Speech

Discussion Paper on Universal Banking and Beyond*

Y. V. Reddy

There are many reasons why I am happy to be here and the most important of these is to have the honour of being with Mr. Narasimham, the Bhishma Pita Maha of financial sector in India. In fact, the Discussion Paper of the Reserve Bank of India (RBI) on "Harmonising the Role and Operations of Development Financial Institutions and Banking" (DP) relies heavily on the report of the Committee on Banking Sector Reforms or Narasimham Committee (NC). In fact, if the Discussion Paper (DP), does not appear to say much that is new, the fault entirely lies with, NC. After all, NC left little that was unsaid on the subject for DP to make an impact!

The DP was released in January 1999 and was discussed almost simultaneously as one of the subjects in a Seminar on Financial Markets and Institutions: Development and Reforms organised by the Society for Capital Market Research and Development. This was followed up by two seminars, devoted exclusively to discussion on DP. The first was organised jointly by the Industrial Development Bank of India (IDBI) and Industrial Credit and Investment Corporation of India (ICICI) in Mumbai. The second was organised jointly by the Federation of Chambers of Commerce and Industry, and Industrial Finance Corporation of India at New Delhi in March 1999. The RBI considers this meeting in the Administrative Staff College of India (ASCI), as the finale, with a gathering of almost all the luminaries of financial world. It should be possible in this seminar to come to definitive conclusions and arrive at consensus on future actions. Indeed, that is the purpose of this seminar, being the last in the series.

In the Key Note address, therefore, I will start with some clarifications on the DP, in the light of discussions so far. This will be followed by a narration of consensus arrived at so far on some issues and, of issues that are yet to be resolved. Some of the recent developments, international and domestic, may warrant looking beyond DP, especially on linkage between banking and insurance. A brief account of international practice would be relevant to us at this juncture. Finally, in viewing universal banking in a broader context including insurance, regulatory issues, especially regulatory co-ordination and regulations of conglomerates would come up. A possible approach to regulatory co-ordination is presented for discussion and debate.

Clarification

At the outset, it is necessary to be clear about focus of DP; what it sets out to cover, so that expectations are appropriate. The main focus is to rationalise and harmonise the relative roles of banks and DFIs in future. Draft proposals in the DP address this issue keeping in view both the general approach to universal banking which has a primary regulatory dimension, and the long-term capital needs of the corporate sector which has a primary developmental dimension. Hence, DP should be considered in a slightly different, though related, context from immediate measures to solve the problems faced by Development Financial Institutions (DFIs), in raising long-term resources at reasonable cost in lieu of concessional resources that were available to them till the reform process began. In fact, improved access to short-term resources through the traditional banking route helps diversify DFIs' business but would not necessarily add to the long-term resource base. The problems faced by the DFIs now or in the immediate future do require attention but their conversion into universal bank, by itself is neither a necessary nor a

sufficient option to overcome the difficulties.

Second, there are no legal or regulatory restrictions on adoption of universal banking in India. There are, however, prudential requirements as also entry conditions applicable to all banks and DFIs could certainly do banking business if they satisfy them. However, for DFIs, there are two practical impediments viz., (a) backlog of liabilities in a DFI on which reserve requirements have not been provided; and (b) the relatively high reserve requirements, particularly Cash Reserve Ratio (CRR). Needless to say, once the CRR is brought down by the RBI from about 10 per cent to, say the statutory minimum of three per cent, or even less in the banking system, DFIs would find it less cumbersome to satisfy the preconditions for becoming universal bank. The RBI is committed to bring down CRR, and the pace would depend on fiscal and monetary conditions. Thus, DFIs should find it easier to move towards universal banking in future, as reserve requirements are brought down.

Third, on the issue of reserve requirements on stock of liabilities of DFIs, a view is expressed that such reserve requirements be applied only on incremental liabilities. The suggestion would appeal as a good bureaucratic solution for a DFI problem, but one should pause and consider its acceptability as a defensible and true prudential measure. The real solution is to bring down the reserve requirements across the board.

Fourth, there is a further suggestion that reserve requirements should be applicable only to cash and cash like liabilities in respect of banks. In other words, the reserve requirements are to be linked to the maturity profile of liabilities. This could operate in a way that would make it easier for DFIs to become universal banks. This suggestion has large systemic implications and validity as a prudential measure needs to be looked at.

Fifth, and here the issue relates to transition path. A view is expressed that DFI should be permitted to become universal bank immediately with a predetermined timeframe in which reserve requirements are to be met by DFIs. Apart from implications of regulatory forbearance and level playing field arguments, it may be difficult to design a straight jacket transition path which would meet the needs of diverse DFIs.

Sixth, the RBI can only indicate appropriate regulatory regime for universal banking, but would it be proper for the RBI to impose a decision or insist on a time table for a DFI to become universal bank? The move towards universal banking, the pace and mix of services will be dictated by consumer demands and the response of concerned bank or DFI. The RBI can only put in place an appropriate regulatory framework that enables rather than inhibits such a move, while ensuring consistency with monetary policy and prudential standards.

Seventh, and in the context of time-frame, there is an impression that the RBI insists on a five year timeframe. The five year timeframe was indicated as 'ideal', taking into account a judgement on possible reduction in reserve levels in future and prospects of DFIs being able to meet prudential requirements smoothly. As mentioned in DP, there is no minimum or maximum time prescribed for a DFI to become universal bank; only an indicative or ideal time frame has been mentioned in the DP.

Eighth, on the status of DFIs, for purposes of regulation, a formal legally tenable and clearly identifiable regulatory framework of the RBI is available basically for banks and for non-bank financial companies. DFIs as a category are still loosely defined as indicated in DP and are in a way an amalgam of State/Central level, company/corporate forms, with different extents and degrees of public sector ownership and performing refinance, direct finance and other functions. The DP had given an approach to bring them under a transparent framework as suggested by NC.

Ninth, there are many issues which are relevant but were not covered by the DP for a number of reasons. Thus, issues such as inherent and relative capabilities of DFIs and banks to undertake universal banking on an extensive scale; details of consolidated supervision; nature of pressure from consumers in favour of universal banking; pressures towards universal banking due to globalisation and financial integration, etc. have not been detailed. However, two of the issues not covered in the DP, but that have gained importance since circulation of the DP, relate to link with insurance and issue of regulatory co-ordination. I propose to flag these two emerging issues for discussion in this seminar.

Consensus and Issues

It may be useful to recall major elements of the architecture of the financial system for the future envisaged in the DP and identify the consensus as well as unresolved issues as evident from the discussions held so far.

First, while the approach to universal banking is generally endorsed, there are differences among the participants on the pace, and sequencing. Some felt that the DP's indication of five years was too long, while others felt that DFIs need to continue as specialised institutions longer. Yet another view was that the RBI was too flexible and a uniform framework and rigid time-table was preferred to flexible, case-by-case approach advocated in the DP. There was also a view that the consumers would drive the movement to universal banking, but regulators have to enable such pressures to operate, maintaining prudential standards and systemic stability. Enabling framework is to be timed and sequenced. Incidentally, a few questioned the desirability of allowing 100 per cent DFI owned banking subsidiary as a backdoor entry to banking. Perhaps, more detailed discussion on these with special reference to role of the RBI would be useful.

Second, some expressed that DFIs need to continue as DFIs and indeed should be accorded special support, while a few felt that DFIs operations themselves are hindering the development of corporate debt market. There were extreme views also that the demise of DFIs is imminent and the issue is rebirth. There was some sort of agreement that there should be in future, only banks and NBFCs, but the issue is how DFIs will transit to one of the two categories and how are they to be treated and regulated by the RBI till a transition occurs. There is some reluctance among some participants to DFIs becoming "mere NBFCs". The issue then is, what should they be, under what category of appropriate regulation by the RBI or by any other appropriate regulator. Further, if DFI opts to continue indefinitely as DFI, would it then be an NBFC, and if so, under a separate or an existing category. Mr. Khan, in a recent discussion paper on Corporate Governance mentioned that the financial institutions should be brought fully under the regulatory and supervisory ambit of the RBI. He adds that the RBI/Department of Supervision need to devise suitable tools/ norms for financial instituions regulation/ supervision consistent with the

nature of their operations.

Third, there was a general agreement that banks are special for a country like India. As and when DFI chooses to become a bank, what should be the transition path in terms of availability of access to public deposits on par with banks *vis-à-vis* reserve requirements? How should the asset liability risk management be structured during the transition? Can it be straight jacket or case-by-case? How to reconcile the conflicting considerations including issue of level playing field between banks, which are admittedly special for us and non-banks? One view was that SLR should be dispensed with and CRR reduced straightaway, but these decisions are taken not only on compulsions of universal banking, but essentially as part of overall fiscal-monetary considerations.

Fourth, though there has not been detailed discussion, there appears to be a consent in favour of consolidated approach to supervision and regulation. The dangers of universal banks being big, and risks of failure of big universal banks, if regulation is inadequate, were touched upon. A few felt that real focus should be on asset-liability management than on business. There was a clear divergence of opinion on superregulator, though discussion was somewhat limited.

Fifth, the superiority of corporate form of organisation under Companies Act in respect of financial intermediaries appears to be technically favoured but there has been inadequate attention on this issue. In particular, its relevance for flexibility to meet the demands of universal banking including mergers etc. are yet to be debated. There was a mention about the importance of corporate governance in a consolidated framework of operation and regulation.

Sixth, the delinking of refinance institutions from supervisory functions has attracted marginal attention.

Seventh, the RBI has expressed itself in favour of relinquishing its ownership roles in respect of financial intermediaries, but, Government has to take a view and this would need legislative action. A strong view was expressed that the RBI should itself divest its shareholding to market rather than transfer its share to Government.

Eighth, the institutions concerned have not yet indicated formal initiatives towards harmonisation such as constituting a coordination committee. But, a variety of fora have been operating to ensure effective coordination. These could be further reviewed.

Universal Banking and Insurance : International Trends

A formal process of examining the various issues pertaining to banks' entry into insurance sector commenced a few days ago with consultations between Ministry of Finance, the Reserve Bank of India and Insurance Regulatory Authority. It is, therefore, appropriate that the discussion on issue of universal banking, which till recently was addressed in a narrow context, is now widened to include insurance and adopts broader definition of universal banking.

As mentioned in the DP, the term 'universal banks' in general refers to the combination of commercial banking and investment banking, i.e., issuing underwriting, investing and trading in securities. In a very broad sense, however, the term 'universal banks' refers to those banks that

offer a wide variety of financial services, especially insurance. International experience indicates that while there has been deregulation of combining of commercial banking and investment banking, including securities business, deregulation concerning the combination of banking and insurance business has been somewhat limited, at least until recently. Historically, the banking and insurance activities have been strictly segregated in most countries, except by way of ownership linkages. Only licensed insurance companies have generally been allowed to engage in insurance activities and the business of insurance companies has been largely confined to insurance and financial activities closely related to it.

There is distinction between production of insurance services, i.e. underwriting which is the principal function and, distribution of insurance products, i.e., agency function. Restrictions are most strictly adhered to in connection with the "production" of services; but approaches have been much more flexible in the field of "distribution". Thus, banks have generally been permitted to act as distributors of insurance products. Even here, however, several countries apply restrictions, such as a blanket prohibition or strict limits.

Another distinction that needs to be made is between providing of insurance services in-house and the ownership linkages with insurance companies. Restrictions on ownership linkages between banks and insurance companies have generally been considerably less severe than on the in-house provision of underwriting and distribution services. These restrictions have also been relaxed somewhat in a number of countries in the recent years.

On banks taking up insurance activities, in most European countries banks are allowed to set up insurance subsidiaries ("downstream linkages") but in some others such as the US and Japan, restrictions do exist. The cross-country pattern of restrictions on the ownership of banks by insurance companies ("upstream linkages") is more or less like that of downward linkages. Most countries that do not in principle set any limits on downstream linkages do not set them on upstream ones either.

One of the diversification paths widely used by banks in recent years has been the penetration of the insurance industry, either directly or, most often, through an alliance with an insurance company. As a result, financial conglomerates, which had previously been mainly limited to banking and a range of securities activities, have increasingly extended their reach into the insurance sector.

Generally, banks have followed one of the three paths to the insurance industry. Some banks have set up their own insurance company in recent years. Some banks bought shares of the existing insurance companies. A third group of banks has chosen to swap shares with insurance companies.

Insurance companies in many countries have also acquired stakes in some banks. Those shareholdings can be seen as an investment, or as a way of diversifying from the insurance business, or, finally as a procedure for promoting the distribution of insurance products through bank branches.

Banks and insurance companies have shown common interest for a number of reasons.

Commercial banks can use their distribution network to sell all types of insurance, particularly life insurance, to their traditional customers. Insurance companies are experienced in designing certain complex financial products and are offering financial products for placing savings that private customers find particularly appealing, such as, retirement funds or single-premium insurance policies.

Most important, the combining of banking and insurance activities raises the serious problem of the dual regulation to which they are subject and this requires close co-ordination between the agencies regulating them.

There are concerns among regulators that, any expansion in insurance activities by banks will result in new and more managerially complex risks. Such risks could ultimately harm the bank itself. In such contingencies, there could be increased claims on the deposit insurance fund or the safety net in general.

There are three organisational ways in which banks could engage in insurance activities: in-house, via a department of the bank; via a separately capitalized subsidiary of the bank, or via a separately capitalised affiliate of the bank holding company. The regulators do recognise that the risks to the bank will depend on the degree of integration and the organisational structure chosen in which to engage in insurance activities.

Universal Banking and Insurance : Indian Scene

In India, as and when insurance sector is opened up to the private sector including participation by foreign investment, many entities including major industrial houses, banks, FIs, NBFCs and mutual funds may like to enter insurance business. Some of our banks have already expressed interest in entering the insurance industry. Some DFIs have also shown interest. The process of discussion has just begun and it would be appropriate to take a view on the desirable extent of functional as well as ownership linkages between banking and insurance business, both in public and private sector. There are legal aspects that need to be examined so that enabling provisions or notifications are considered by appropriate regulatory jurisdiction and co-ordination is even more important, and on this also, an approach will be suggested later.

Banks in India are of a wide variety. Two broad categories are commercial banks and co-operative banks. In commercial banks category, there are nationalised banks, State Bank of India and its subsidiaries, foreign banks and private sector banks. There are also Regional Rural Banks. In co-operative banks category, there are state co-operative banks, central co-operative banks, primary or urban co-operative banks. The linkages between these different banks and variety of insurance businesses need to be considered.

Presently, there is no provision in the Banking Regulation Act whereby a bank could undertake the insurance business. The Act may have to be amended before banks could undertake insurance business. Alternatively, there is a provision in the Banking Regulation Act whereby banks could take any other form of business which the central government may notify. Thus, if the central government notifies insurance business as a lawful activity for a banking company, perhaps banks would be able to undertake insurance business. It may, of course, be necessary to specify what type of insurance business they could undertake.

DFIs could be broadly divided into two categories, viz., those set up under the Companies Act, 1956 and those which are statutory bodies set up under the Acts of Parliament. Companies set-up under the Companies Act, could be permitted to undertake banking and insurance business provided it is allowed in the object clause of the Memorandum of Association. As regards statutory bodies, while there is no specific mention allowing FIs to undertake insurance business, but it should be possible for Government to permit by simple notification. Technically, NBFCs, like other companies could also be permitted to undertake banking and insurance activities, provided it is allowed in the Memorandum of Association.

As regards insurance companies, in order to stave off the risk of specialisation, insurance institutions may also like to diversify, especially by entering into banking business. This will be possible only when the relevant Acts are suitably amended, and regulatory framework is put in place.

Thus, Government will have to take a view on linkages between banks and insurance companies, both as the owner of public sector banks, DFIs and insurance companies, and as a sovereign that has to assign appropriate regulatory jurisdiction whenever the two activities overlap. Indeed, the design of appropriate regulatory framework may be considered as a pre-condition for any notification or permission for banks or DFIs to be involved in any type of insurance activity.

This would imply a view on the overall regulatory co-ordination in the financial sector. Since such common activities operate with scale economies, conglomerates will have to be expected and appropriate regulation designed for such conglomerates.

Regulatory Issues

There are three important developments that have taken place in recent years which are relevant to this debate on an appropriate regulatory framework for India now. First, the question of supervision of financial conglomerates has gained significance, and global consensus would be relevant to us. Second, draft of a new capital adequacy framework has been circulated by Bank for International Settlements which is under discussion. Third, a review of regulatory structures has been undertaken in many countries and for example, the UK has already adopted a super regulator approach.

The Joint Forum on Financial Conglomerates (Joint Forum) was established in early 1996 under the aegis of the Basle Committee on Banking Supervision (Basle Committee), the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIA) to take forward the work of the Tripartite Group whose report was released in July 1995. The Forum has examined ways to enhance supervisory co-ordination, including the benefits and drawbacks to establishing criteria to identify and define the responsibilities of a co-ordinator. The papers prepared by the Forum relate to Capital Adequacy Principles, Fit and Proper Principles, Framework for Supervisory Information Sharing, Principles for Supervisory Information Sharing, Co-ordinator and Supervisory Questionnaire.

The Forum's focus has been, primarily, on diversified financial firms with complex organisational and management structures whose large scale activities cross national borders and

sectoral boundaries. However, the lessons drawn and the guidance prepared could also apply to smaller conglomerates or conglomerates that only operate domestically.

The new capital adequacy framework of BIS on banking, circulated as a consultative paper to replace the existing BIS capital adequacy norms also addresses the issue of consolidation of accounts and capital adequacy. The banking accord is to be applied on a consolidated basis for preserving the integrity of capital base in the banking system. The new accord has to be extended to include, on a fully consolidated basis, holding companies that are parents of banking group. As an alternative to full consolidation, the application of the accord on stand-alone basis, would be acceptable, provided investments in subsidiaries and significant minority owned stakes are deducted from the capital. The draft emphasises the need to continue efforts aimed at aligning capital standards of banking, securities, insurance supervisors in order to assist the assessment of conglomerate-wide capital adequacy. The draft also lays emphasis on the need for co-operation among banking, securities and insurance supervisors to ensure that the overall level of capital and its distribution are adequate to meet the risks within the mixed group and the risks arising elsewhere in the group are adequately taken into account.

The draft is being examined in the RBI and at some stage soon, a detailed discussion among the interested parties would be appropriate. Our views need to be firmed up and transmitted to BIS effectively.

There has, in the recent years, been an on-going debate about the most effective structure for financial services regulation. It is driven mainly by the rapid changes in the financial services industry itself - blurring the boundaries between traditionally distinct forms of financial intermediation and distinct categories of institutions through which such intermediation took place. It is driven partly by public expectations in terms of both the prudential and the behavioural standards of financial intermediaries. We are no exception to this trend and we have the experience of some countries like UK, which could be studied.

An Approach for India

There is a need to review our regulatory framework, not only in the light of the global developments that have been mentioned, but also due to domestic compulsions.

The domestic compulsions that may warrant a review of the institutional structure of financial regulation in India are : (a) There are regulatory gaps, as for example private placement of debt. (b) There are regulatory overlaps; for example there is a growing recognition about this issue from the point of view of developing market for securitised debt. (c) There is a perceived need for formal co-ordination between the regulatory agencies, which is currently occurring through an informal high level group on capital markets presided over by the Governor of the RBI with SEBI Chairman and Finance Secretary as Members. (d) A variety of issues are coming up with regard to the issue of Government nominees on the regulatory bodies and their role in regulation. Of course, in the Reserve Bank of India, the Government nominee is a member of the Board but is a non-voting member. But, in other organisations like SEBI, where there may be more than one nominee of Government, the question of regulatory-autonomy arises, more so if the Government is also the owner of regulated institutions. (e) There are new developments like the establishment of insurance regulatory authority. There can be regulatory overlaps, for example,

if State Bank of India diversifies into insurance business or insurance companies diversify into banking business. The concept of universal banking implies multiple business activities. The institutional approach focuses on institutions (say, banks) while the functional approach focuses on business activity (say securities trading). The multiple business activities, especially through possible conglomerates would need a review of regulatory framework.

I had just a couple of weeks ago floated a tentative technical proposal in a seminar on corporate governance, jointly sponsored by Dr. Yerram Raju of this College and Dr. Y.R.K. Reddy of Yaga Consultants. Since there is no point in creating new bureaucracies, there are practical difficulties in massive redeploy-ment of personnel, and expertise for regulation cannot be created overnight, some ways of filling up the regulatory gaps and overlaps should be found without disrupting the existing regulatory structures. The proposal is to explore the feasibility of an umbrella regulatory legislation which creates an apex regulatory authority without disturbing the existing jurisdiction. The features of the proposal are: The Board for Financial Supervision of the RBI can continue to supervise banks and non-banks but with the Deputy Governor as Chairman; the insurance regulating authority will supervise insurance companies and Securities and Exchange Board of India will continue with its regulatory jurisdiction. The apex financial regulatory authority may be constituted, by statute with the Governor of the Reserve Bank of India as Chairman and the members could be Chairmen of the three regulatory agencies. The apex body should also include some outside experts on a part-time basis. Finance Secretary could be a permanent special invitee or a regular member without voting rights as in the case of the RBI Board. The apex authority could have by law, jurisdiction to assign regulatory gaps to one of the agencies; arbitrate on regulatory overlaps and ensure regulatory co-ordination. The apex authority could be serviced by a part-time secretariat of the RBI. In a way the proposal improves and formalises the present informal arrangement into a legislative based authority.

Let me hasten to add that between the apex regulatory authority that I suggested and super-regulator model, I will be tempted to prefer the U.K. model of Super-regulator for only one purpose. Because, Deputy Governor of Bank of England moved as head of the new body, I could hope for Mr. Talwar's elevation as super-regulator. Yet, I would favour simpler version of apex authority that I just described, on objective considerations.

Conclusion

Friends, I hope that the deliberations would provide significant guidance to many of us, and indeed should help resolve some issues now, while setting the agenda for future.

I am also happy that the papers and deliberations of the seminar series on the DP would be published soon.

Let me wish the seminar a grand success.

*** Keynote address by Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India, at the Seminar on "Harmonising the Role and Operations of Development Financial Institutions and Banks", on June 28, 1999.**

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