Grievances Cell to handle customer complaints. The small finance banks will come under the purview of RBI's Banking Ombudsman Scheme, 2006.
 - 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. Transition path

The small finance bank may choose to continue as a differentiated bank. If it aspires to transit into a universal bank, such transition will not be automatic, but would be subject to it applying to RBI for such conversion and fulfilling minimum paid-up capital / net worth requirement as applicable to universal banks; its satisfactory track record of performance as a small finance bank for a minimum period of five years and the outcome of RBI's due diligence exercise. On transition into a universal bank, it will be subjected to all the norms including NOFHC structure as applicable to universal banks.

15. 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 business plan as per paragraph 11 and other requisite information as per the Annex. Applications for setting up of small finance banks in the private sector, along with other details as mentioned above, contained in an envelope superscribed "Application for Small Finance Bank" should be addressed to:

The Chief General Manager,
Department of Banking Regulation,
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 January 16, 2015. After experience gained in dealing with small finance banks, applications will be received on a continuous basis. However, these guidelines are subject to periodic review and revision.

16. 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 eighteen months from the date of granting such in-principle approval and would thereafter lapse automatically. Therefore, the bank will have to be set up within eighteen months 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 finance banks in the initial years, and with experience gained, may suitably revise the approach.
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Additional information to be furnished

I. Existing Structure

1. Information on the individual promoter :
 - a. Name of the promoter, date of birth, residential status, parents' names, PAN No., branch and bank account details including the credit facilities.
 - b. Detailed information on the background and experience of the individual promoter, his/her expertise, track record of business and financial worth, details of promoter's direct and indirect interests in various entities/companies/industries, etc.

2. Information on the entity promoting the bank :

Shareholding pattern of the promoter entity, Memorandum and Articles of Association and financial statements of the promoter entity for the past five years (including a tabulation of important financial indicators for the said years), and income tax returns for last three years.

3. Information on the individuals and entities in the promoter group :
 - a. Names of the individuals and entities, details of shareholding, management and corporate structure of all the entities, a pictorial organogram indicating the structure, shareholding and total assets of the entities.
 - b. Annual reports of the past five years of all the group entities.
 - c. Tabulation of names of all the individuals and entities in the promoter group (including financial, non-financial and overseas entities) with details of date of incorporation, Registered Office address, activity of the entity, PAN No., TAN No., CIN No., income tax circle to which the entity belongs, account number, branch and bank account details of the entities including the credit facilities and regulators of the entity (registration details in the case of entities regulated by SEBI), details of listing (on stock exchanges) of the entities in the group.

II. Proposed Structure

1. The applicants should furnish detailed information about the persons/entities, who would subscribe to 5 per cent or more of the paid-up equity capital (shareholding pattern) of the proposed bank, including foreign equity participation, in the proposed bank and the sources of capital of the proposed investors.
2. The proposed promoter shareholding and plan for dilution of promoter shareholding in compliance with the guidelines.

III. Project Report

A project report covering business potential and viability of the proposed bank, the proposed area of operation, the business plan¹, any other financial services proposed to be offered, plan for compliance with prudential norms on CRR/SLR², composition of loan portfolio, priority sector, etc. as per the guidelines, and any other information that is considered relevant. The project report should give as much concrete details as feasible, based on adequate ground level information and avoid unrealistic or unduly ambitious projections. The business plan should address how the bank proposes to achieve financial inclusion³ and in the case of an NBFC / MFI applicant, how the existing business of NBFC / MFI will fold into the bank or divested / disposed of.

IV. Any other information

The promoters may furnish any other relevant information and documents supporting the applications. Further, the RBI may call for any other additional information, as may be required, in due course.

¹ Business plan should, *inter alia*, include (but not limited to), the underlying assumptions, the existing infrastructure/ network/ branches, and the proposed product lines, target clientele, target locations, usage of technology, risk management, plans relating to human resources, branch network, alternative points of presence, opening of branches in unbanked rural areas, priority sector compliance, financial projections for five years, etc.

² In case of NBFC applicants, information on existing CRR / SLR requirement, projected CRR / SLR requirement and plan for compliance with statutory norms on CRR / SLR may be given.

³ Financial Inclusion Plan should include (but not limited to), details of joint venture or partnership for offering financial inclusion products, promoting financial literacy, achieving the objective of small finance banks, etc.