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MONETARY AND CREDIT INFORMATION REVIEW

UCBs

Investments in Non-SLR Securities

With a view to allowing primary (urban) co-operative banks (UCBs) greater flexibility in making non-SLR investments, the Reserve Bank has issued guidelines as below:

(i) Non-SLR investments would continue to be limited to 10 per cent of a UCB's total deposits as on March 31 of the previous year

(ii) Investments would be limited to "A" or equivalent rated commercial papers (CPs), debentures and bonds that are redeemable in nature. Investments in perpetual debt instruments are, however, not permitted.

(iii) Investments in unlisted securities should not exceed 10 per cent of the total non-SLR investments at any time. Where UCBs have already exceeded this limit, no incremental investment in such securities would be permitted.

(iv) Investments in units of mutual funds, except debt mutual funds and money market mutual funds, would not be permitted. The existing holding in units of other than debt mutual funds and money market mutual funds, including those in Unit Trust of India (UTI) should be disinvested. Till such time that they are held in the books of the UCB, they would be reckoned as non-SLR investments for the purpose of the limit at (i) above.

(v) Fresh investments in shares of all India financial institutions (AIFIs) would also not be permitted. The existing share holding in these institutions may be phased out and till such time they are held in the books of the bank, they would be reckoned as non-SLR investments for the purpose of the limit at (i) above.

(vi) All fresh investments under non-SLR category should be classified under 'held for trading' (HFT)/'available for sale' (AFS) categories only and marked to market as applicable to these categories of investments.

(vii) Balances held in deposit accounts with commercial banks and in permitted scheduled UCBs and investments in certificates of deposit (CDs) issued by commercial banks would be outside the limit of 10 per cent of total deposits prescribed for non-SLR investments.

(viii) The total amount of funds placed as inter-bank deposits (for all purposes including clearing, remittance, etc.) should not exceed 10 per cent of the demand and tine liabilities (DTL) of a UCB as on March 31 of the previous year. The prudential inter-bank exposure limit of 10 per cent of the DTL would be all-inclusive and not limited to inter-bank call and notice money. Exception has, however, been made for Tier I UCBs, which may place deposits up to 15 per cent of their NDTL with public sector banks over and above the prudential limit of 10 per cent of NDTL

(ix) Exposure to any single bank should not exceed 2 per cent of the depositing bank's DTL as on March 31 of the previous year, inclusive of its total non-SLR investments and deposits placed with that bank. Deposits, if any, placed for availing constituent subsidiary general ledger (CSGL) facility, currency chest facility and non-fund based

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facilities like bank guarantee (BG), letter of credit (LC) would be excluded to determine the single bank exposure limit for this purpose.

(x) All investments as above, barring deposits placed with banks would be subject to the prescribed prudential individual/group exposure limits.

(xi) All investments, other than those in CPs and CDs, should be in instruments with an original maturity of at least one year.

(xii) Non-scheduled UCBs having single branch-cum-head-office or having multiple branches within a single district, having a deposit base of Rs.100 crore or less are exempt from maintaining SLR in prescribed assets up to 15 per cent of their DTL, on keeping the required amount, in interest bearing deposits with State Bank of India and its subsidiary banks and public sector banks including Industrial Development Bank of India Ltd. Such deposits are not covered under these guidelines and the limits prescribed at (vii) above are exclusive of such deposits.

UCBs have been advised to review their investment policy and ensure that it provides for the nature and extent of investments intended to be made in non-SLR instruments now permitted, the risk parameters and cut-loss limits for holding/ divesting the investments. UCBs should also put in place proper risk management systems for capturing and analysing the risk involved in non-SLR investment and taking remedial measures in time.

The boards of UCBs should review the following aspects of non-SLR investment at half-yearly intervals:

- Total business (investment and divestment) during the reporting period.
- Compliance with prudential limits prescribed for non-SLR investment.
- Compliance with the prudential guidelines issued by the Reserve Bank on non-SLR securities.
- Rating migration of the issuers/issues held in the bank's books and consequent diminution in the portfolio quality.
- Extent of non-performing investments in the non-SLR category and sufficient provision thereof

UCBs should also disclose the details of the issuer-wise composition of non-SLR investments and non-performing investments in the 'Notes on Accounts' of the balance sheet.

Shifting of Offices

The Reserve Bank will now consider requests from UCBs (other than 'unit' banks) to shift their branches from one city to another in their area of operation within the same state, subject to the conditions that -

- The new centre is of the same or lower population group as the existing centre e.g., a branch at a 'D' centre can be shifted to another 'D' centre only.
- A branch located in an under-banked district can be shifted to another centre in an under-banked district only.
- The shifting should be beneficial to the bank in terms of cost and business.

UCBs may submit their applications in this regard to the regional office of the Reserve Bank's Urban Banks Department in whose jurisdiction the UCB's head office is situated.

BANKING

Monitoring Advances

Reiterating its earlier instructions, the Reserve Bank has advised banks to put in place stringent safeguards pertaining to post sanction monitoring of advances, such as, regular inspection of borrowers' assets charged to the banks, periodical visits to the assisted units, stock audits, etc,, especially where accounts show signs of turning into non-performing assets (NPAs). In such cases banks should strengthen their monitoring system by resorting to more frequent inspections of borrowers' godowns, ensuring that sale proceeds are routed through the borrower's accounts maintained with the bank and insisting on pledge of the stock in place of hypothecation.

Banks have also been advised that whenever stocks under hypothecation to cash credit and other loan accounts are found to have been sold but the proceeds have not been credited to the loan account, such action should normally be treated as a fraud. In such cases, banks should take immediate steps to secure the remaining stock so as to prevent further erosion in the value of the available security and also other action as warranted.

RRBs

Instructions on Shifting/Merger of Branches Modified

As the restrictive provisions of service area approach have been dispensed with, the Reserve Bank has modified its earlier instructions issued to regional rural banks (RRBs) regarding shifting/merger of branches. The modified instructions are -

Shifting of Branches

At Rural Centres

RRBs may shift branches in rural centres without obtaining the Reserve Bank's prior approval, subject to the condition that, both the existing and proposed centres are within the same block and that the relocated branch would be able to cater adequately to the banking needs of the villages served by the existing branch.

At Semi-Urban Centres

RRBs may shift their branches at semi-urban centres within the same locality/municipal ward without the Reserve Bank's prior approval. It should, however, be ensured that the locality/ward is not rendered unbanked due to the shifting of branch/es.

Merger of Loss Making Branches

Where two loss making branches of an RRB are in close proximity to each other (i.e. within a distance of about 5 kms.), the RRB may consider merging the two branches with a view to rationalising the spatial spread and reducing establishment/ operating costs.

Conversion of Satellite Offices into Full-fledged Branches

RRBs are now allowed to convert their satellite offices into full-fledged branches after obtaining concurrence from the Empowered Committee on RRBs. RRBs should, however, also obtain necessary licence from the Reserve Bank's regional office concerned.

Opening of Extension Counters

RRBs are now allowed to set up extension counters at places of worship and market places. The condition of being principal bankers would not apply in such cases. RRBs should, however, obtain the necessary licence from the Reserve Bank's regional office concerned.

FEMA

Rupee Loans to NRI Employees of Indian Companies

Authorised Dealer Category – I (AD Category – I) banks have now been permitted to grant rupee loans to non-resident indian (NRI) employees of Indian companies for acquiring shares of the companies under the employees stock option (ESOP) scheme. The loan scheme should be as per the policy approved by the bank's board and would further be subject to the conditions as follows :

(a) The loan amount should not exceed 90 per cent of the purchase price of the shares or rupees 20 lakh per NRI employee, whichever is lower.

(b) The rate of interest and margin on such loans may be decided by the banks, subject to the directives issued by the Reserve Bank from time to time.

(c) The amount should be paid directly to the company and should not be credited to the borrowers' non-resident accounts in India.

(d) The loan amount should be repaid by the borrower by way of inward remittances or by debit to his non-resident ordinary (NRO)/non-resident (external) rupee (NRE)/foreign currency non-resident (banks) {FCNR(B)} account.

(e) The loans would be included for reckoning capital market exposures and the bank should ensure compliance with the prudential limits, prescribed by the Reserve Bank from time to time, for such exposure to capital market.

CUSTOMER SERVICE

Branch Level Customer Service Committees

In order to encourage a formal channel of communication between customers and banks at the branch level, the Reserve Bank has advised banks to include their customers in their branch level customer service committees. Further, as senior citizens usually form an important constituency in banks, a senior citizen should also be included in the committee.

The branch level committees should submit quarterly reports giving inputs/suggestions to the Standing Committee on Customer Service, which should examine them and give relevant feedback to the Customer Service Committee of the board for necessary policy/procedural action. The Branch Level Customer Service Committee should meet at least once a month to study complaints/suggestions, cases of delay, difficulties faced/ reported by customers/members of the Committee and evolve ways and means of improving customer service.

Banks to furnish Copy of Loan Agreement to Borrowers

Reiterating its earlier instructions of May 2003, the Reserve Bank has advised banks/financial institutions (FIs) to invariably furnish a copy of the loan agreement along with a copy each of all enclosures quoted in the loan agreement to all borrowers at the time of sanction/disbursement of loans.

INFORMATION

Holding Companies in Banking Groups

The Reserve Bank of India released a discussion paper on Holding Companies in Banking Groups on August 24, 2007. The discussion paper which is open for public comments till October 7, 2007 has been summarised below:

Major Motivations for BHCs/FHCs in India

In terms of existing instructions in India, a bank's aggregate investment in financial services companies including subsidiaries is limited to 20 per cent of the paid up capital and reserves of the bank. In a Bank Holding Company (BHC)/ Financial Holding Company (FHC) structure, this restriction will not apply as the investment in subsidiaries and associates will be made directly by the BHC/FHC. Once the subsidiaries are separated from the banks, the growth of the subsidiaries/ associates would not be constrained on account of capital.

The government holding of public sector banks through a BHC/FHC will not be possible under the existing statutes. However, if statutes are amended to count for effective holding then, the most important advantage in shifting to BHC/FHC model would be that the capital requirements of banks' subsidiaries would be de-linked from the banks' capital.

Since the non-banking entities within the banking group would be directly owned by the BHC, the contagion and reputation risk on account of affiliates for the bank is perceived to be less severe as compared with at present.

Financial Conglomerates with IHCs

The intermediate holding companies (IHCs) model has been mainly used by multinational corporations to take tax advantage by setting up the intermediate holding companies in tax havens. The intermediate holding companies have also been used for regulatory arbitrage.

Concerns

General concerns

- Governments and financial sector regulators have always been concerned about the multi-layering of a corporate structure through a web of special purpose entities and intermediate holding companies. Particularly, the bank supervisors have viewed them as an impediment to effective supervision. The problem of regulators becomes accentuated if the intermediate companies do not fall within their regulatory ambit.

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- The financial conglomerates, especially the ones, involving multi-layered companies with intermediate holding companies incorporated in different jurisdictions, tend to be large as they are involved in a number of activities. The top holding company starts losing the grip on the step-down subsidiaries. The regulators are forced to extend liquidity support of financial safety net beyond usual measures to prevent a system wide financial crisis. This gives the market participants a feeling that when a crisis hits an institution that is 'too big to fail', the regulator would come to the rescue regardless of the circumstances that led to the crisis. Such perceptions coupled with the fact that complex financial institutions are also susceptible to the problem of weak internal controls, lack of flexibility and poor integration, ultimately result in weaker regulatory and supervisory control. It becomes really challenging and cumbersome for the regulators to supervise and assess the possible second order effects arising out of multi-layered complex structures.
- The multi-layering of corporate structure is not considered good from investors' point of view as they do not really know where the money invested by them would be eventually used. Thus, it becomes difficult for them to assess the true risk involved in their investments.
- While the impact of multiple gearing of capital through holding companies can be effectively eliminated through consolidation, the challenging issue would be the ‘excessive leverage’ by the downstream affiliates if the intermediate holding company issues debt not qualifying for its capital instruments, but downstreams the proceeds to a dependent in the form of equity or other elements of regulatory capital. Excessive leverage can constitute a prudential risk for the regulated entity if undue stress is placed on the regulated entity resulting from the obligation on the parent to service that debt. A similar problem can arise where a parent issues capital instruments of one quality (e.g Tier II capital instruments) and downstreams them as instruments of a higher quality (Tier I capital instruments).
- Apart from increasing the regulatory burden, the legal framework of the jurisdictions allowing such structures especially the bankruptcy/restructuring laws/procedures, capabilities of the accounting and audit profession have to be suitably upgraded.
- The structure involving IHCs within a conglomerate principally organised on Bank Subsidiary Model will not completely insulate the bank from the capital burden of the subsidiaries.

India Specific Concerns

- If the intermediate holding company confines its investments to the shares of group companies only and does not carry out any other financial activities, which is likely to be the case most of the times, it would not require registration under Section 45-I A of the RBI Act and would, therefore, not come under the regulatory purview of the Reserve Bank's Department of Non-Banking Supervision. Presence of an unregulated IHC will raise concerns about the supervision of banking groups.
- In a Bank Subsidiary conglomerate model, which is presently being followed in India, the intermediate holding companies, especially those combining non-banking subsidiaries/associates of the parent bank, will pose specific difficulties. While the bank will be able to avoid the present 20 per cent regulatory limit on investment in the financial services companies, the RBI's regulatory concerns on account of the overextension of the bank group and increase in corresponding reputation risk, will continue. These concerns will be further accentuated if the holding company is unregulated, which is likely to be the case under the existing regulation as the RBI may have difficulty in obtaining crucial information from the IHC as also in enforcing any prudential behavior required of such an IHC. The regulatory concerns in fact would be relevant even in the case when an unregulated IHC is inserted in a BHC/FHC model.
- Another possible complication can arise because of the legal restrictions on foreign holding in some subsidiaries like insurance companies. In insurance companies, the direct or indirect foreign holding cannot exceed 26 per cent. However, when the Indian promoter company is a banking company, the proportion of foreign holding in such a banking company would not be taken into account for the purpose of calculating 26 per cent cap of foreign holding in Indian insurance company in view of Regulation 11 (1) (g) (iii) of IRDA Regulations. In the IHC structure, the insurance company would be a subsidiary of the IHC, which in turn would be a wholly owned subsidiary of the bank, the above exemption would not be allowed. Though it might be within the power of the concerned regulator to give a ruling in favour of the IHC structure, it might still be open to legal review.

There are considerable advantages in having FHC/BHC structure inasmuch as the banks would be much better protected from the possible adverse effects from the activities of their non-banking financial subsidiaries. In fact, it may also be possible to consider allowing non banking subsidiaries under the FHC/BHC structure to undertake riskier activities which have not been allowed so far to bank subsidiaries such as commodity broking.

It will be useful to explore the possibility of adopting a BHC/FHC Model. However, a proper legal framework needs to be created before such structures are floated and it is ensured that no unregulated entities are present within the structure. It will also be useful to contain the complexity in the BHC/FHC Model as also in the Bank Subsidiary Model of conglomeration to the bare minimum. Towards this end, it will be desirable to avoid intermediate holding company structures.

Comments/suggestions may be sent to r_kumar@rbi.org.in

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