

Setting Up an Off-shore Banking Unit at Gift City India – Regulatory Framework

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Abstract

Banking business is very old in India and dates back to 1770 when the first bank was established in Calcutta by the name Bank of Hindustan. This bank was closed in 1832. We know the business of money lending is even older when Mahajans and money lenders used to lend money to farmers and traders and charged exorbitant interest. The first commercial bank in the history of the evolution of banking in India was Oudh Commercial Bank which was established in the year 1881.

INTRODUCTION

Banking business is very old in India and dates back to 1770 when the first bank was established in Calcutta by the name Bank of Hindustan. This bank was closed in 1832. We know the business of money lending is even older when Mahajans and money lenders used to lend money to farmers and traders and charged exorbitant interest. The first commercial bank in the history of the evolution of banking in India was Oudh Commercial Bank which was established in the year 1881.

The East India Company had established three banks during the British rule in India viz. Bank of Bengal, Bank of Bombay and Bank of Madras which were called the Presidential Banks. Later in 1921, these banks were merged into a single bank called Imperial Bank of India. It was later nationalized in the year 1955 and the name was changed to The State Bank of India. When India became independent, there were around 600 banks which were operating in India. However due to several reasons including frauds, lack of technology, lack of transparency and lack of strong sectoral regulations, many banks could not survive.

The Reserve Bank of India was set up on the basis of the recommendations of the Hilton Young Commission. The Reserve Bank of India Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank, which commenced operations on April 1, 1935.

When India became independent, all the major banks of the country were owned by private persons and the large number of populations which was residing in villages were still dependent on money lenders for their financial needs.

To overcome the difficulties in Banking sector, Government of India enacted the Banking Regulation Act, 1949. The Reserve Bank of India was nationalized with effect from 1st January, 1949 based on the Reserve Bank of India (Transfer to Public Ownership) Act, 1948. Nationalization of major banks was undertaken by the Government in two tranches, first 14 banks in 1969 and again 6 banks in 1980.

There have been constant reforms in banking sector since then. Several commissions and committees were set up. After the liberalisation

of the economy, bank licenses were once again granted to private sectors which brought much needed technology and efficiency in banking sector.

Over a period of time RBI took many initiatives through regulations to bring competition and efficiency among the banks. To address the concern of ever increasing stressed assets, RBI brought stringent prudential norms. All scheduled commercial banks including public, private and foreign banks operating in India are regulated by RBI through different regulations in the form of Notifications, Master Circulars and Master Directions. RBI also regulates Cooperative Banks, Regional Banks and Rural Banks apart from the Non-Banking Financial Companies.

While section 6 of the Banking Regulation Act, 1949 stipulates what all activities a banking company can do, RBI drawing its power from the same Act, regulates the business of the banks. Some of the important regulations it has issued are with regards to:

1. Restrictions on Loans and Advances.
2. Regulations on Interest on loans and advances.
3. Deposit taking and rate of interest on deposits.
4. Income Recognition and Asset Classification norms (IRAC Norms).
5. Market Risk and Interbank dealings.
6. Import/Export and other Foreign Exchange activities.
7. Branch authorization policy.

However, the Government of India was still not happy with the growth of the Financial Markets in the country. Under the Reserve Bank of India regulations, India could not achieve the status

of Global Financial Market on the lines of London, Hong Kong or Singapore. The aim was looking far away even after the State of Gujarat established a first Special Economic Zone (SEZ) for Financial Institutions including Banks, Insurance Companies, Stock Exchanges by name of “Gujarat International Finance Tec-City” (GIFT City) near Ahmedabad, Gujarat, India. GIFT City has received the status of International Financial Service Center, first of its kind in India.

To liberate the Banking Units in GIFT City which are known as Off-shore Banking Unit (OBU), The International Financial Services Centres Authority (IFSCA) has been established on April 27, 2020 under the International Financial Services Centres Authority Act, 2019.

Currently, the GIFT IFSC is the only International Financial Services Centre in India. All the powers of the domestic financial regulators, namely, RBI, SEBI, PFRDA and IRDAI which regulate the businesses in India domestic area are now vested in IFSCA.

With a motive to promote ease of doing business in IFSCs and provide world class regulatory environment, the IFSCA has been established as a Unified Regulator. The main objective of the IFSCA is to develop a strong global connect and focus on the needs of the Indian economy as well as to serve as an international financial platform for the Regional and the Global economy as a whole. IFSCA is expected to be having more liberal regulations and make IFSC a Global Financial Hub on the lines of London, Hong Kong or Singapore Financial Markets which serves as Global Financial Markets. In this direction, Finance Minister of India presented the union budget on 1st Feb 2023 wherein she mentioned that the powers of SEZ Commissioner for

approval of Banking Units in GIFT City shall also be delegated to IFSCA.

SETTING UP OF A BANKING UNIT AT IFSC

IFSCA has issued the International Financial Services Authority (Banking) Regulations 2020 providing the regulations for opening an office/branch at IFSC. As we mentioned, GIFT City is the only IFSC so far under the regulations which is a Special Economic Zone (SEZ).

Section 3 of the regulation states that Indian and Foreign Banks shall require a license to set up an IFSC Banking Unit (BU or IBU) for which an application has to be made by the parent bank. The application shall satisfy that

- ☐ The parent bank shall provide necessary capital for the BU, subject to a minimum of USD 20 million.
- ☐ A no objection certificate must be obtained from the home regulator.
- ☐ An undertaking stating that the bank shall provide liquidity for the BU whenever needed for the operations.

The authority may give 30 days to the applicant to make written submissions if the authority does not grant the license.

Only one BU can be established by the Parent Bank in each IFSC as a branch, Representative Offices shall be allowed to be set up.

BU must comply with the regulations provided by the Home Regulator.

A BU must maintain the Liquidity Coverage Ratio and the Net Stable Funding Ratio, with the authority's permission it may be maintained by the parent bank. The BU also has to adhere to the guidelines regarding leverage ratio and

exposure ceiling. The Lender of Last Resort support is not available for a BU.

The liabilities of a BU (except deposits raised from residents in or outside India) are exempted from Cash Reserve Ratio.

A BU has to conduct Business in a freely convertible foreign currency, though it may conduct business in INR subject to settlement of the financial transaction in relation to such business in freely convertible foreign currency.

BU may open accounts in such currency for individuals, corporate or institutional entities. Cash Transactions in foreign currency are not permitted. BU can open current, savings or term deposits for individuals (Foreign currency) and current and term deposits in all other cases.

The BU can undertake any or all of the activities mentioned under the Banking Regulations Act, 1949.(Section 3 and 6).

The BU has to follow KYC, CFT and AML norms fulfill their reporting obligations to the Authority.

BU has to submit reports in USD. The BU has to maintain books of accounts, records and documents in such freely convertible foreign currency.

BU can have a an INR account out of the freely convertible currency to defray their administrative and statutory expenses. The BU has to maintain separate nostro accounts with correspondent banks, distinct from the nostro accounts maintained by the other branches of the same parent bank in India

IFSCA has issued three handbooks for the guidance of aspirants who wish to set up an office in GIFT City SEZ. Three hand books are i) IFSCA Banking Handbook – General Directions, ii) IFSCA Banking Handbook –

Prudential Directions, and iii) IFSCA Banking Handbook – Conduct of Business Directions. We are however limiting our paper to the regulations related to setting up the Banking Unit as per general directions in GIFT City, Gujarat, India which is the only approved International Financial Services Centre under IFSCA Act.

1. Making an Application to IFSCA

To apply for an IBU license, an application is required to be made in the prescribed form along with the payment of application fee by the parent bank.

Application Form would require all the particulars of the bank including the particulars of the beneficial owners and the scale of operations etc. It would also provide the name of the proposed CEO, their qualifications, experience, age and proposed remuneration along with the reasons for opening a Branch in IFSC. The application form shall also contain the ownership and management structure including the countries/jurisdictions where it operates and the details of listing, credit ratings, and business plan etc.

Bank would also be required to fill the details of financial position of the bank (for the last three years and current position) such as total assets (USD Million), CRAR, Tier 1 capital ratio, ROE and profit etc.

Application would also contain the details of the Supervisory Arrangement in home country

- o Home regulatory/supervisory authority
- o Details of supervisory arrangements to which the bank is subjected to including prudential norms
- o Consolidated and comprehensive supervision of the regulator on the holding bank, including the manner in which it

supervises the bank, its subsidiaries and associates to assess the bank's overall financial condition and compliance with laws and regulations.

- o Supervisory Action Plan that is being implemented by the Bank, pursuant to Supervisory Review, to be submitted as a separate document, detailing the directions and action taken/in progress

- o State the instances where refusal or restriction is placed on the right to carry on business or profession requiring a license, registration or other permission.

- o Details of correspondent banking relationships with Indian banks (applicable only to foreign banks) and banks operating at GIFT IFSC and the aggregate amount of lines of credit/ other limits extended to them

- o Details of foreign currency loans extended to Indian companies and other types of business transacted such as underwriting of equity/debt issues of Indian companies etc.

- o Permissible mode of presence for foreign banks in the applicant bank's home country

- o Details of home country regulations for foreign banks

- o Entry level norms for foreign banks who wish to establish presence in the home country of the applicant bank including norms for :

- ☐ Large Exposure Norms
- ☐ Asset Maintenance Ratio requirements, if any
- ☐ Acceptance of retail deposits
- ☐ Availability of deposit insurance coverage

☐ Resolution Requirements

Other important information required for making an application:

☐ Penalties/fines levied on the applicant bank in the last five years

☐ Any case of serious misconduct/unethical behaviour/criminal action

☐ initiated against the senior officials of the bank in the last five years

☐ Level of AML/CFT compliance by the parent bank

Standard documents to be enclosed:

☐ Copies of memorandum and articles of association or similar documents

☐ Last three years financial statements

☐ Business projections for the first three years and the strategy to achieve them

☐ Approval letter from the bank's board

☐ Letter of Comfort from the parent bank to maintain a minimum capital of USD 20 million for the IBU from the date of commencement of operations of the IBU. (para 3 (i)(a) of the directions)

☐ Undertaking from the parent bank of conditions in para 3(i)(b) of the directions

☐ Copy of No Objection letter from home regulator of the parent bank regarding setting up of the banking unit in the international financial services centre; (para 3 (i)(c) of the directions)

☐ Organogram of proposed IBU along with functions and responsibilities

Details / Check List of documents to be submitted by banks along with their application for setting up an IBU at GIFT SEZ.

1. Information from banks as per the enclosed format

2. Specific permission from the home country regulator for setting up an IBU at GIFT SEZ IFSC and their regulatory approval thereof for the bank's presence at IFSC.

3. Approval from the Bank's board to set up an IBU at GIFT SEZ IFSC

4. Letter of comfort from the Parent bank to maintain a minimum capital of USD 20 million for the IBU from the date of commencement of operations of the IBU.

5. Undertaking from the Banking company (parent bank) of conditions in para 3(i)(b) of the Directions

6. Provisional Permission from SEZ authorities to operate at GIFT SEZ IFSC

7. Provisional letter of allotment of office space at GIFT City, Gujarat

8. Last 3 years financial statements/ balance sheets

9. Business plan with strategies, projections and products offered for the first 3 years.

10. Copies of Memorandum and Articles of Association or similar documents

11. Regulator may ask for other details depending on the specific request.

After considering the application and ascertaining eligibility, IFSCA shall communicate an in-principle approval and may require the applicant to satisfy conditions within the specified time to be eligible to be issued a license. The Applicant on satisfying the conditions mentioned in the in principle

approval, shall be granted a license by the Authority.

2. Governance Directions (GOV)

The banking Company has to appoint a governing body of the proposed IBU, the same shall be communicated to the Authority. The Governing body must have at least 3 members and it has to meet at least once each quarter and 6 times a year.

Governing body has to be a part of the Board of Directors/ Management committee. The members have the responsibility of overseeing the IBU's business in or from the IFSC.

Principles of Governance:

The Governing Body has to approve the governance framework, risk management framework, internal control and assurance framework, and business strategy and business plan of the IBU. In case any of the frameworks already exist and is duly approved by the governing body the compliance will be valid. Business Strategy and business plan has to be approved by the governing body even if it is approved by any governing body of the Banking Company. The senior management has to ensure that the approved frameworks are effectively maintained and implemented.

The banking company has to ensure that the people appointed to the governing body, senior management, and as the CEO/Head must have the appropriate knowledge, skills and expertise to ensure effective management. A period review at least annually must be taken of the approved frameworks, the governing body has to provide necessary inputs to the Banking Company about shortcomings observed in the approved frameworks along with a suggestion to modify the frameworks. The copy of the inputs must be shared with the authority as soon as they are shared with the Banking Company.

3. Controlled and Designated Functions (CODF)

The Banking Company has to make a few mandatory appointments for an IBU and such appointments can only be held by approved individuals.

- ☐ CEO/Head-IBU
- ☐ Compliance Officer
- ☐ Any other role that the Authority may direct

The CEO/Head has the ultimate responsibility for the day-to-day management, supervision and control of all the IBU activities, likewise the compliance officer has ultimate responsibility for all compliance related matters. The authority may permit an individual to exercise 2 or more controlled functions.

The Governing body of the IBU has to review the decision annually. The Authority may direct the IBU to stop the combining of functions.

For an officer to receive an Approved Individual status the banking company has to complete a form and paying a fee to the authority. The aforementioned form contains

- ☐ A declaration by the applicant individual that ensures the information in the form is correct and that the applicant is fit and proper for the position. It also declares that the individual understands the powers of the IFSCA. The declaration also contains the proposed title of the Individual.

- ☐ A declaration by the banking company stating that the individual has been assessed and the information prescribes is correct and complete. The declaration also states that the documents submitted become property of the

IFSCA. The declaration has to be signed by a person who has the authority to give consent for the matter at hand.

☐ General Information about the Banking Unit and Company. (Name, IFSCA License Number, Application Contact Point and their position, contact number, e-mail and address)

☐ General Information about the applicant individual (Title, Name, DOB, PAN/Password, Nationality, Residential address, any previous registrations with the IFSCA, Contact details including number, e-mail, and postal address)

☐ The Controlled Function applying for. (Proposed Job title, commencement date, CV, full time or not.)

☐ Educational and professional qualifications. (dates, name of institutes, details of diploma, degree and qualification)

☐ Employment history or any other positions held

☐ Professional memberships.

☐ A fit and proper questionnaire

For the assessment of the applicant individual the Authority shall keep in mind the following Individual's regard to moral and ethical principles, competence and capability on the basis of educational and professional qualifications, financial soundness assessed by assets and liabilities, proposed role within the IBU.

The Authority shall disqualify an applicant if they are bankrupt, have been convicted of a criminal offence, is the subject of a concluded disciplinary by a regulatory body leading to a disciplinary action. The IBU can request the Authority to waive some requirements on the basis on any authorization or approval the

employee may have received outside the jurisdiction of the Authority.

4. Core Principles (CORP)

The principles for an IBU are

☐ Must observe high standards of integrity, equitability and fairness in its dealings and follow expected standards of professional standards.

☐ Must maintain adequate resources and management

☐ Must carry out due diligence and ensure its employees possess the necessary skills

☐ Must observe proper standards of conduct

☐ Must comply with the governance framework

☐ Must ensure that due regard is given to protecting interests of a client, relevant information is communicated clearly.

☐ Must take all reasonable steps for identifying, disclosing, preventing and managing all conflicts of interest.

☐ Must have a remuneration strategy which are well aligned with the long term interests of the IBU

☐ Must deal with Authority in an open and cooperative way.

Principles for approved Individuals and other employees

☐ High standards of integrity and expected standards of conduct

☐ Due diligence and skill

☐ Reasonable care to ensure that the business of the IBU is responsibly managed and controlled

□ Reasonable care to ensure compliance with all relevant laws and guidelines

□ Dealing with the authority in an open and co-operative manner.

5. Systems and Controls. (SYSCO)

The IBU must establish and maintain systems and controls and undertake regular reviews of the same. The IBU must produce a business plan which enables it to manage the risks to which its clients are exposed. The business plan must consider the IBU's current business activities and the forecast for the next 12 months. The plan must be documented and updated.

The IBU must establish and maintain systems and controls that ensure that the IBU does not engage in conduct that may constitute market abuse, financial crime, and contravention of applicable regulations and directions.

6. Supervision

The IFSCA can exercise provisions of relevant legislations of the acts mentioned below:

□ The Reserve Bank of India Act, 1934

□ The Banking Regulation Act, 1949

□ The Deposit Insurance and Credit Guarantee Corporation Act, 1961

□ The Foreign Exchange Management Act, 1999

□ The Credit Information Companies (Regulation) Act, 2005

□ The Government Securities Act, 2006

□ The Payment and System Settlements Act, 2005

□ The Securities Contracts (Regulation) Act, 1956

□ The Securities and Exchange Board of India Act, 1992

□ The Depositories Act, 1996

□ The Insurance Act, 1938

□ The General Insurance Business (Nationalisation) Act, 1972

□ The Insurance Regulatory and Development Authority Act, 1999

□ The Pension Fund Regulatory and Development Authority Act, 2013

The Banking Regulation Act, 1949 empowers the Authority to inspect and supervise the BU, the authority can do so by on site inspection and offsite surveillance.

The Authority may suspend, withdraw, restrict a license, impose penalties, prohibit, restrict any activity under certain circumstances such as failing to satisfy license criteria, not commencing business with 12 months or in order to protect the interests of clients or for the stability of the financial system.

The IBU has to follow the prudential requirements of the home regulator. If the requirements are in variance (Home regulator and the Authority) then the IBU shall demonstrate compliance with the minimum requirements as prescribed by the Authority. The IBU also has to submit a periodic certification confirming compliance with all prudential limits/ ceilings/ conditions applicable as per the Home regulator. The Authority can take suitable supervisory and enforcement actions including imposition of a penalty with respect of any breach of the guidelines and regulations issued by the home regulator. The IBU also has to share a copy of compliance reports submitted to the home regulator.

7. Raising Queries Pertaining to Banking

Any individual or organization who wants any clarification on setting up the Banking Unit in the GIFT City Gujarat which is the only SEZ and IFSC under Act, can ask questions directly to the IFSCA regarding any information concerning IFSCA (Banking) Regulations, 2020 and The IFSCA Banking Handbooks. In the recent budget presented by the Finance Minister of India Mrs Nirmala Sitharaman, it has been mentioned that the authorities of SEZ for allowing permission for setting up the Banking Unit shall be delegated to IFSCA itself for making the process more seamless with a view of ease of doing business. This may be notified soon as part of Finance Act of 2023.