

Approach to Universal Banking

DBS.FID. No. C-24 / 01.02.00 / 2000-2001

28 April 2001

**To the Chief Executive Officers,
All-India Term-lending and Refinancing Institutions**

Dear Sir,

Approach to Universal Banking

Please refer to our Circular No.DBS.FID.286/02.01.00 / 99-2000 dated 1 November 1999 forwarding therewith a copy of the Mid-term Review of Monetary and Credit Policy of RBI for 1999-2000. It would be observed from para 89 (copy enclosed at **Annexure I**) of the policy statement that though the DFIs are expected to continue to have a special role in the Indian financial system till the debt market demonstrates substantial improvements in terms of liquidity and depth, the FIs have an option to transform into a bank provided the prudential norms as applicable to banks are fully satisfied. For achieving full compliance with the regulatory norms as applicable to banks, the approach recognises the need for a transition path to be worked out by the FIs.

2. In this context, we advise that in evolving the path for transition of a FI to a universal bank, several operational and regulatory issues will need to be addressed. Some of the salient issues are briefly enumerated at **Annexure II** for information and guidance of the financial institutions. In order to avoid any transitional problems, it is also desirable to ensure that transition is gradual and sufficient precaution is taken to fully conform to requirements of consolidated supervision. Should an FI choose to exercise the option available to it and formally decide to convert itself into a universal bank, it may formulate a road map for the transition path and strategy for smooth conversion into an universal bank over a specified time frame. The plan should specifically provide for full compliance with prudential norms as applicable to banks over the proposed period. The plan may be submitted to RBI for consideration and further discussion, if necessary.

3. Please acknowledge receipt.

Yours faithfully,

(K.C. Bandyopadhyay)
Chief General Manager

Encls: As above

ANNEXURE I

**Excerpt from the Mid-term Review of the Monetary and Credit Policy
of Reserve Bank of India for 1999-2000**

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89. The Narsimham Committee II suggested that Development Financial Institutions (DFIs) should convert ultimately into either commercial banks or non-bank finance companies. The Khan Working Group held the view that DFIs should be allowed to become banks at the earliest. The RBI released a 'Discussion Paper' (DP) in January 1999 for wider public debate. The feedback on the discussion paper indicated that while the universal banking is desirable from the point of view of efficiency of resource use, there is need for caution in moving towards such a system by banks and DFIs. Major areas requiring attention are the status of financial sector reforms, the state of preparedness of the concerned institutions, the evolution of the regulatory regime and above all a viable transition path for institutions which are desirous of moving in the direction of universal banking. It is proposed to adopt the following broad approach for considering proposals in this area:

- (a) The principle of "Universal Banking" is a desirable goal and some progress has already been made by permitting banks to diversify into investments and long-term financing and the DFIs to lend for working capital, etc. However, banks have certain special characteristics and as such any dilution of RBI's prudential and supervisory norms for conduct of banking business would be inadvisable. Further, any conglomerate, in which a bank is present, should be subject to a consolidated approach to supervision and regulation.
- (b) Though the DFIs would continue to have a special role in the Indian financial System, until the debt market demonstrates substantial improvements in terms of liquidity and depth, any DFI, which wishes to do so, should have the option to transform into bank (which it can exercise), provided the prudential norms as applicable to banks are fully satisfied. To this end, a DFI would need to prepare a transition path in order to fully comply with the regulatory requirement of a bank. The DFI concerned may consult RBI for such transition arrangements. Reserve Bank will consider such requests on a case by case basis.
- (c) the regulatory framework of RBI in respect of DFIs would need to be strengthened if they are given greater access to short-term resources for meeting their financing requirements, which is necessary.
- (d) In due course, and in the light of evolution of the financial system, Narasimham Committee's recommendation that, ultimately there should be only banks and restructured NBFCs can be operationalised.

ANNEXURE II

Salient operational and regulatory issues to be addressed by the FIs for conversion into a Universal Bank

a) Reserve requirements

Compliance with the cash reserve ratio and statutory liquidity ratio requirements (under Section 42 of RBI Act, 1934, and Section 24 of the Banking Regulation Act, 1949, respectively) would be mandatory for an FI after its conversion into a universal bank.

b) Permissible activities

Any activity of an FI currently undertaken but not permissible for a bank under Section 6(1) of the B. R. Act, 1949, may have to be stopped or divested after its conversion into a universal bank..

c) Disposal of non-banking assets -

Any immovable property, howsoever acquired by an FI, would, after its conversion into a universal bank, be required to be disposed of within the maximum period of 7 years from the date of acquisition, in terms of Section 9 of the B. R. Act.

d) Composition of the Board

Changing the composition of the Board of Directors might become necessary for some of the FIs after their conversion into a universal bank, to ensure compliance with the provisions of Section 10(A) of the B. R. Act, which requires at least 51% of the total number of directors to have special knowledge and experience.

e) Prohibition on floating charge of assets

The floating charge, if created by an FI, over its assets, would require, after its conversion into a universal bank, ratification by the Reserve Bank of India under Section 14(A) of the B. R. Act, since a banking company is not allowed to create a floating charge on the undertaking or any property of the company unless duly certified by RBI as required under the Section.

f) Nature of subsidiaries

If any of the existing subsidiaries of an FI is engaged in an activity not permitted under Section 6(1) of the B R Act , then on conversion of the FI into a universal bank, delinking of such subsidiary / activity from the operations of the universal bank would become necessary since Section 19 of the Act permits a bank to have subsidiaries only for one or more of the activities permitted under Section 6(1) of B. R. Act.

g) Restriction on investments

An FI with equity investment in companies in excess of 30 per cent of the paid up share capital of that company or 30 per cent of its own paid-up share capital and reserves, whichever is less, on its conversion into a universal bank, would need to divest such excess holdings to secure compliance with the provisions of Section 19(2) of the B. R. Act, which prohibits a bank from holding shares in a company in excess of these limits.

h) Connected lending

Section 20 of the B. R. Act prohibits grant of loans and advances by a bank on security of its own shares or grant of loans or advances on behalf of any of its directors or to any firm in which its director/manager or employee or guarantor is interested. The compliance with these provisions would be mandatory after conversion of an FI to a universal bank.

i) Licensing

An FI converting into a universal bank would be required to obtain a banking licence from RBI under Section 22 of the B. R. Act, for carrying on banking business in India, after complying with the applicable conditions.

j) Branch network

An FI, after its conversion into a bank, would also be required to comply with extant branch licensing policy of RBI under which the new banks are required to allot at least 25 per cent of their total number of branches in semi-urban and rural areas.

k) Assets in India

An FI after its conversion into a universal bank, will be required to ensure that at the close of business on the last Friday of every quarter, its total assets held in India are not less than 75 per cent of its total demand and time liabilities in India, as required of a bank under Section 25 of the B R Act.

l) Format of annual reports

After converting into a universal bank, an FI will be required to publish its annual balance sheet and profit and loss account in the forms set out in the Third Schedule to the B R Act, as prescribed for a banking company under Section 29 and Section 30 of the B. R. Act .

m) Managerial remuneration of the Chief Executive Officers

On conversion into a universal bank, the appointment and remuneration of the existing Chief Executive Officers may have to be reviewed with the approval of RBI in terms of the provisions of Section 35 B of the B. R. Act. The Section stipulates fixation of remuneration of the Chairman and Managing Director of a bank by Reserve Bank of India taking into account the profitability, net NPAs and other financial parameters. Under the Section, prior approval of RBI would also be required for appointment of Chairman and Managing Director.

n) Deposit insurance

An FI, on conversion into a universal bank, would also be required to comply with the requirement of compulsory deposit insurance from DICGC up to a maximum of Rs.1 lakh per account, as applicable to the banks.

o) Authorised Dealer's Licence

Some of the FIs at present hold restricted AD licence from RBI, Exchange Control Department to enable them to undertake transactions necessary for or incidental to their prescribed functions. On conversion into a universal bank, the new bank would normally be eligible for full fledged authorised dealer licence and would also attract the full rigour of the Exchange Control Regulations applicable to the banks at present, including prohibition on raising resources through external commercial borrowings.

p) Priority sector lending

On conversion of an FI to a universal bank, the obligation for lending to "priority sector" up to a prescribed percentage of their 'net bank credit' would also become applicable to it .

q) Prudential norms

After conversion of an FI in to a bank, the extant prudential norms of RBI for the all-India financial institutions would no longer be applicable but the norms as applicable to banks would be attracted and will need to be fully complied with.

(This list of regulatory and operational issues is only illustrative and not exhaustive).