Bank Financing of Equities and Investments in Shares: Revised Guidelines

DBOD. BP. BC. 119 / 21.04.137 / 2000-2001

May 11 , 2001

All commercial banks (excluding RRBs and LABs)

Dear Sir,

Bank Financing of Equities and Investments in Shares: Revised Guidelines

As you are aware, in pursuance of the announcement made in October, 2000 in the Mid-term Review of the Monetary and Credit Policy for the year 2000-2001, the RBI- SEBI Technical Committee has reviewed the RBI guidelines set out in circular DBOD.BP.BC.51/21.04.137/2000-01 dated November 10, 2000 on banks' investment in shares as also advances against shares and other connected exposures. Based on the feed back received from banks and market participants on the recommendations made by the Technical Committee and on the amendments proposed to the earlier guidelines, Reserve Bank of India has since revised the guidelines on banks' investment in shares and financing of equities. In this connection, a reference is also invited to paragraph 105 of the Statement on Monetary and Credit Policy for the year 2001-2002. The revised guidelines are enclosed in the Annexure for compliance by banks and are in supersession of earlier circular DBOD. BP. BC. 51/ 21.04. 137/ 2000-01 dated November 10, 2000.

2. The revised guidelines include certain "Transitional Provisions" in order to ensure smooth transition to the new guidelines and to provide sufficient time to banks to adjust their portfolio of investment in shares and advances / guarantees against shares.

3. The CMDs / CEOs of banks are requested to give their personal attention particularly to the provisions relating to putting in place the risk management and internal control systems enunciated in paragraph 12 of the revised guidelines.

4. This circular may please be put up before the Board of Directors at its next meeting.

5. Please acknowledge receipt.

Yours faithfully,
(M.R. Srinivasan)
Chief General Manager-in- Charge.

Annexure

Reserve Bank of India
Department of Banking Operations and Development(DBO&D)
Central Office

Revised Guidelines on Bank Financing of Equities and Investments in Shares
referred to in circular DBOD. BP. BC. 119 / 21.04.137 / 2000-2001
dated May 11, 2001

Coverage of the Guidelines

1. Broadly, banks can acquire shares, debentures and units of mutual funds etc., for three different purposes :

(a) for making direct investment in shares / debentures etc. at bank's own risk;

(b) for making loans and advances to individuals and sharebroking entities for the purpose of making investment in capital markets on their own account. Here, the investment risk is that of the individual or stock-broking entities. Loans / advances by banks are normally fixed in value and carry the stipulated interest rate, and the risk to banks could arise on account of inadequacy of margins or the inability of borrowers to meet their repayment / interest obligations to banks because of volatility in share prices or other related reasons, and

(c) shares/ debentures may be assigned to banks by individuals and corporates as collateral and additional security for certain approved purposes which do not involve stock broking or investment in capital market.

These guidelines cover investments in shares, convertible bonds and debentures and units of equity-oriented mutual funds and advances against equity shares, bonds and debentures, units of mutual funds, etc. for purposes (a) and (b) above. In respect of (c) above, banks are free to accept additional shares, debentures, units of mutual funds etc. as collateral for approved purposes as per the normal banking practice and appraisal procedures.

Ceiling on overall exposure to capital market :

2. The ceiling of 5 per cent prescribed for investment in shares will henceforth apply to **total** exposure including both fund based and non-fund based, to capital market by a bank in all forms. The ceiling will illustratively cover :

i) Direct investment by a bank in equity shares, convertible bonds and debentures and units of equity oriented mutual funds;
ii) Advances against shares to individuals for investment in equity shares (including IPOs), bonds and debentures, units of equity-oriented mutual funds etc;
iii) Secured and unsecured advances to stockbrokers and guarantees issued on behalf of stockbrokers and market makers;

3. The 5 per cent ceiling will be computed in relation to the bank's total outstanding advances (including Commercial Paper) as on March 31, of the previous year. Non-fund based facilities and investment by banks in non-convertible debentures and other similar instruments (excluding Commercial Paper), should not be included in computing the total outstanding advances of the

bank. Further, for computing the ceiling on exposure to capital market, direct investment in shares by banks will be calculated at cost price of the shares.

4. As mentioned in paragraph 1 (c) above, it is clarified that the ceiling of 5 per cent will not include collateral of equity shares / bonds and debentures offered to the bank by corporares other than NBFCs, for availing of secured loans for working capital or other productive purposes which do not involve stock broking or investment in capital markets. Advances made by banks to individuals for personal purposes like education, housing, consumption etc., will also be outside the 5 per cent ceiling.

Ceiling on direct investment in shares, etc

5. Within the above overall ceiling of 5 per cent for total exposure to capital market, the total investment in shares, convertible bonds and debentures and units of equity-oriented mutual funds by a bank should not exceed 20 per cent of its net worth, as hitherto. While making investment in equity shares etc., whose prices are subject to volatility, the banks should keep in view the following guidelines :

(i) The ceiling for investment in shares, etc., as stated in the above paragraph (i.e., 20 per cent of net worth), 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 and corporate strategy.

(ii) 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 compliance with the risk management and internal control systems indicated below.

(iii) 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. Such investments should be in specific schemes of UTI / Mutual Funds and not by way of placement of funds with UTI / Mutual Funds for investment in the capital market on their behalf.

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

(v) Investment in equity shares and convertible bonds and debentures of corporate entities should as hitherto, be reckoned for the purpose of arriving at the prudential norm of single-borrower and borrower-group exposure ceilings.

Advances against shares and debentures

(a) Advances to individuals :

6. The present maximum ceilings of advances to individuals against security of shares and debentures (i.e. Rs.10 lakhs against physical shares and Rs.20 lakh against dematerialized shares) will continue. Such loans are meant for genuine individual investors, and banks should not support collusive action by a large group of individuals, belonging to the same corporate or their inter-connected entities to take multiple loans in order to support particular scrips or stock-broking activities of the concerned firms.

(b) Financing of Initial Public Offerings(IPOs):

7. The maximum amount of finance that can be granted to an individual for IPOs (i.e., Rs.10 lakh) as at present, remains unchanged. The corporates should not be extended finance for investment in other companies' IPOs and NBFCs should not be provided finance for further lending to individuals for IPOs. Finance extended by a bank for IPOs should be reckoned as an exposure to capital market.

(c) Avoidance of concentration to a few stock broking entities :

8. The banks are free to provide credit facilities to stock brokers and market makers on the basis of their commercial judgment, within the policy framework approved by their Boards. However, in order to avoid any nexus emerging between inter-connected stock broking entities and banks, the Board of each bank should fix, within the overall ceiling of 5 per cent prescribed in paragraph 2 above, a sub-ceiling for total advances to –

(i) all the stock brokers and market makers (both fund based and non-fund based, i.e. guarantees) and

(ii) to any single stock broking entity, including its associates / inter-connected companies.

(d) Margins on advances against shares / issue of guarantees.

9. A uniform margin of 40 per cent shall be applied on all advances / financing of IPOs / issue of guarantees. A minimum cash margin of 20 per cent (within the margin of 40%) shall be maintained in respect of guarantees issued by banks. The above margin of 40 per cent will apply to all fresh advances / guarantees issued. The existing advances / guarantees issued may continue at the earlier margins until they come up for renewal.

(e) Financing of arbitrage operations

10. Banks should not undertake arbitrage operations themselves or extend credit facilities directly or indirectly to stockbrokers for arbitrage operations in Stock Exchanges.

11. While banks are permitted to acquire shares from the secondary market, they should ensure that no sale transaction is undertaken without actually holding the shares in its investment account.

Risk Management and internal control systems:

12. Banks desirous of making investment in equity shares / debentures, financing of equities and issue of guarantees within the above ceiling, should observe the following guidelines:

a) Investment policy

(i) Build up adequate expertise in equity research by establishing a dedicated equity research department, as warranted by their scale of operations ;

(ii) Formulate a transparent policy and procedure for investment in shares, etc., with the approval of the Board ;

b) Investment Committee

The decision in regard to direct investment in shares, convertible bonds and debentures should be taken by the Investment Committee set up by the bank's Board. The Investment Committee should be held accountable for the investments made by the bank.

c) Risk Management

(i) Banks should ensure that their exposure to stockbrokers is well diversified in terms of number of broker clients, individual inter-connected broking entities.

(ii) While sanctioning advances to stockbrokers, the banks should take into account the track record and credit worthiness of the broker, financial position of the broker, operations on his own account and on behalf of clients, average turn over period of stocks and shares, the extent to which broker's funds are required to be involved in his business operations, etc.

(iii) While processing proposals for loans to stockbrokers, banks are also advised to obtain details of facilities enjoyed by the broker and all his connected companies from other banks.

(iv) While granting advances against shares and debentures to other borrowers also, banks should obtain the details of credit facilities availed by them or their associates/inter-connected companies from other banks for the same purpose (i.e. investment in shares etc.). This is necessary in order to ensure that high leverage is not built up by the borrower or his associate or inter-connected companies with bank finance ;

d) Separation of functional responsibilities

(i) There should be clear separation of decision making in regard to investment in shares / advances against shares which will be done by the Investment Committee,

(ii) The surveillance and monitoring of investment in shares / advances against shares shall be done by the Audit Committee of the Board, which shall review in each of its meetings, the total exposure of the bank to capital market both fund based and non-fund based, in different forms as stated in paragraph 1 above and ensure that the guidelines issued by RBI are complied with and adequate risk management and internal control systems are in place.

(iii) The Audit Committee shall keep the Board informed about the overall exposure to capital market, the compliance with the RBI and Board guidelines, adequacy of risk management and internal control systems etc.

(v) In order to avoid any possible conflict of interest, it should be ensured that the stockbrokers as directors on the Boards of banks or in any other capacity, do not involve themselves in any manner with the Investment Committee or in the decisions in regard to making investments in shares, etc., or advances against shares.

<u>Valuation and Disclosure</u>

13. Equity shares in a bank's portfolio - as primary security or as collateral for advances or for issue of guarantees and as an investment- should be marked to market preferably on a daily basis, but at least on weekly basis. Banks should disclose the total investments made in equity shares, convertible bonds and debentures and units of equity oriented mutual funds as also aggregate advances against shares in the 'Notes on Account' to their balance sheets.

Transitional provisions:

14. In respect of banks whose exposure to capital market by way of investment in shares and advances against shares is in excess of the ceiling as prescribed in paragraph 2 above, the following transitional provisions are provided in order to ensure smooth transition to the revised guidelines:

a. Such banks whose exposure to capital market is in excess of the ceiling prescribed in paragraph 2 above, should formulate a time-bound plan for gradually reducing their exposure to stock market in line with the prudential ceiling now prescribed. In working out the time bound plan, the advances granted to individuals against shares for investment purposes, may not be recalled and in case of any difficulties arising on this account, the banks may approach RBI for suitable relaxation. This time-bound plan, along with data on exposures under investment and various categories of advances / guarantees, should be submitted to the RBI by June 15, 2001. Meanwhile, these banks should not make any fresh investment in equity shares / advances against shares and issue guarantees.
b. The margin of 40% indicated in paragraph 9 above will apply to all fresh advances / financing of IPOs / issue of guarantees. Earlier advances / guarantees may continue at the existing margins until they come up for renewal.

c. CMDs / CEOs of all banks should review their present portfolio of investment in shares / advances against shares / guarantees and in case investment / advances / guarantees are beyond the limits prescribed by its Board or are in violation of the guidelines of November 10, 2000, such investment / advances / guarantees should be reduced at the earliest. This review should also cover cases of excessive advances / guarantees in favour of any particular entities and their inter-connected companies.

Review of the Guidelines

15 A review of the amended Guidelines will again be undertaken by the RBI-SEBI Technical Committee after six months. For this purpose, banks may submit data relating to the actual investment in equity shares, convertible bonds and debentures and equity-oriented mutual funds as also advances against shares to individuals, stock brokers and their associates / inter-connected companies, guarantees issued on behalf of brokers, financing of IPOs, the operational problems if any, faced by banks, etc. to RBI by the end of September, 2001.