SETTING UP OF A SMALL FINANCE BANK

- 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).**

- 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.

- SFB 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 decided to licence new "small finance banks", in the private sector.

OBJECTIVE OF A SMALL FINANCE BANK

a) provision of **savings vehicle and primarily to unserved and underserved sections of the population** and,

b) supply of credit to small business units, small & marginal farmers; micro and small industries and other unorganized sector entities through high technology & low-cost operations.

REGISTRATION, LICENSING AND REGULATIONS

- A small finance bank is registered as a **public limited company under the Companies Act, 2013.**

It is 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 SFB are 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.

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ELIGIBLE PROMOTERS

- Resident individuals/professionals with 10 years of experience in banking and finance and Companies and Societies owned and controlled by **residents are eligible as promoters to set up small finance banks.**

- Existing Non-Banking Finance Companies (NBFCs), Micro Finance Institutions (MFIs), and Local Area Banks (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.

- 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 assesses 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.**

SCOPE OF ACTIVITIES

a) 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 unorganized sector entities.**

b) 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

c) The small finance bank can also become a Category I - Authorized Dealer in foreign exchange business for its clients' requirements.

d) It **cannot set up subsidiaries** to undertake non-banking financial services activities.

EXPANSION OF BRANCHES

- The annual branch expansion plans of the SFB 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 percent of its branches in**

unbanked rural centres (population up to 9,999 as per the latest census).

- There is no restriction in the area of operations of small finance banks; however, preference is 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.**

Bank's name

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

CAPITAL REQUIREMENT

- The minimum paid-up equity capital for small finance banks has been prescribed at **Rs. 100 crores**.
- it is required to maintain a **minimum capital adequacy ratio of 15 percent 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 percent of RWAs.
- Tier II capital should be limited to a maximum of 100 per cent of total Tier I capital

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CAPITAL ADEQUACY FRAMEWORK

Minimum Capital Requirement	15%
Common Equity Tier 1	6%
Additional Tier I	1.5%
Minimum Tier I capital	7.5%
Tier 2 capital	7.5%
Capital Conservation Buffer	Not Applicable
Countercyclical capital buffer	Not Applicable
Pre-specified Trigger for conversion of AT1	CET1 at 6% up to March 31, 2019, and 7% thereafter

LEVERAGE RATIO

Leverage Ratio	4.5%	Calculated as percentage of Tier I capital to Total Exposure

Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)

LCR, as applicable to scheduled commercial banks, will be applicable to small finance banks. The transition period for the SFBs for achieving the prescribed level of LCR would be as follows:

	Till Dec, 31, 2017	By Jan 1, 2018	By Jan 1, 2019	By Jan 1, 2020	By Jan 1, 2021
Min LCR	60%	70%	80%	90%	100%

NSFR will be applicable to small finance banks on par with scheduled commercial banks as and when finalized.

PROMOTER'S CONTRIBUTION

- The promoter's minimum initial contribution to the paid-up equity capital of such a small finance bank should be **at least 40%.**
- If the initial shareholding by promoters 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 percent of paid-up equity capital should 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**.
- However, after the small **finance bank reaches the net worth of 7 500 crore, listing will be mandatory within three years of reaching that net worth**.

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 up to a **maximum of 74 per cent of the paid-up capital of the bank**

- 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 percent 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**

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%.**

- This limit can be raised to 26 per cent in a phased manner by the RBI.

PRUDENTIAL NORMS

- SFB will be set up, it will be required **to extend 75% of its ANBC** to the sectors eligible for **classification as priority sector lending (PSL) by RBI.**

- **While 40% 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% & 15% of its capital funds, respectively.**

- The bank extends loans primarily to small borrowers, **at least 50% of its loan portfolio should constitute loans & advances of up to ₹25 lakh.**

ADDITIONAL CONDITIONS FOR NBCs/MFIs/LABs CONVERTING INTO A BANK

- An existing NBFC/MFI/LAB, if it meets the conditions under these guide-lines**, 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 should have a minimum net worth of ₹100 crore or **it should infuse additional paid-up equity capital to achieve a net worth of ₹100 crore**.

- The **small finance bank and the NBFC/MFI cannot co-exist.**

- 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 prescribed.**

BUSINESS PLAN

- The applicants for SFB licenses are **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 SFBs** 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 license, RBI may consider **restricting the bank's expansion, effecting change in management and imposing other penal measures as may be necessary.**

CORPORATE GOVERNANCE

- The Board of the small finance bank should have **a majority of independent Directors.**
- The bank should comply with the corporate governance guidelines including 'Fit and proper' criteria for Directors as issued by RBI from time to time.

a) Constitution and functioning of board of directors

The extant provisions as applicable to banking companies shall be applicable to FBs as well.

b) **Constitution and functioning of committees of the board, management level committees, remuneration policies**

The extant provisions in this regard as applicable to private sector banks, shall be applicable to SFBs as well.

OTHER CONDITIONS FOR SETTING UP OF FBs

- 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.**

- Individuals (including relatives) and entities other than the **promoters will not be permitted to have shareholding in excess of 10% 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%** of the paid-up equity capital by entities other than the promoters, RBI may consider providing **time up to 3 years for the shareholding to be brought down to 10%**

- 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.

TRANSITION PATH

- 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.

PROCEDURE FOR APPLICATION FOR SETTING UP A SMALL FINANCE BANK

Existing Structure

a) **Information on the individual promoter:**

- Name of the promoter, date of birth, residential status, parents' names, PAN Number, branch and bank account details including the credit facilities availed.
- 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.

b) **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** and income tax returns for last three years.

c) **Information on the individuals and entities in the promoter group:**

- Annual reports of all the group entities for the past five years.
- Tabulation of names of all the individuals and entities in the promoter group (including financial, non-financial and overseas entities)

OTHER STIPULATIONS FOR SFBs

Inter-bank borrowings

- SFBs will be allowed exemption from the existing regulatory ceiling on inter-bank borrowings till the existing loans mature or up to three years, whichever is earlier.

Investment classification and valuation norms

The extant provisions in this regard as applicable to scheduled commercial banks will be applicable to SFBs as well.

Restrictions on loans and advances (including lending to NBFCs) including regulatory limits

The extant provisions in this regard as applicable to scheduled commercial banks will be applicable to SFBs as well.

Income recognition, asset classification and provisioning norms on advances including that for restructuring of credit facilities

The extant provisions in this regard as applicable to scheduled commercial banks will be applicable to SFBs as well.

Para-banking activities

(i) SFBs are **not permitted to undertake any para-banking activity except that allowed as per the Licensing Guidelines** and the related FAQs issued.

(ii) SFBs are **permitted to use Interest Rate Futures (IRF)** for the purpose of proprietary hedging.

Risk management

- As the **risks and risk management techniques for SFBs** will be on par with the **scheduled commercial banks,**
- the extant provisions in this regard **as applicable to scheduled commercial banks,** shall be applicable to SFBs as well.

CRR, SLR, disclosures and statutory/regulatory reports

The extant provisions in this regard as applicable to scheduled commercial banks will be applicable to SFBs as well.

Ownership and control regulations

The extant provisions in this regard as applicable to private sector banks, will be applicable to FBs as well except what is provided in the existing regulation contained in the Licensing Guidelines.

BANKING OPERATIONS

Branch authorization policy

- SFBs should follow the **extant instructions pertaining to the branch authorization policy, as applicable to scheduled commercial banks** in all respects.
- SFBs are required **to have 25% of their branches in unbanked rural centres within one year** from the date of commencement of operations.

Bank charges, lockers, nominations, facilities to disabled persons, etc.

The extant provisions as applicable to **scheduled commercial banks shall be applicable to SFBs as well.**

Marginal Cost of Funds based Lending Rate (MCLR), other related regulations on interest rates and fair practice code for lenders

The extant provisions as applicable to **scheduled commercial banks shall be applicable to SFBs as well**

Financial inclusion and development

- SFBs should be encouraged to lend to SHGs.
- The lending banks will be permitted to avail the priority sector lending (PSL) classification for the loans made to such NBCs, as long as the assets financed out of such loans are PSL eligible assets.

Bank deposits

- All RBI and BR Act provisions and RBI directions relating to **minimum balance, inoperative accounts, unclaimed deposits including transfer of such deposits to the Depositors Education and Awareness Fund** maintained by RBI on regular basis, nominations, cheques/drafts, etc., will be applicable to the SFBs.
- **Small Finance Banks**

a) may at their discretion, issue passbooks for the deposit accounts;

b) should give written/printed proof of the first time deposit, in addition to the electronic confirmation of the deposit;

c) should send statement of accounts once in six months to the registered address free of cost, if passbooks have not been issued;

d) may provide statement of account in paper form on request on chargeable basis or otherwise, if passbooks have not been issued;

e) may provide account information through multiple user-friendly modes such as SMS and/or internet banking; and

f) should provide electronic confirmation through SMS/e-mail/printed proof for each account transaction

KYC requirements

- At their discretion, SFBs may (like all other banks) **decide not to take the wet signature while opening accounts,** and instead rely upon the electronic authentication/confirmation
- However, all the extant regulations concerning KYC including those covering the Central KYC Registry, and any subsequent instructions in

this regard, as applicable to commercial banks, would be applicable to SFBs.

Foreign exchange business

- SFBs may conduct some additional foreign exchange businesses as may be specifically permitted by the Reserve Bank.
- implement the provisions of Foreign Contribution (Regulation) Act, 2010 (as applicable to scheduled commercial banks).

Other banking services -Currency distribution (covering detection of forged and counterfeit notes, currency chest facilities, facilities for exchange of notes)

- SFBs may, at their option, exchange mutilated and defective notes at their branches.
- All extant regulations concerning currency chests, as applicable to commercial banks, will be applicable to SFBs.

Customer education and protection

- All customer grievance issues related to a particular satellite office/door-step customer service centre should be addressed both at the centres and the base branches

- SFBs will be covered by the Banking Ombudsman (BO) Scheme.

- The customer service policy approved by the boards of the SFBs should **provide for continuous and intensive monitoring of customer grievance redressal by the SFBs.**

- RBI will closely supervise the grievance redress system of the bank through both onsite and off-site surveillance system

Credit information reporting

- SFBs should become members of all the **four credit information companies (CICs) and report all credit data to them,** as per current RBI directions.
- SFBs should also follow the RBI directions regarding declaration and reporting of large defaulters' and wilful defaulters' data to the CICs.

Outsourcing of operations, internet banking and mobile banking

The extant provisions as applicable to scheduled commercial banks shall be applicable to SFBs as well

Implementation of Ind AS

Implementation of Indian Accounting Standards (IndAS) would be applicable to SFBs once they become scheduled banks. In view of the same, it is recommended that the SFBs start adoption of the same in order to avoid transition costs subsequently.