Tactful Management Research Journal
Vol. 2 | Issue. 10 | July 2014
ISSN :2319-7943
Impact Factor : 1.5326 (UIF)

ORIGINAL ARTICLE

OWNERSHIP ISSUES IN PRIVATE SECTOR BANKS

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Abstract:

The Indian banking sector has emerged as one of the strongest drivers of India's economic growth. It has a large geographic and functional coverage. The sector has undergone significant developments and investments in the recent past. Here commercial banks cater to short and medium term financing requirements, while national level and state level financial institutions meet longer-term requirements. Banking industry in India has also achieved a new height with the changing times. In 2013 RBI issued a fresh set of regulations which would govern the licensing of banks in future. There are some significant differences with the 2004 regulations. Present study focuses on the various issues connected with the ownership of private banks and its implications on its governance.

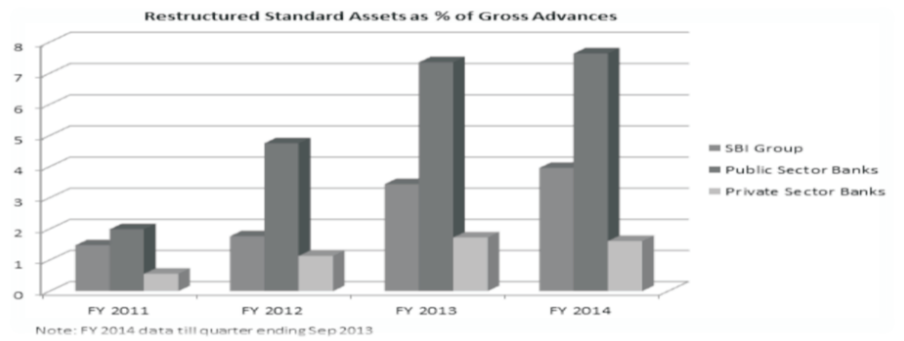
KEYWORDS:

Private sector Banks, Ownership Regulation, Authorized Bank Investors.

INTRODUCTION:

The Indian financial system has made impressive strides in resource mobilization, geographical and functional reach, financial viability, profitability and competitiveness, since nationalization of banks in 1969 and liberalization of economic policies since early 1990s. With the penetration of banks into the nook and corner of the country, the average population per branch office (APPBO) declined from about 64,000 in 1969 (as per 1961 census) to about a fifth of that number - 12,400 now as per 2001 census. The private sector banks have a share of about 18 per cent of the total banking assets in India. The existing 13 old private sector banks, which have been in existence much before the Banking Regulation Act was enacted in 1949, together with the 7 new private sector banks, have been growing at 20 per cent. However, the performance of the old private sector banks was not so impressive in the areas of branch expansion compared to their new peers in the private sector. While 13 old private sector banks together had 5,555 branches, 7 new private sector banks had 7,857 branches as on March 31, 2012.

Please cite this Article as : Madhu Iyengar[1] and Vijaylaxmi Iyengar[2] , "OWNERSHIP ISSUES IN PRIVATE SECTOR BANKS" : Tactful Management Research Journal (July ; 2014)



Graph-1 RESTRUCTURED ASSETS

Source: Report of the Committee to Review Governance of Boards of Banks in India (2014)

Governance issues in private sector banks originate from a different set of considerations to those applicable to public sector banks. Several of the fetters which constrain public sector banks, the structure of the board governance problem therefore gets articulated differently: There are issues that arise from ownership constraints stipulated by RBI, and others which arise from the boards themselves.

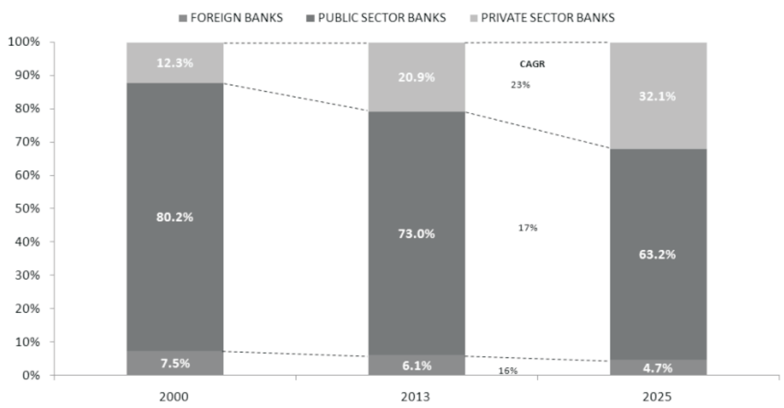
OWNERSHIP STRUCTURE IN THE INDIAN BANKING SECTOR

During the liberalization period a more liberal entry of private and foreign banks was allowed, as a result of which the total number of banks in the industry increased and the ownership structure of the Indian banking sector changed somewhat in the first few years post liberalization, due to the entry of new banks, the number of private sector banks first increased in the mid-1990s, but since then the number has declined due to mergers or closures. The number of foreign banks increased steadily through the 1980s, and mid 1990s, and then declined. The total number of banks peaked at 105 in the mid-1990s but by 2007 the number had declined to 82, which was only marginally higher than their number in the early 1990s when liberalization had started.

OBJECTIVE OF THE STUDY: To study the ownership issues in private sector banks

METHODOLOGY: The paper is non-empirical and based on the reports of RBI and presented through graphical representations and tables.

RELATED STUDY



Graph-2 Estimates of market share based on linear projection

Source: Report of the Committee to Review Governance of Boards of Banks in India (2014)

J. Sarkar (2013), the market share of the public sector banks will decline from 80 per cent in 2000 to just over 60 per cent in 2025. Second, the market share of private sector banks is projected to rise to about a third by 2025 from just over 12 per cent in 2000. Third, the foreign banks are projected to continue to remain marginal players in the market for bank assets. These projections suggest a very significant transformation in market structure over a quarter century.

J. Sarkar (2010), 'Ownership and Corporate Governance in Indian Firms', Journal of Corporate Governance: An Emerging Scenario, argues that the pervasiveness of insider control in Indian corporates has persisted, and that outside block holders seldom have controlling stakes or the ability to act as a countervailing force against insiders, although 'the picture is somewhat better for larger firms'.

R. Chung, M. Kim and J. Kim (2002) in 'Institutional investors and opportunistic earnings management', Journal of Corporate Finance, examine whether large institutional shareholdings in a firm deter earnings management in reported profits. Using discretionary accounting accruals as the measure of earnings management, the study finds that the presence of large institutional shareholdings inhibits the altering of reported profits towards the managers' desired level, and thereby contributes to improved governance.

J. Sarkar and S. Sarkar, (2000),' Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India'. International Review of Finance, examine the impact of block shareholders in Indian companies. They point to a non-linearity in the impact of foreign institutional investors: as their shareholding proportion rises in companies, so does the value of the firm, but that this effect becomes more pronounced once the extent of holding crosses 25 per cent. In contrast they find that government controlled institutional investors have no positive impact on company value.

OWNERSHIP ISSUES IN PRIVATE SECTOR BANKS

1. EXISTING OWNERSHIP REGULATION

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Until 2004 there was no ownership restrictions imposed on private sector banks. The changes imposed in that year, further buttressed in 2005, introduced a 5 per cent equity cap on a single financial investor, which could be enhanced to 10 percent with RBI approval. Promoters or controlling shareholders were also expected to reduce their holdings to not more than 10 per cent. Diversification of ownership appeared to follow a US-UK tradition, which also meant that business houses could not take dominant stakes in, and thereby exercise significant control of, banks. This was in contrast to the tradition of business conglomerates controlling banks through keiretsus in Japan and chaebols in South Korea. The Japanese-Korean model seemed very discredited after the Asian financial crisis of 1997-98.

However the financial crisis of 2008 which affected banks in the US, the UK and several parts of Europe suggests that the Anglo-Saxon model did not necessarily lead to better governance in banks. Risk mitigation, an aspect of governance in bank boards, certainly appeared to have collapsed, threatening several well-known banks with bankruptcy. It is therefore legitimate to ask whether placing stringent limits on bank ownership in India serves desirable governance imperative.

In 2013 RBI issued a fresh set of regulations which would govern the licensing of banks in future. There are some significant differences with the 2004 regulations. New banks would henceforth need to be owned by non-operative financial holding companies (NOFHCs) with promoters forbidden from holding direct stakes in these banks; a higher minimum capital adequacy of at least 13 per cent has been demanded; all bank-type lending businesses conducted within a promoter group through any financial services company (including a non-banking finance company) would need to be merged with the bank licensed; initial NOFHC equity would need to be at least 40 per cent for 5 years, and no more than 20 per cent within 10 years and 15 per cent within 12 years; and foreign investment would be restricted to 49 per cent in the first five years.

While it is legitimate to ask how two sets of guidelines applicable to private sector banks can constitute a level regulatory playing field, it must be presumed that RBI will tighten regulation for existing private sector banks to converge to the 2013 guidelines. Not all of this will be immediately feasible (for instance the setting up of NOFHCs for existing banks) but RBI would do well to minimise the dissonance rapidly. In some ways this regulatory duality reinforces the patchwork nature of bank regulation, segmented by differing licensing regimes based on ownership and history. The one-license regime advocated in Recommendation 4.8 therefore benefits banks in both the public and private sector.

2. OWNERSHIP REGULATIONS IN OTHER JURISDICTIONS

We examine four jurisdictions, of which three are in Asia. In Indonesia, a 25 per cent stake is

defined as a controlling stake, requiring central bank approval. Non-controlling stakes, lower than 25 per cent, face no other constraints and are permitted without approval. This freedom is permitted for overseas investors as well. In Japan, the threshold is defined as applicable to a major shareholder, and is pegged at 20 percent or 15 per cent if the shareholder has material influence. Major shareholders need central bank approval, while others do not, including those from overseas. Thus the threshold is 15 per cent if control is sought to be exercised, and 20 per cent in other situations as for instance in a purely financial investment.
In South Korea, the norms are more nuanced, and differentiate between a non-financial business (termed NBFOs) and a financial business. NBFOs can own up to 4 per cent freely, but can go up to 9 per cent with central bank approval. Financial businesses can go up to 10 per cent freely, but can also go higher with successive approvals to get beyond 10, 25 and 33 per cent. In Germany, there appear to be no specific regulations limiting controlling or major shareholding in banks.

3 AUTHORISED BANK INVESTORS

If India's private sector banks are to grow, it appears desirable that they be permitted to access pools of capital available in India and elsewhere without imposing excessively narrow investment limits. When individual holdings are small and shareholders are diffused, they also tend to be disengaged. Allowing larger individual blocks of shareholding helps to correct this, and is generally good for governance. It is therefore proposed that RBI permit greater investment flexibility to a category termed Authorised Bank Investors (ABIs), defined to include all funds with diversified investors which are discretionally managed by fund managers and are deemed fit and proper

4 FIT AND PROPER

RBI has been assiduous, in its periodic circulars, in recommending that boards follow the notion of 'fit and proper' in its identification of investors and of board directors. Despite certain principles laid out by RBI, their applicability to specific contexts could lack precision.48 there are two issues meriting discussion. At a minimalist level, fit and proper is an exclusion criterion. Potential directors convicted of fraud or incoming investors who have been subject to major criminal penalties can be argued to be not fit and proper. This minimalist interpretation signifies who should be excluded rather than included.

But bank boards need to aim higher as an inclusion category, seeking talented professionals on boards and reputed investment funds as shareholders, for the governance and reputation gains which these would bring the bank. Reputed investment funds ask demanding questions of bank managements, and are known to exit when answers are unsatisfactory. Talented directors similarly improve board governance. Fit and proper cannot be the criterion for such inclusion, and needs to move to a more demanding threshold. Nevertheless, as an exclusion criterion the concept has utility, though RBI would need to be vigilant that it is not misused. It may also be impractical to expect a detailed due-diligence to be conducted by RBI or banks prior to investment. If however RBI concludes at any stage, based on information brought before it, that an investor in a bank is not fit and proper, RBI would have the right to freeze the investor's voting rights and seek disinvestment from the bank within a specified period after giving the shareholder the opportunity of being heard. As the initial onus of being regarded as fit and proper therefore falls on the investor, RBI should consider providing an informal guidance service to investors on whether any past regulatory or other action against an investor could affect its fit and proper categorization.

Based on the above issues, the following three Recommendations are proposed:

Recommendation 1: RBI should designate a specific category of investors in banks as Authorised Bank Investors (ABIs), defined to include all funds with diversified investors which are discretionally managed by fund managers and are deemed to be fit and proper. ABIs would therefore include pension funds, provident funds, long-only mutual funds, long-short hedge funds, exchange-traded funds and private equity funds (including sovereign wealth funds) provided they are diversified, discretionally managed and found to be 'fit and proper'. ABIs would exclude all proprietary funds (including those which are hedge funds or set up by corporates), non-banking finance companies and insurance companies.

Recommendation 2: A single ABI should be permitted a maximum 20 per cent investment stake in a bank without regulatory approval provided it possesses no right to appoint a board director. An ABI which is given board representation, and thereby exercises a measure of influence, should be permitted a lower 15 per cent maximum investment limit without regulatory approval. Every other investor should be permitted no more than 10 per cent without regulatory approval.

Recommendation .3: It would be impractical for either RBI or a bank to conduct a prior scrutiny on whether an investor is 'fit and proper' before an investment occurs. If, however, at any stage and based on information laid before it, RBI concludes that an investor in a bank is not fit and proper, RBI would be entitled to freeze the investor's voting rights in the bank and to seek its disinvestment within a specified time period. As the initial onus of belief in being fit and proper therefore falls on the investor, RBI should also consider offering an informal guidance service on whether past regulatory or other action against an investor would disqualify categorisation as fit and proper.

5 MATERIAL INVESTORS

Material investors in banks include both promoters who set up banks and others who exercise some measure of influence in the board by nominating a director. The earlier discussion proposed a framework for limiting investment by ABIs who also exercise influence. But there could be other categories of investors as well who exercise influence. The 2013 regulations require that promoters of banks would need an initial minimal holding of 40 per cent, and that within 10 years this would need to be lowered to 20 per cent and within 12 years to 15 per cent.

The rationale for the insistence on lowering the investment limit on a continuing basis is presumably that banks should become broad-based after some years, though it must be observed that there appears to be no such requirement in the other jurisdictions within Asia discussed earlier. It must also be observed that if the maximum shareholding for promoter investors is set very low, the alignment of incentives between shareholders and managements could weaken, and banks could be more vulnerable, as managements could then be primarily concerned with their own interests rather than those of shareholders. This is a fundamental corporate governance problem across all companies, but RBI could be in danger of exacerbating it in relation to banks by asking for a significant dilution to as low as 15 per cent.49 A higher limit of 25 per cent appears desirable, particularly in view of the separate recommendation now made that ABI investment could go up to 20 per cent.

The above issue motivates the following Recommendation:

Recommendation 4: For promoter investors other than ABIs it is proposed that the continual stake ceiling be raised to 25 per cent.

Summarizes the ceiling on bank stakes held by different categories of bank investors. Any investor who gets a board seat would be categorized as a material investor

Category of Investor	Maximum stake (%)
Promoter (Continuing stake)	25
ABI without influence	20
ABI with influence	15
Other Investors	10

Table-1 CEILING ON BANK STAKES HELD BY DIFFERENT CATEGORIES OF INVESTORS

Source: Report of the Committee to Review Governance of Boards of Banks in India (2014)

6 LISTING OF BANKS

There are presently four unlisted private sector banks. Listing introduces a new layer of shareholder accountability and therefore of governance, and it has been RBI policy to encourage early listing. The 2013 guidelines for new private sector banks, for instance, mandate that banks should list within three years of commencing business.

From a capital market prospective the time of listing must depend on several factors ;whether the bank has management skills and the competitive positioning to create value for incoming shareholders (difficult to gauge in three years); whether there will be adequate market interest in the stock (often dependent on overall market trends, difficult to compress with certainty into the final months of a three year window); and the recent financials of the bank and their likely future trajectory (particularly if the financials are poor in the initial years). Further, 'good governance' promoters of companies (including banks) may wish to grow their businesses slowly and cautiously, their ability to generate value in their investments within such a short period is compromised, and such promoters are-short-changed by early listing; equally, the ability of 'poor governance' promoters to justify selling quickly is enhanced, and minority shareholders are subsequently shortchanged. It is therefore puzzling as to why RBI has argued in favour early listing from a governance standpoint as premature listing could be damaging to incoming minority shareholders' interests. Asymmetric information between a company management and incoming investors at the stage of the initial public offering is acute: if existing governance at the time of listing is indifferent, but not perceived as such by the market, minority shareholders generally fare poorly.

It therefore appears desirable that the time of listing should be entirely at the discretion of the bank management, and not be subject to any regulatory pressure, whether in the case of the existing unlisted banks or the banks licensed under the 2013 guidelines. It leads to the following

Recommendation 5: It would be inappropriate for regulation to stipulate a period within which banks should be listed, particularly from a governance perspective, as premature listing could be
Injurious to minority share holder interests

7 CAPITALS FOR DISTRESSED BANKS

If a bank becomes distressed because of an escalation in bad debts, its need for capital rises sharply merely to meet regulatory norms on adequate capital. Existing policy appears to show no special dispensation for such banks, and it is presumed that a stronger bank would take it over. However, elsewhere in Asia, and particularly after the Asian crisis of 1997-98, regulation has permitted long-term funds to take controlling stakes in such distressed banks. These are typically private equity funds, including sovereign wealth funds. Indonesia and South Korea are examples of countries which have encouraged this, thereby bringing in much needed capital and, through a new management, turning round the banks.

Purely for distressed banks, such a strategy for India would be very helpful. RBI would need to maintain a list of such private sector banks on a continual basis and to discreetly advise the banks of its willingness to permit larger control blocks to be brought in.

If the strategy is to be successfully executed, the control blocks would need to be significant. It is proposed that private equity funds, including sovereign wealth funds but excluding all other ABIs, be permitted to take up to a 40 per cent controlling stake.

The justification for permitting private equity funds to invest in distressed banks through such transactions lies in their long average investment duration and their proven record of having done so in other jurisdictions. It leads to the following Recommendation:

Recommendation .6: For banks identified by RBI as distressed, it is proposed that private equity funds, including sovereign wealth funds, be permitted to take a controlling stake of upto 40 per cent. Permitting larger block holdings than at present in the manner proposed above will not lead to incoming investment transactions unless shareholders have voting rights in proportion to their shareholding. The maximum voting rights were earlier pegged at 10 per cent, but an amendment in 2012 has enabled raising this to 26 per cent. RBI has hitherto not issued regulations in accordance with the legislative change. It is unclear how not permitting voting rights in proportion to shareholding can constitute good regulatory practice, and this leads to the following Recommendation:

Recommendation 7: The principle of proportionate voting rights should constitute part of the regulatory bedrock which fosters good bank governance, as it aligns investors' powers in shareholder meetings with the size of their shareholding. It is therefore desirable for RBI to raise the limit for voting rights to 26 per cent, in accordance with legislative changes recently enacted. It is also desirable to further amend legislation to remove all constraints on voting rights in order to align it with company law.

8 ENTREPRENEUR-LED BANKS

India's experience with entrepreneur-led banks has been mixed, but there are countries where such banks commonly exist. The US and Hong Kong (the latter with its family owned bank) are jurisdictions such banks are plainly visible. Several existing public sector banks started Entrepreneur-Led Banks and-evidence of this is to be also found in the old private sector banks. In particular, where entrepreneurs have displayed the ability to run other financial services businesses successfully by handling risk management well; there is greater confidence in their ability to run banks as well. This could be one channel for the licensing of new banks.

In Entrepreneur-Led Banks there could however be a major governance issue. The entrepreneur is the controlling shareholder in the bank, but could also come in as the bank's CEO. In other banks there is a separation between ownership and management, but this would be absent in Entrepreneur-Led Banks board independence which requires board to act in the interest of all shareholders and not just the share holders could be compromised. It is therefore often suggested that in such banks, the entrepreneur-investor ought not to be permitted to become the bank's CEO. It must be recognised, however, that this argument would negate the very rationale of professionally qualified and experienced entrepreneurs starting banks, for the drive to run a bank would often underpin an investor's interest in injecting capital into the bank.

An alternative mechanism would be for RBI to retain confidence that such boards are adequately independent. If in an entrepreneur-led bank the board commands little credibility that it is is adequately independent with professionals of high standing, then there is a serious issue of board independence and therefore of governance; in such cases, permitting the controlling shareholder to remain as the CEO risks misgovernance. Where however the bank board is well diversified and commands credibility for its independence, there need be no misgivings on the controlling shareholder remaining the CEO.

Recommendation 8: Where the principal shareholder in an entrepreneur-led bank is also the bank's CEO, RBI should satisfy itself that the board is adequately diversified and independent, with professionals of high standing. Where RBI lacks confidence of such independence, the controlling shareholder should be asked to step down as CEO.

CONCLUSION

The pre and post liberalization era has witnessed various environmental changes which directly affects the aforesaid phenomena. It is evident that post liberalization era has spread new colors of growth in India. The present study findings focused that the governance issues in private sector banks originate from a different set of considerations to those applicable to public sector banks. Several of the fetters which constrain public sector banks. The structure of the board governance problem therefore gets articulated differently: There are issues that arise from ownership constraints stipulated by RBI, and others which arise from the boards themselves.

For new private sector banks to reach the magnitude of public sector banks it would still take a long time and in many cases, for the new private sector banks, their attention to details and providing customer satisfaction seem to be the main impetus rather than growing in magnitude. When it comes to managing operations efficiently, the new private sector banks have done a better job and this is reflected in their lower operating cost ratio and higher Return on Assets (for the sample excluding the State Bank of India and its seven associates). The smaller and well managed network of these banks is partially responsible for this but, the automation process followed by them and the modernisation drive implemented by many of them have helped them to cut their costs and this provides them with the competitive edge.

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