

Incremental reform of banking law in India

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Abstract

A banking sector regulator must be non-partisan and separate from government. However, the banking sector in India comprises banks of many kinds: private banks, public sector banks, cooperative banks, and regional rural banks. The laws that govern the sector have evolved to grant special powers over some categories of banks to the Union government, thereby, diluting or sometimes even nullifying the power of the Indian banking regulator, the Reserve Bank of India (RBI), over these banks. In most cases, the power of the RBI has been diluted or nullified in respect of public sector banks and the State Bank of India. This is not desirable from the perspective of ownership neutral regulation and creates an unfair playing field for banks in the sector. It also raises serious conflict of interest concerns, where the government is both a borrower and regulator, can influence the functioning of some banks. This article examines the legal provisions that undermine the regulatory powers of the RBI including on shareholding, appointment of directors, winding up and making schemes. It argues for an ownership-neutral regulatory framework emphasising the need for greater autonomy for the RBI, and the creation of a clear separation between the governments borrowing and regulatory role. The aim is to chart the pathway towards a more robust regulation of the banking sector in India.

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1 Introduction

An extensive literature from the 1990s onward has shown the difficulties of the Indian banking system through all the three dimensions of growth, stability and inclusion. The banking system as presently constructed hinders the efficient allocation of capital and thus hinders growth. The banking system suffers from limitations on micro-prudential and macro-prudential regulation, which has led to difficulties of bank failure, systemic crises and demands upon taxpayer resources. The processes of competition and innovation are held back, through a combination of central planning about how banks work, through entry barriers which limit bank entry, and through rules that hinder non-banks from competing with banks. This harms inclusion.

In 2011, the Financial Sector Legislative Reforms Commission (FSLRC) proposed fundamental reform of financial regulation in the form of a bill called the ‘Indian Financial Code’ (Shah Forthcoming). This draft law, which replaces all extant financial law, worked on the two problems. The first was to establish the foundations of rule of law, accountability and state capability for financial agencies. The second was to establish clarity on the pillars of financial regulation – micro-prudential regulation, consumer protection, resolution and macro-prudential regulation. Such a reform based on a holistic view of market failure and state failure in finance was visualised to comprehensively address the problems of Indian finance. Even though this draft law has not been enacted by the Parliament, it provides a useful base to ask what are a set of incremental amendments to banking law which can diminish the difficulties of Indian banking?

The work of FSLRC decouples progress on financial regulation from the problem of bank privatisation. The main strategy there lies in thinking about how banking regulation can work better, in an ownership neutral way. In this paper, we take this same stance. While economists universally understand the difficulties of government ownership of banks, the tactical detail of how and when bank privatisation will take place is a matter of operational art, as in the end-game of Air India’s public ownership. The important question for financial regulation is to improve state capability, in an ownership-neutral way.

In this paper, we examine the laws that shape banks and banking regulation. These include (1) Banking Companies (Acquisition and Transfer of Undertaking) Act 1970 and 1980, which were passed to facilitate bank nationalisation in 1969 and 1981, and which we refer to collectively as the Bank Nationalisation Acts; (2) The State Bank of India Act 1955 and State Bank of India (Subsidiary Banks) Act 1955, which govern the functioning of State Bank of India (SBI), which has now been merged with its subsidiary banks; and (3) Banking Regulation Act 1949, which is the main act that empowers the Reserve Bank of India to be the regulatory authority of the banking sector. This multiplicity of laws and institutions has inconsistencies and obvious limitations on the governance of banks.

We address the following questions. How does the framework of laws governing banking in India create some of the systemic problems that Indian banking faces? What clauses in specific laws create what issues? Specifically, what clauses lead to poor governance of PSU

banks? What excessive powers does the Central Government get through specific clauses of these laws? What clauses create an uneven regulatory field? What are the remedies to correct the problems created by the legal framework? We identify the difficulties, and also offer a prioritisation of the most important difficulties.

2 An ownership-neutral governance framework for banks

An overview of the laws and institutions governing of private and public banks in India is presented in Table 1.¹ The table below lists the laws under which private and public sector banks in India operate and the institutions that administer these laws. The difference in the laws between these two categories comes from private banks being registered entities under the Companies Act (2013). The nationalisation of banks was implemented under the Banking Companies (Acquisition and Transfer of Undertakings) Acts of 1970 and 1980, which created the public sector banks.

Table 1 Laws and Institutions Governing Indian Banks

	Ownership Structure	
	Private	Public
Laws		
Reserve Bank of India Act (1934)	✓	✓
Banking Regulation Act (1949)	✓	✓
SEBI (Listing Obligations and Disclosure Requirements) Regulations (2015)	✓	✓
Companies Act (2013)	✓	–
Banking Companies (Acquisition and Transfer of Undertakings) Acts (1970 & 1980)	–	✓
State Bank of India Act (1955)	–	✓
State Bank of India (Subsidiary Banks) Act (1959)	–	✓
Institutions		
Reserve Bank of India (RBI)	✓	✓
Securities and Exchange Board of India (SEBI)	✓	✓
Ministry of Corporate Affairs	✓	–
Ministry of Finance	–	✓

As a consequence of these, private sector banks are registered companies reporting to the Ministry of Corporate Affairs, while public sector banks report to the Ministry of Finance

¹Rao and Sri 2019 scored the disclosure practices based on Regulation 49 of SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015 across three listed private and three public sector banks. Goel and Kang 2018⁹ examined disclosures across eight public and private sector banks. Mamta Brahmhatt and Patel 2012 compare the disclosures of public and private banks. These three papers look at *the outputs* of financial regulation. In this paper, we go upstream, to examine the *the laws*.

of the Union government. There is a multiplicity of laws which governs all the entities, that form part of the banking sector in India as can be seen in Table 1. Inevitably, this leads to inherent conflicts within the sector, which in turn, have unforeseen adverse consequences to the efficiency and robustness of the Indian banking sector operations.

First, the banking system is an uneven playing field where privately owned and public sector banks (PSU) are subject to different rules. All private sector banks have to comply with the Companies Act. On the other hand, PSU banks are not companies. Hence, oversight of the company law on important issues such as appointment of key management personnel like the Chief Executive Officer, the Board of Directors or approving of annual accounts is conducted differently for private and PSU banks.

Second, the laws listed in Table 1 enshrine governance where the central government has privilege, beyond what company law will permit a majority owner for private companies. While some powers of the central government may be justified on the grounds of national interest, standards of governance would require taking away all the powers vested with the government to ensure that the minority shareholders are not negatively impacted and overall standards of governance are uniform across banks.

Third, these laws also limit the oversight of the regulators over PSU banks. For example, Section 51 of the Banking Regulation Act states that several sections of this Act will not apply to the PSU banks, including SBI. As a consequence of this, the regulator is constrained in its ability to regulate the conduct of the PSU banks. A recent example of this issue is the paper by the Reserve Bank of India (RBI) on governance of the banks. While this paper spells out at great length, the importance of the functioning of the board and the management of the banks, to ensure the highest standards of governance, it excuses PSU banks from following similar standards.

Fourth, there is a critical difference between the Companies Act and the Banking Companies (Acquisition and transfer of Undertakings) Act, which is that while the former provides a well-laid process for mergers and acquisitions, the latter does not. The consequence is that *any change in the structure* of PSU banks needs parliamentary approval. This makes it harder to implement any change to the structure of these banks. PSUs would follow the process through high courts if they were allowed to be companies under the Companies Act.

These present only a few examples of contradictions when banking functions are carried out by two types of legal entities. Such contradictions are further compounded in the current environment, where there has been a high growth in the number and type of entities that can also provide some banking functions. These include entities such as the Non-Banking Finance Companies (NBFCs) and FinTech firms. All these interact with the existing banking sector, but also extend the set of all entities that make up the banking sector of the country. It is important to take into account the governance of these entities as well, in order to understand the integrity of the entire banking sector, and how it can be optimally contribute to economic growth and dynamism. We examine how this matters

within a setting of an often suggested banking sector reform in the following section.

In the past, debates on creating ownership neutral laws in India have primarily centered around the question of bank privatisation. Key arguments made are that nationalised banks have limitations of capacity when compared with private banks, and that the law does not facilitate sufficient oversight over nationalised banks by regulators. Observations and recommendations of the Group 1999 on Restructuring Weak Public Sector Banks suggest the path of privatisation “as an acceptable course as this process alone can reduce the government’s responsibility of capitalising banks further and, in the long run, enable it to recoup, fully or partially, the investment made in their capital.”

A first requisite step to implement a policy recommendation is to analyse the cost and benefits of the policy. The recommendation of privatising public sector banks poses multiple challenges, all of which need to be first identified and listed. Once these are understood, potential paths to the policy implementation can be established, along with the implications of each path. With such an analysis in hand, the political decision of which path to adopt for privatisation can be better supported.

With such an approach, while privatisation may be considered desirable from the benefits, it is accompanied by the appreciation that the cost of restructuring can be prohibitively high. Any effort towards privatisation will be gradual beginning with small entities and then graduating to the larger ones. This is a complex path since it will involve dispersion of shareholding which in turn will raise political economy concerns related to what such dispersion will mean for policy objectives.

Steps towards privatisation will be affected by the legal foundations of nationalised banks. For example, Review Governance of Boards of Banks in India 2014 identified the following issues: (a) dual regulation by Ministry of Finance and RBI; (b) lack of independence in Board appointments; (c) significant and widening gaps in compensation with private banks, leading to erosion of specialist skills; (d) external vigilance enforcement through CVC and CBI; and (e) applicability of the RTI Act (although limited).

This makes it apparent in identifying how to make amendments to the present laws that shape PSU banks to enable the creation of an ownership-neutral legal framework is critical for banking sector reforms. A common legal framework for banks ought to treat all participants in the sector with the same governance standards. It requires a regulatory environment that licenses entities based on their ability to sustain and provide banking services, that does not place an unfair advantage on one entity over the other. Amendments to the current laws and regulation that enables such an equalisation would also facilitate bank privatisation.

3 A diagnosis of the legal framework

The analysis aims to answer the following questions: How do the banking laws apply to different categories of banking firms in India? Do the laws apply equally to private and public sector banks? If the laws are differently applicable to different categories, what are the implications of these differences for governance and functioning of these banks in India? Further, what should be the prioritisation of amendments in the path towards ownership-neutrality?

The analysis starts by first identifying and listing the set of different categories of banking entities in India. The categories are selected based on differences in (i) organisation, structure and ownership, as well as (ii) the target consumers. The categories of entities selected for this study include: 1. Scheduled Commercial Banks (SCB), 2. Non-scheduled Commercial Banks, 3. Regional Rural Banks (RRB), 4. Cooperative Banks (UCB, DSSB, STCB), and 5. Nationalised banks.

Once these different banking firms are identified, the differences in banking laws applicable to each selected category of banks are identified and examined in detail, for a subset of these entities. We select the principal banking law that governs each category of banks along with any applicable rules. We do not include an analysis of the Companies Act 2013 or the relevant Securities and Exchange Board of India (SEBI) regulations applicable to listed banks. The laws analysed for the purpose of this paper are: Banking Regulation Act (1949); State Bank of India Act (1955); Regional Rural Banks Act (1976); Banking Companies (Acquisition and Transfer of Undertakings) Act (1980); Reserve Bank of India Act (1934).

These laws are analysed from four functions. ‘Licensing and business operations’ include provisions on licensing of banks and the daily business of banks. ‘Regulatory oversight’ include provisions on regulation making, oversight by RBI, reporting, applicability of the law, overriding provisions, exemptions, mergers, winding up, directions, suspensions and supersessions of the board. ‘Shareholding and voting’ which include provisions on capital requirements and increase, voting rights. And ‘Organisation management’ which include provisions on employment and directors.

The findings are organised into a **prioritisation matrix**. Here, we apply subjective analysis based on our experience in working with these laws, in order to determine the different levels of significance of each of the differences across the categories of banks. In order to do this, we apply a three-level colour matrix. The lightest colour representing the lowest significance and the highest representing the most significance.

4 Findings

Regulation, supervision and the rules for operations and management vary for nationalised banks, SBI, private sector banks and cooperative banks. The differences arise on account

of three reasons:

The RBI primarily derives power to regulate banks from the Reserve Bank of India Act, 1934 (RBI Act), the Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970 and 1980 (Nationalisation Acts) and the Banking Regulation Act, 1949 (BR Act). Most provisions are applicable to “banking companies” - defined as a company registered under the Companies Act 1956.² Since most nationalised banks were created under separate statutes, they are technically not “banking companies” and therefore are not covered by these provisions in the BR Act.

Further, certain provisions under the BR Act are ownership-specific and specifically exclude some banks from the applicability of the BR Act.³ Similarly, the BR Act has specific provisions and amendments to sections for cooperative banks.⁴

Lastly, the laws that establish some banks such as the SBI Act and the Nationalisation Acts, have specifications different from those in the BR Act.

In the following subsections, we highlight some of the key differences in the laws arising out of one of the three reasons stated above.

4.1 Licensing and business operations

Licensing and eligibility to incorporate a bank

RBI is required to issue licenses for private sector banks, cooperative banks, and RRBs but not for nationalised banks and SBI.⁵ Further, there are prescribed eligibility criteria for incorporating private banks and RRBs but not specially for SBI and nationalised banks.⁶ RBI may cancel a license for all banks other than nationalised banks.⁷

The differences in licensing requirements have implications for competition in the sector as it places different entry barriers for entities that are essentially providing the same service; with the only difference being ownership.

Further, the prescribed licensing procedure under the Banking Regulation Act 1949, is designed to ensure that applicants meet certain financial and governance standards. For instance, before granting the license to private banks, RBI may inspect the company’s books to measure financial soundness including the adequacy of its capital structure.⁸ The RBI is also also evaluate the general character and competence of the company’s mangement to determine its suitability for holding a banking license.⁹ The RBI may also issue a license

²Since most banks were incorporated before 2013 when the new Companies Act came into existence

³See, for instance: Section 51, The BR Act, 1949.

⁴Section 56

⁵Section 22; Section 51, Banking Regulation Act 1949

⁶Section 22 Banking Regulation Act 1949

⁷Section 22(4); Section 51, Banking Regulation Act 1949

⁸Section 22(2), 22(3) and 22(3A), Banking Regulation Act 1949

⁹Section 22(2), Banking Regulation Act 1949

and impose restrictions on how the license holder operates.¹⁰

Shareholding, subsidiaries and loan restrictions on non-nationalised banks

Subsidiaries: All banks other than nationalised banks require prior permission of the RBI to set up subsidiaries.¹¹ While this provision appears to be in continuation of the provisions on bank licensing (RBI has power to grant licenses for banks other than public sector banks), it is unclear why this exemption exists in the first place. It assumes that the Union government, is in a better position than the banking regulator to determine whether some banks, based on their ownership, deserve to open subsidiaries while others do not. There is a possibility that, driven by political economy reasons, public sector banks may be allowed to set up subsidiaries or even branches regardless of their financial health.

Loans to directors: RBI may also impose restrictions on loans to directors of private banks but not for nationalised banks, SBI and RRBs.¹²

Private sector banks are explicitly prohibited from issuing loans to directors, firms where a director holds an interest, companies or individuals connected to directors.¹³ This provision has retrospective effect and therefore applies even if the loan or advance was granted before the provision came into force. To remit loans to directors, or companies or individuals connected to directors, prior RBI approval is required.

While the SBI Act has some restrictions on loans to employees, there is no complete ban on granting loans to employees. For instance, The Central Board or the Executive Committee as the case may be, at SBI may allow this.¹⁴ It is unclear why private banks are held to a higher standard. Further, the approvals from the Central Board or Executive Committee are not subject to RBI consultation, effectively creating a sphere of governance outside of RBI's oversight in the area of loans to bank employees. There are no such restrictions on public sector banks that are governed by the bank nationalisation laws.

Debt of interested parties: The prior permission of the RBI is required before remitting debt due by directors, companies/individuals in which directors are interested, partners or guarantors for private banks but not for nationalised banks, SBI or RRBs.¹⁵ There are no explicit provisions on operational procedures such as loan management or write-off policies in the bank nationalisation laws. This is not ideal given that the restrictions on who the bank can lend to (directors and so on) are not specifically restricted under the SBI Act or the nationalisation laws. This could give rise to perverse incentives where the SBI or a nationalised bank may lend to a director or other interested party and then remit the loan. Given that public sector banks and SBI are major players in the banking sector including as lenders to the state, operational relaxations such as these may affect the health of their

¹⁰Section 23(2), Banking Regulation Act 1949

¹¹Section 19(1), Section 51, Banking Regulation Act 1949

¹²Section 20(b)(ii), Section 51, Banking Regulation Act 1949

¹³Section 20, Banking Regulation Act 1949

¹⁴Sections 66 and 67, State Bank of India Act, 1955

¹⁵Section 20A, Banking Regulation Act 1949

books, if done frequently.

Restrictions on foreign ownership

Under the Bank Nationalisation Acts, no individual or company resident outside India or incorporated under an Act not in force in India, or any branch of such company, can hold more than 20% of the paid-up capital of a nationalised bank.¹⁶ This is also the position under the Consolidated FDI Policy in operation at present.¹⁷

No such restriction under the BR Act, 1949 in respect of private sector banks. Under the Consolidated FDI Policy 2020, the cap is 74% : automatic up to 49%, and government route beyond 49% and up to 74%.¹⁸ Extending same treatment as under Banking Regulation Act, 1949 and the Consolidated FDI Policy 2020 may be considered (in an incremental, if necessary).

We categorise each of these differences into the priority matrix. The matrix is driven by the implications of the provision on the licensing and operation of banks.

Table 2 Priority Matrix: Licensing and Business Operations

Item	Low	Medium	High
1. Licensing and eligibility to incorporate a bank		✓	
2. Subsidiaries and loan restrictions on non-nationalised banks	✓		
3. Restrictions on foreign ownership		✓	

4.2 Regulatory oversight

Suspension of the governing law

The Union Government may suspend the applicability of the governing law for private and cooperative banks based on a representation from the RBI,¹⁹ but not for nationalised banks, SBI or RRBs as they are not banking companies as defined under the BR Act and there is no specific provision to this effect in their governing laws. Further, the BR Act specifies that the RBI can exercise this power without a representation to the Union Government in case of special emergencies.²⁰

Suspension, mergers and amalgamations of banks

¹⁶First proviso to Section 3(2D), Bank Nationalisation Acts.

¹⁷Section 5.2.19 (*Banking - Public Sector*), Consolidated FDI Policy 2020. This limit is applicable in respect of SBI as well.

¹⁸Section 5.2.18 (*Banking - Private Sector*), Consolidated FDI Policy 2020.

¹⁹Section 4(1), Section 4(1)r/w Section 56(a)(i); Section 3, Section 4(2), Section 4(2) r/w Section 56(a)(i); Section 3, Banking Regulation Act, 1949

²⁰Section 4(2), Banking Regulation Act, 1949

The RBI can trigger a suspension, merger or amalgamation for private banks and cooperative banks but not for nationalised banks, the SBI or RRBs.²¹ The Union Government, on the other hand can do so for all categories of banks including private sector banks on a report from the RBI.²² Further, in case of RRBs the Union Government need not specifically consult the RBI in this process,²³ but must consult NABARD and the sponsor bank.

The Union government may also acquire undertakings of banking companies on report of the RBI that it is necessary but not for nationalised banks, SBI and RRBs.²⁴ Further the government may direct all banks to acquire another.²⁵ The RBI cannot.

The power of suspension, merger or amalgamation of banks is an important power of the banking regulator as it is core to the mandate of maintaining the health of banks. It is a decision for a specialist regulator who understands the banking field and who does not have a vested interest in any particular bank. This is a power that must therefore be exclusively within the realm of the Reserve Bank of India, regardless of the ownership of the bank.

Removal of managerial personnel by the regulator

The RBI may remove managerial personnel from SBI, private banks and cooperative banks but not for nationalised banks or RRBs.²⁶ In case of RRBs the sponsor bank can remove personnel and not the RBI. It is unclear which entity can do so for nationalised banks.

Winding up and liquidation of a banks

There is a bar on the applicability of winding up provisions in other laws for nationalised banks²⁷; SBI,²⁸ and Regional Rural Banks,²⁹ There is no barring of provisions for private banks (both scheduled and non-scheduled) or cooperative banks. While private banks are governed by the provisions of the Companies Act in some cases, this is not the case for PSBs, SBI, and RRBs. The implication of this is that while for private banks the procedure to wind up is predictable and can be challenged for any deviation from the rule of law, in PSBs, SBI and RRBs it will be more challenging to do so as the procedure may be different in each case. In case of winding up of private banks, RBI will be the official liquidator but not for nationalised banks, SBI and RRBs. Further, Companies Act provisions on liquidators and winding up will not apply necessarily apply to nationalised banks, SBI and RRBs.

²¹Section 45; Section 4; Section 3, Section 45, Section 56, Banking Regulation Act, 1949

²²Section 36AE, Banking Regulation Act 1949

²³Section 23A (1), Regional Rural Banks Act, 1976

²⁴Section 36AE; Section 5(c),5(d), Section 51, Banking Regulation Act, 1949

²⁵Section 35(1), State Bank of India Act, 1955; Section 23A, Regional Rural Banks Act, 1976; Section 44A(7), Banking Regulation Act 1949

²⁶Section 10B(6), 36AA, Banking Regulation Act 1949; Section 114, Regional Rural Banks Act, 1976

²⁷Section 18, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980; Section 18 Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970

²⁸Section 45, State Bank of India Act, 1955

²⁹Section 26, Regional Rural Banks Act 1976

Further, the Union Government can order liquidation and winding up of nationalised banks, SBI and RRBs,³⁰ but not for private banks. The RBI on the other hand cannot trigger liquidation or winding up of nationalised banks, SBI and RRBs but can for private sector banks. However, the Union Government may grant RBI the power to issue directions to initiate insolvency resolution in some cases.³¹ Given that these banks lend to the Union government, it raises a conflict of interest issue wherein it creates an incentive to not declare insolvency or winding up. There is also no specific authority for winding up of financial firms in India. The jurisprudence on this is therefore not developed in India. Giving a non-banking regulator this power in this environment, may lead to sub-optimal outcomes.

Similarly an RBI certificate is required for voluntary winding up of private banks.³² The HC may issue suo motu orders for winding up for voluntary winding up of private banks but not specifically for nationalised banks, SBI or RRBs as they are not banking companies registered under the Companies Act.³³

Further a HC may publicly examine directors or promoters of private banks during winding up but not for nationalised banks, RRBs and SBI.³⁴ Further, HC can order repayment or restoration from delinquent directors, promoters or managers of private banks during winding up but not for nationalised banks, RRBs and SBI.³⁵ In case of winding up of nationalised banks, SBI or RRBs, the HC does not have exclusive power to decide all claims in case of winding up.

Supersession of the board of a bank

The boards of private banks and cooperative banks can be superseded by RBI after consultation with the Union Government but not the boards of nationalised banks, regional rural banks and SBI.³⁶ Only the Union Government can supersede the boards of these banks on the recommendation of the RBI.³⁷ Even though the SBI Act and the nationalisation require a recommendation from the RBI before the Union government issues an order for supersession, given that the RBI is the banking sector regulator. However, it is unclear why the RBI requires to consult the Union government before it issues an order for board supersession of private and cooperative banks.

Power to issue directions to the banking sector

³⁰Section 18, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980; Section 45, State Bank of India Act, 1955; Section 23D, Regional Rural Banks Act, 1976

³¹Section 35AA, Banking Regulation Act, 1949

³²Section 44(1), Banking Regulation Act 1949

³³Section 44(3), Banking Regulation Act 1949

³⁴Section 45L, Banking Regulation Act 1949

³⁵Section 45H, Banking Regulation Act 1949

³⁶Section 36ACA, Banking Regulation Act, 1949; Section 36AAA; Section 3, Section 56, Section 36AAA Banking Regulation Act, 1949

³⁷Section 18A, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980; Section 24A, State Bank of India Act 1955

The RBI has the power to give directions to all banks.³⁸ Further, the Union Government also has the power to issue directions to nationalised banks, SBI and RRBs in consultation with the RBI.³⁹ While there is a provision for consultation with the RBI, this could raise conflict of interest issues given that the Union government borrows heavily from SBI and nationalised banks.

Power to make schemes for the banking sector

Only the Union Government may make schemes in respect of banks but not the RBI.⁴⁰ These schemes may be made in consultation with the RBI. It is unclear why the Union government has been given this power. This provision is not only discriminatory but also raises serious conflict of interest issues given that the Union government borrows heavily from SBI and nationalised banks.

Miscellaneous powers of the RBI over banks

Transactions: RBI may prohibit a transaction or class of transactions in respect of private banks and cooperative banks but not SBI, RRBs or nationalised banks.⁴¹

Meetings: RBI also has the power to require meetings, depute officers to meetings, observe, changes in management within the specified time in public interest for all banks other than nationalised banks.⁴²

Penalties: RBI has the power to impose penalties for only private banks.⁴³

RBI approval for amendments and appointments

RBI approval is required for amendments related to the appointment of directors by an agreement or MOA/AOA for private banks but not for nationalised banks, SBI and RRBs.⁴⁴ RBI approval is also required for appointment, reappointment, termination of chairman, WD, MD, CEO of private banks but not for RRBs, SBI and nationalised banks.⁴⁵

Overall, these provisions reduce oversight the RBI on some banks within the banking sector and leave room to create an uneven regulatory playing field between entities within the same sector, where the banking regulator has oversight over some banks and the Union government has oversight over others. This dual oversight mechanism is not ideal because the Union government does not necessarily have specialised knowledge to effectively govern

³⁸Section 35A; Section 51 Banking Regulation Act, 1949

³⁹Section 8, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980; Section 18, State Bank of India Act, 1955; Section 24, Regional Rural Banks Act, 1976

⁴⁰Section 36AF, Banking Regulation Act 1949; Section 9, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980

⁴¹Section 36(1)(a); Section 51, Banking Regulation Act 1949

⁴²Section 51; Section 36(1)(d), Banking Regulation Act 1949

⁴³Section 47A, Banking Regulation Act, 1949

⁴⁴Section 35B(1)(a); Section 51 Banking Regulation Act, 1949

⁴⁵Section 51, Banking Regulation Act 1949; Section 36(1)(d), Banking Regulation Act 1949

the sector. It is also problematic given that the Union government borrows from the banks it have regulatory oversight over.

We categorise each of these differences into the priority matrix. The matrix is driven by the implications of the provisions on the supervision of banks.

Table 3 Priority Matrix: Regulatory Oversight

Item	Low	Medium	High
1. Suspension of governing law		✓	
2. Regulation-making power to boards		✓	
3. Suspension, mergers, acquisitions		✓	
4. Removal of managerial personnel by RBI			✓
5. Winding up and liquidation			✓
6. Supersession of the board			✓
7. Power to issue directions			✓
8. Miscellaneous powers of the RBI over banks			✓
9. RBI approval for amendments and appointments			✓

4.3 Shares and voting

Shareholding

RBI may impose restrictions on shareholding by private banks but not for nationalised banks, SBI and RRBs.⁴⁶

Shareholding restrictions have the following implications: using these powers RBI could prevent certain entities or individuals from gaining control over private banks; it promotes diversified shareholding rather than concentrating ownership in single hands. There is no ostensible logic on why similar restrictions do not exist for public sector banks. The only justification would be if the bank nationalisation laws or the State Bank of India law, have restrictions of their own that they impose on these banks. A review of the provisions of these laws, does not reveal that this is the case.

The SBI Act imposes some restrictions on the shareholding requirements for shareholders *other than* the Union government. For instance, no shareholder, other than the Union government can exercise voting rights in excess of ten per cent of the issued capital.⁴⁷ The Union government has also been given the *power to exempt some shareholders* from this condition.⁴⁸ This is in addition to the power of control the Union government has as a majority shareholder in the State Bank of India.⁴⁹ This is particularly problematic given

⁴⁶Section 12B(4), Banking Regulation Act 1949

⁴⁷Section 11, State Bank of India Act, 1955

⁴⁸Proviso to Section 11, State Bank of India Act, 1955

⁴⁹Proviso 3 to Section 5(2) State Bank of India Act, 1955

that public sector banks, including SBI have significant exposure on account of lending to the Indian state.⁵⁰ This also creates a conflict of interest, where a borrower is also a majority shareholder in the lending bank. This not only creates grounds for perverse incentives, it is antithetical to corporate governance standards and regulations for financial stability. In fact, given the vast exposure of these banks, even as lenders to the Indian state, there should be similar restrictions, if not more, on public sector banks.

In the same vein, preferential shareholders, other than the Union government, can vote only on resolutions that directly impact their rights as preference shareholders.⁵¹ The principle behind this is not granting preferential shareholders control in bank decisions. These provisions are not only discriminatory based on ownership but they also derogate from the RBI's mandate to ensure financial stability in banks and direct how banks are to be regulated to this end.

Restrictions on voting rights within the board

In nationalised banks and SBI, only the Union Government is entitled to exercise voting rights in respect of any shares held in excess of ten per cent of the total voting rights of all the shareholders.⁵² There are no such restrictions prescribed for RRBs and private banks.

In respect of preference shareholders, additional restriction: they are entitled to vote only on resolutions which directly affect the rights attached to the preference shares.⁵³ This is also capped at 10%.⁵⁴

Under Companies Act, 2013, preference shareholders are only allowed to vote on:⁵⁵

1. Resolutions placed before the company which directly affect the rights attached to the preference shares;
2. Any resolution for the winding up of the company;
3. Repayment or reduction of its equity or preference capital.

The BR Act, 1949 does not restrict exercise of voting rights in respect of all 3 matters above, but states that no shareholder can exercise voting rights a on poll in excess of 10% of the total voting rights of all shareholders of the banking company.⁵⁶ However, the RBI may increase this cap to 26% in a phased manner.⁵⁷ The current level of ceiling is at 15%.⁵⁸

⁵⁰See: **chitgupiEtAl2024**

⁵¹Proviso to Section 11, State Bank of India Act, 1955

⁵²Section 3(2E), Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980; Section 11, State Bank of India Act 1955

⁵³First proviso to Section 3(2E), Bank Nationalisation Acts.

⁵⁴Second proviso to Section 3(2E), Bank Nationalisation Acts.

⁵⁵Section 47 (*Voting Rights*), Companies Act, 2013.

⁵⁶Section 12(2), BR Act, 1949.

⁵⁷First proviso to Section 12(2), BR Act, 1949.

⁵⁸Para 7, RBI 2016

The BR Act, 1949 however, restricts a right available to preference shareholders under the Companies Act. When dividend in respect of a class of preference shares has not been paid for 2 years or more, preference shareholders have the right to vote on *all* resolutions placed before the company.⁵⁹ This is unavailable to preference shareholders of banking companies.⁶⁰

Extending same treatment as under Banking Regulation Act, 1949 and Companies Act may be considered to ensure neutrality.

Restrictions on holding shares of other banks

The law has restrictions on private banks, SBI and RRBs holding shares in other banks without exception.⁶¹ In the case of nationalised banks, there is no express restriction in the law.

Authorised capital

There are different specifications for prescribed authorised capital requirements, even across nationalised banks and SBI. For nationalised banks this amount is three thousand crores of rupees divided into three hundred crores of fully paid-up shares of ten rupees each.⁶² For SBI it is five thousand crores of rupees divided into five hundred crores of fully paid-up shares of ten rupees each.⁶³ For RRBs it is Five cores of rupees divided into five lakh of fully paid up shares of one hundred rupees each.⁶⁴ For private banks there is no amount specified. However, the aggregate value of its paid-up capital and reserves shall not be less than fifteen lakhs of rupees and if it has a place or places of business in the city of Bombay or Calcutta or both, twenty lakhs of rupees.⁶⁵

Further, the Union Government may increase reduce the authorised capital of nationalised banks, RRBs and SBI.⁶⁶ In case of SBI, the government can do so in consultation with the RBI.⁶⁷ This cannot be done for private sector banks.

Issued capital by banks

Banks may increase their issued capital, however, depending on the type of bank, different permissions may be required. For nationalised banks, they may increase issued capital with the prior approval of the government in consultation with the RBI.⁶⁸ In case of SBI the

⁵⁹Second proviso to Section 47(2), Companies Act, 2013.

⁶⁰Second proviso to Section 12(1)(ii), BR Act, 1949.

⁶¹Section 19(2), Section 51, Banking Regulation Act, 1949

⁶²Section 3(2A), Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980

⁶³Section 4, State Bank of India Act, 1955

⁶⁴Section 5, Regional Rural Bank Act, 1976

⁶⁵Section 11 (2) of the Banking Regulation Act, 1949

⁶⁶Proviso 2 to Section (2A), 3(2BB) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980; Section 6(3), Regional Rural Bank Act, 1976

⁶⁷Proviso 2 section 4, State Bank of India Act, 1955

⁶⁸Section 3(2B)(c), Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980

prior approval of both RBI and the Union Government are required.⁶⁹ RRBs may do so after consultation with the state government and sponsor bank with the prior permission of the union government but not RBI.⁷⁰ There is no specification for private banks in the law.

There are two ways in which the Board of a PSB may increase capital.⁷¹ The Board can transfer amounts from the reserve fund established by the bank to its paid-up capital. The Board can raise funds by issuing equity shares or preference shares through public issue, rights issue, issue of bonus shares, preferential allotment, or private placement.

However, prior conditions apply. The Board can only raise capital through either channel after consultation with the RBI; *and* previous sanction of the Union government. The government is required to hold, at all times, **not less than 51% of the paid-up capital of equity shares of each nationalised bank.**⁷²

There are restrictions in the case of private banks under the Banking Regulation Act, 1949 too, but these are **less onerous**. Subscribed capital should not be less than half the authorised capital; paid-up capital should not be less than half the subscribed capital.⁷³ The capital of banking companies can consist only of equity shares; or equity shares and preference shares.⁷⁴ No person can hold shares or voting rights of a bank company that aggregates 5% or more of the paid-up share capital of the banking company without previous approval of the RBI.⁷⁵

Prior to approval, the RBI will consider whether it is satisfied that such acquisition is⁷⁶ in public interest; in the interest of banking policy; to prevent the affairs of any banking company being conducted in a manner detrimental or prejudicial to its interests; in view of emerging trends in banking and international best practices; in the interest of the banking and financial system in India, the applicant is a fit and proper person.

The RBI has also brought out ‘Master Directions’ that sets out the procedure for application for acquisition of shares or voting rights in private sector banks,⁷⁷ and on ownership in private sector banks.⁷⁸ When an applicant has received approval for 5%, no need for further approvals from the RBI until 10% threshold (although NOC necessary from concerned bank).⁷⁹

Extending same treatment as under Banking Regulation Act, 1949 and Companies Act

⁶⁹Proviso 2 section 5(2); section 3 State Bank of India Act 1955

⁷⁰Section 6(3), Regional Rural Bank Act, 1976

⁷¹Section 3(2B)(a),(c), Bank Nationalisation Acts.

⁷²Section 3(2B)(c), Bank Nationalisation Acts.

⁷³Section 12(1)(i), BR Act, 1949.

⁷⁴Section 12(1)(ii), BR Act, 1949.

⁷⁵Section 12B(1), BR Act, 1949.

⁷⁶Section 12B(2), BR Act, 1949.

⁷⁷RBI 2015

⁷⁸Master Direction-Ownership in Private Sector Banks

⁷⁹First proviso to Para 6.2, Master Directions on Prior Approval for Acquisition, 2015.

may be considered to ensure neutrality.

Table 4 Priority Matrix: Shares and Voting

Item	Low	Medium	High
1. Shareholding			✓
2. Restrictions on voting rights		✓	
3. Restrictions on holding shares of other banks	✓		
4. Authorised capital		✓	
5. Issued capital		✓	

4.4 Organisation management

Control over directorship of a bank

The Bank Nationalisation Acts set out the composition of the Boards, as well as the process to be followed for their appointment⁸⁰ not more than 5 whole-time directors appointed by the government after consultation with the RBI; one director who is a union government official to be nominated by the government; one director, possessing expertise and experience in matters relating to regulation or supervision of commercial banks, nominated by government on the recommendation of the RBI; two directors representing the employees, nominated by the government (1 appointment to be made after consultation with RBI); one director who is a CA with not less than 15 years experience, nominated by government after consultation with RBI; up to three directors to be elected by shareholders other than the government depending on capital raised.

Both the Bank Nationalisation Acts as well as the BR Act give powers to the RBI to appoint additional directors under certain circumstances.⁸¹ Extending the same treatment as under Banking Regulation Act, 1949 may be considered. The union government may appoint directors in SBI and RRBs without consultation with the RBI.

Removal of board members from a bank

Prior permission of the RBI is required to remove board members in private banks but not in nationalised banks, SBI or RRBs.⁸² For RRBs, board members maybe removed in consultation with National Bank where the member belongs to the sponsor bank.⁸³

Remuneration to directors of the board

The RBI may specify remuneration to directors in some cases but not for nationalised banks, RRBs or SBI; while the Union government can for nationalised banks (in case of

⁸⁰Section 9(3), Bank Nationalisation Acts.

⁸¹Section 9A of the Bank Nationalisation Acts; Section 36AB, BR Act, 1949.

⁸²Section 35B(1)(b), Banking Regulation Act, 1949; Section 24(1), State Bank of India Act 1955

⁸³Proviso 11(1A), 11(4) Regional Rural Bank Act, 1976

supersession of the board), RRBs and SBI.⁸⁴ The idea that a borrower (Union government) has control over the board of its own lender is perverse. The Union government should not have control over the boards of any banks in India.

Table 5 Priority Matrix: Organisation Management

Item	Low	Medium	High
1. Control over directorship			✓
2. Removal of board members			✓
3. Remuneration to directors			✓

4.5 Limited scope of the Banking Regulation Act

Statutes that license banking entities other than the Banking Regulation Act include:

1. State Bank of India: Constituted under, and governed by, the State Bank of India Act, 1955.
2. Nationalised Banks: Established under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and 1980.
3. Regional Rural Banks, NABARD, SIDBI etc. are all established under different Acts.

Section 51 of the Banking Regulation Act applies to these special licensed banking entities – of which there are presently 12 scheduled PSBs in India.⁸⁵ The 1970 Bank Nationalisation Act applies to 10 out of the 12. The 1980 Bank Nationalisation Act applied to 6 banks at the time of its enactment - it now applies only to Punjab and Sind Bank, as the others have been merged. These entities remain distinct in governance and operations from other categories of banks.

Nationalised banks are licensed and governed primarily under the Nationalisation Acts. Private sector banks and some cooperative banks are governed under the Banking Regulation Act. The definition of a banking company under each of these acts is different. For instance, the Nationalisation Acts define a banking company as one that “does not include a foreign company” within the meaning of Companies Act. The Banking Regulation Act defines a banking company as “any company which transacts the business of banking in India”

⁸⁴Section 10BB(3), Banking Regulation Act, 1949; Section 18A(7), Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980; Section 9(2), Regional Rural Bank Act, 1976; Section 15(1), Regional Rural Bank Act, 1976

⁸⁵See: List of Scheduled Banks at <https://rbidocs.rbi.org.in/rdocs/Content/PDFs/LSCBSC925ABF8A7E04824BA04596DF5C44006.PDF>

As PSBs are not set up as companies under the Companies Act, 2013, as private banks are, the provisions under the Companies Act, 2013 do not apply. In addition, the way that private banks operate (as per a Memorandum of Association and Articles of Association that *inter alia* set out the manner in which Board meetings will be conducted or how shareholders will exercise their rights etc.) is different from the way that PSBs operate because they are primarily guided by schemes drafted by the Central Government.

5 Discussion

To achieve an ownership-neutral framework, incorporating all public sector banks under the Companies Act 2013, remain the ideal long-term solution. However recognising the inherent political economy challenges, a pragmatic approach involves progressively aligning the regulatory and governance structures of PSBs with those applicable to private sector banks. This can be achieved through the following:

First, *expanding the applicability of the Banking Regulation Act*, to nationalised banks is crucial. This can be done incrementally by extending the provisions currently listed under Section 51 to these banks while simultaneously repealing analogous provisions within the Bank Nationalisation Acts. A prioritised approach could focus initially on sections related to regulatory oversight and RBI's powers of intervention as highlighted in Table 3. This would ensure a more uniform regulatory framework across the banking sector.

Second, *harmonising governance norms* by incorporating relevant provisions of the Companies Act, 2013, into the legal framework governing PSBs is essential. This can be achieved by either amending the Bank Nationalisation Acts to mirror the Companies Act provisions (where parallels exist) or by explicitly incorporating Companies Act provisions by reference. To ensure clarity and precedence, an overarching provision should be added to the Bank Nationalisation Acts stating that in case of inconsistency, the Companies Act provision will prevail. This will address the current disparity in areas like board conduct, shareholder rights and audit committee functions.

Third, *promoting internal governance and autonomy* requires repealing the government-framed schemes that currently guide the internal operations of PSBs. These should be replaced by constitutional documents akin to the Memorandum of Association (MOA) and Articles of Association (AOA) used by companies. Critically, the right of the board and shareholders (excluding the government in its capacity as majority shareholder) to amend these constitutional documents without requiring government or RBI approval needs to be established within the Bank Nationalisation Acts.

Fourth, *reducing the scope for direct government intervention* in the day-to-day operations of PSBs is vital to minimise conflicts of interest. Section 8 of the Bank Nationalisation Acts, which allows the government to issue policy directions, should be carefully reviewed and its scope limited to exceptional circumstances with strong justification and transparent processes. Similarly, the government's power to unilaterally frame schemes under Section 9

should be repealed, with the power to frame such fundamental structural changes residing with the bank's board and subject to regulatory approval by the RBI. This directly addresses the conflict arising from the government being a major borrower from these banks. Finally, *strengthening the RBI's regulatory and supervisory powers* over PSBs to be on par with those over private sector banks is paramount. This involves removing the exemptions granted to PSBs under various sections of the Banking Regulation Act and explicitly granting the RBI powers related to licensing, mergers, amalgamations, removal of managerial personnel, winding up, and imposing penalties, without requiring prior consultation or approval from the government.

Implementing these changes will require legislative amendments to the Bank Nationalisation Acts and potentially the Banking Regulation Act. Navigating the political landscape will necessitate building consensus among stakeholders and clearly articulating the long-term benefits of an ownership-neutral and robust banking sector for the Indian economy.

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