Bank financing of equities and investments in shares

DBOD. BP.BC. 51 /21.04.137/2000-2001

November 10, 2000
Kartika 19, 1922

All Commercial Banks (excluding RRBs)

Dear Sir,

Bank financing of equities and investments in shares

Please refer to paragraph 45 of the Governor's Statement on 'Mid-term Review of Monetary and Credit Policy for the year 2000 – 2001' forwarded with Circular No. MPD. BC. 201/07.01.279/2000-01 dated 10th October, 2000. As indicated therein, the guidelines on banks' investments in shares and financing of equities have been finalised based on the feed back received from banks and other market participants on the draft guidelines earlier issued by RBI. These are given below for compliance by banks :

2. Ceiling on banks' investments in shares and debentures

(i) In terms of circular DBOD No.Dir.BC.61/13.07.05/94 dated May 18, 1994, banks are free to acquire shares, convertible debentures of corporates and units of equity-oriented mutual funds, subject to a ceiling of 5 per cent of the incremental deposits of the previous year. As recommended by the RBI-SEBI Technical Committee, it has been decided that within the overall exposure to sensitive sectors, a bank's exposure to capital market by way of investments in shares, convertible debentures and units of mutual funds (other than debt funds) through primary or secondary markets should not exceed 5 per cent of the bank's total outstanding domestic credit (excluding inter-bank lendings and advances outside India) as on March 31 of the previous year.

(ii) It is clarified that the ceiling for investments in shares, etc., as stated in the above paragraph is the maximum permissible ceiling and a bank's Board of Directors is free to adopt a lower ceiling for the bank, keeping in view its overall risk profile. In respect of those banks where the present outstanding investments in equities are relatively small and well below the above overall ceiling, as a prudential measure, the Board should also lay down an annual ceiling for fresh investments in equities so that any increase in fresh investments in equities takes place in a phased, gradual and cautious manner, within the overall absolute ceiling fixed by the Board.

(iii) Banks may make investment in shares directly taking into account the in-house expertise available within the bank as per the investment policy approved by the Board of Directors subject to the risk management and internal control guidelines indicated in paragraph 7.

(iv) Banks may also make investment in units of UTI and SEBI approved other diversified mutual funds with good track records as per the investment policy approved by the Board of Directors. Banks should make investments in specific schemes of mutual funds / UTI and not place funds with mutual funds / UTI for investments in the capital market on their behalf.

(v) Underwriting commitments taken up by the banks in respect of primary issues through book building route would also be within the above overall ceiling.

(vi) Investments in shares and debentures / bonds should as hitherto, be reckoned for the purpose of arriving at the prudential norm of single borrower and borrower- group exposure ceilings, as stipulated in our circular DBOD. No. BP. BC 132/66-89 dated 26th May,1989.

(vii) Credit substitutes like Commercial Paper, non-convertible debentures, etc., may not be reckoned as part of credit portfolio for arriving at the ceiling on bank's investments in shares and debentures.

(viii) Banks whose investments in shares, etc., are now in excess of the above overall ceiling may bring down their investments gradually to conform to the ceiling, by March 31, 2001.

3. **Financing of Initial Public Offerings (IPOs)**

(i) Banks may grant advances for subscribing to IPOs to individuals. The maximum amount of finance that can be extended to an individual against IPOs should be Rs.10 lakh, as applicable to advances against physical shares. The other terms and conditions for financing of IPOs (including the minimum margin of 50 per cent and 25 per cent against physical and dematerialised shares, respectively) should be the same as those applicable to advances against shares to individuals, set out in our Master Circular DBOD.No.Dir.BC.90/ 13.07.05/1998 dated August 28, 1998. The corporates should not be extended credit by banks for investment in other companies' IPOs. Similarly, banks should not provide finance to NBFCs for further lending to individuals for IPOs.

(ii) Finance extended by a bank for IPOs should be reckoned as an exposure to capital market.

4. Issue of guarantees on behalf of brokers

In terms of our above Master Circular dated 28th August, 1998, banks are free to determine the margin to be maintained for issue of guarantees on behalf of share brokers, as per the loan policy approved by their Boards. It has now been decided that a minimum margin of 25 per cent inclusive of cash margin, should be obtained by banks for issue of guarantees on behalf of share brokers. Banks may, at their discretion, obtain margin higher than 25 per cent as per the policy approved by their Board of Directors.

5. Advances against shares and debentures to individuals and share brokers and market makers:

(i) **Advances to individuals**:

The terms and conditions relating to financing of individuals against shares and debentures, viz., maximum amount of finance of Rs. 10 lakh and Rs. 20 lakh against physical and dematerialized shares with a minimum margin of 50 per cent and 25 per cent, respectively, formulation of a lending policy by the Board, laying down an aggregate limit for advances against shares to individuals, etc., set out in the Master circular dated 28th August, 1998 would remain unchanged.

(ii) **Advances to share brokers:**

As set out in the Master circular dated 28th August,1998, banks are free to provide need based overdraft facilities / line of credit to share brokers and market makers against shares and debentures held by them as stock-in-trade after making a careful assessment of the requirements for finance taking into account the financial position of the borrower, operations on his own account and on behalf of clients and other relevant factors indicated therein. Banks are also free to grant working capital facilities to stock brokers registered with SEBI, to meet the cash flow gap between delivery and payment for DVP transactions undertaken on behalf of institutional clients. As indicated therein, banks may decide on the basis of their commercial judgement, the quantum as well as margin on the finance provided to the stock brokers and market makers.

(iii) **Advances to corporates for meeting promoters' contribution, bridge loan against expected equity flows, etc:**

Loans sanctioned to corporates against the security of shares for meeting promoters' contribution to the equity of new companies in anticipation of raising resources and bridge loans sanctioned to companies for a period not exceeding one year against expected equity flows/issues, expected proceeds of non-convertible debentures, external commercial borrowings, GDRs and/or funds in the nature of foreign direct investments, (which are now within the ceiling of 5 per cent of the incremental deposits of the previous year in terms of Master Circular dated 28th August, 1998 and Circular DBOD.No.DIR.BC.2/13.07.05/99 dated 29th January, 1999, respectively), would continue to be within the overall ceiling stipulated in paragraph 2 above.

6. Conformity with provisions of Banking Regulation Act,1949:

(i) The bank's exposure by way of investment in shares and advances against shares should meet the statutory requirements regarding holding of shares of a company contained in sections 19(2) and (3) and 20(1)(a) of the Banking Regulation Act, 1949, as also the single borrower and borrower-group exposure norms stipulated by the RBI.

(ii) The other terms and conditions contained in the Master Circular dated 28th August, 1998 remain unchanged.

7. Risk Management and internal control

Banks desirous of making investments in equity shares, etc. within the above ceiling and financing of equities, should observe the following guidelines:

a) Build up adequate expertise in equity research by establishing a dedicated equity research department, as warranted by their scale of operation,
b) Formulate a transparent policy and procedure for investment in shares, etc,
c) The decision in regard to individual investments in shares, etc., should be taken by the Investment Committee set up by the bank. The Investment Committee should be held accountable for the investments made by the bank.
d) Banks should review on an ongoing basis, their investment in shares with a view to assessing the risks due to volatility in asset prices.
e) As a prudential measure, a bank's exposure to investment in equities whose prices are subject to volatility (e.g., shares, convertible debentures and units of equity- oriented mutual funds) should not normally exceed 20 per cent of its net worth.
f) The RBI- SEBI Committee in its report has observed that internationally, advances against shares are also treated as lending to 'sensitive sector' on account of the volatility in prices. The Committee has further observed that most of the banks have not laid down, as part of their lending policy, any prudential norm on maximum exposure to capital market, including investments as well as advances against shares. The Committee has therefore, recommended that the Boards of banks should lay down a prudential ceiling on the bank's total exposure to capital market, keeping in view its overall risk profile. Accordingly, in addition to the ceiling of 5 per cent on investments prescribed in paragraph 2 (i), Board of Directors of banks should also fix an overall ceiling on advances against shares, i.e., financing of IPOs, advances to individuals and share brokers and market makers, issue of guarantees on behalf of brokers, advances to corporates to meet promoters' contribution, etc.

g) The following may be excluded for reckoning the bank's aggregate exposure by way of financing of equities:
   i. Advances against collateral security of shares.
   ii. Advances to individuals for personal purposes like education, housing, consumption, etc., against the security of shares.

8. <u>Valuation and disclosure</u>

Banks should mark to market their investment portfolio in equities like other investments as per the valuation norms indicated in our circular DBOD. No. BP .BC 32 / 21.04.048 / 2000-2001 dated 16th October, 2000. Further, banks should disclose the total investments made in shares, convertible debentures and units of equity oriented mutual funds as also aggregate advances against shares, etc., in the 'Notes on Accounts' to their balance sheets, beginning from the year ending March 2001.

9. <u>Review of Guidelines</u>

A reference is invited to paragraph 46 of the Statement on the Mid-term Review of the Monetary and Credit Policy, indicating that the Standing Technical Committee of RBI and SEBI will review the guidelines after six months in consultation with banks keeping in view their institutional set up, operational mechanism and the experience gained. Information on policy approved by the Board in respect of each bank, the institutional set up for undertaking investments, actual investments made by each bank directly or through mutual funds as well as any operational problem faced by a bank may be made available to the Committee at the time of next review.

10. <u>Reporting requirements</u>

Since the returns on advances granted by banks against shares and debentures as also investments in equity shares, etc. are submitted as part of the first tranche of OSMOS returns, banks need not forward separately to us the return on advances against shares as required in paragraph 10 of the Master Circular dated 28th August, 1998.

11. Please acknowledge receipt of this circular.

Yours faithfully,

[A. L. Narasimhan]
Chief General Manager