

## **Exposure Norms**

DBOD No. Dir. BC. 17/13.03.00/2002-03

August 22, 2003  
Shravana 31, 1924(S)

Chief Executives of all Scheduled Commercial Banks  
(Excluding RRBs and LABs)

Dear Sir,

### **Master Circular – Exposure Norms**

Please refer to the Master Circular DBOD. No. Dir .BC. 20/13.03.00/2002-03 dated 20th August 2002 consolidating the instructions/guidelines issued to banks till 30<sup>th</sup> June 2002 relating to Exposure Norms. The Master Circular has been suitably updated by incorporating the instructions issued up to 30<sup>th</sup> June 2003 and has been placed on the RBI website (<http://www.rbi.org.in>).

2. This Master Circular is a compilation of the instructions contained in the circulars issued by RBI on the above subject, which are operational as on the date of this circular.

Yours faithfully,

**(M.R. Srinivasan)**

Chief General Manager-in- charge

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### Master Circular on Exposure Norms

#### 1. General

As a prudential measure aimed at better risk management and avoidance of concentration of credit risks, the Reserve Bank of India has advised the banks to fix limits on their exposure to specific industry or sectors and has prescribed regulatory limits on banks' exposure to individual and group borrowers in India and unsecured guarantees and unsecured advances. In addition, banks are also required to observe certain statutory and regulatory exposure limits in respect of advances against / investments in shares, debentures and bonds.

#### 2. Credit Exposures to Individual/Group Borrowers

##### 2.1 Ceilings

- 2.1.1 The exposure ceiling should be fixed in relation to bank's capital funds. Internationally, exposure ceilings are computed in relation to total capital as defined under capital adequacy standards (Tier I and Tier II Capital). Taking into account the best international practices, it has been decided to adopt the concept of capital funds as defined under capital adequacy standards for determining exposure ceiling uniformly both by domestic and foreign banks, effective from 31 March 2002. The exposure ceiling limits applicable from April 1, 2002, which is based on the capital funds in India as computed above would be 15 per cent of capital funds in case of single borrower and 40 percent in the case of a borrower group.

Foreign banks were advised to continue with the level of their exposure to single/group borrowers, in excess of the prudential norms, upto March 31, 2003. However, keeping in view the difficulties experienced by some of them to comply with the norms by the stipulated date i.e. April 1, 2003, as a special case, they have been given relaxation in respect of the following:

- (i) In the case of merger/acquisition of different borrowing companies, if the bank's group exposure exceeds the prudential norm, foreign banks may continue with the excess group exposure till March 31, 2004.
- (ii) The existing fund and non-fund based facilities in bonds/debentures and performance guarantees etc. exceeding the exposure ceilings, may continue till their expiry/maturity.

In no case, foreign banks should assume fresh exposure to single/group borrowers beyond the permissible ceiling.

2.1.2 Credit exposure to borrowers belonging to a group may exceed the exposure norm of 40 per cent of the bank's capital funds by an additional 10 per cent (i.e up to 50 per cent), provided the additional credit exposure is on account of extension of credit to infrastructure projects. Credit exposure to single borrower may exceed the exposure norm of 15 per cent of the bank's capital funds by an additional 5 per cent (i.e. up to 20 per cent) provided the additional credit exposure is on account of infrastructure as defined below.

2.1.3 Definition of 'infrastructure lending'

Any credit facility in whatever form extended by lenders (i.e. banks, FIs or NBFCs) to an infrastructure facility as specified below falls within the definition of "infrastructure lending". In other words, a credit facility provided to a borrower company engaged in:

- i. developing or
- ii. operating and maintaining, or
- iii. developing, operating and maintaining

any infrastructure facility that is a project in any of the following sectors:

- i. a road, including toll road, a bridge or a rail system;
- ii. a highway project including other activities being an integral part of the highway project;
- iii. a port, airport, inland waterway or inland port;
- iv. a water supply project, irrigation project, water treatment system, sanitation and sewerage system or solid waste management system;
- v. telecommunication services whether basic or cellular, including radio paging, domestic satellite service (i.e., a satellite owned and operated by an Indian company for providing telecommunication service), network of trunking, broadband network and internet services;
- vi. an industrial park or special economic zone ;
- vii. generation or generation and distribution of power
- viii. transmission or distribution of power by laying a network of new transmission or distribution lines.
- ix. Any other infrastructure facility of similar nature

#### **2.1.4 Lending under Consortium Arrangements**

The exposure limits will be applicable even in case of lending under consortium arrangements, wherever formalised.

### **2.2 EXEMPTIONS**

#### **2.2.1 Rehabilitation of Sick/Weak Industrial Units**

The ceilings on single/group exposure limits would not be applicable to existing/additional credit facilities (including funding of interest and irregularities) granted to weak/sick industrial units under rehabilitation packages.

#### **2.2.2 Food credit**

Borrowers to whom limits are allocated directly by the Reserve Bank, for food credit, will be exempt from the ceiling.

### **2.3 Definitions**

#### **2.3.1 Exposure**

Exposure shall include credit exposure (funded and non-funded credit limits) and investment exposure (including underwriting and similar commitments) as well as certain types of investments in companies. The sanctioned limits or outstandings, whichever are higher, shall be reckoned for arriving at exposure limit. In line with international best practices, it has been decided that effective from April 1, 2003, non-fund based exposures should also be reckoned at 100 per cent of the limit or outstandings, whichever is higher. *However, loans and advances granted against the security of bank's own term deposits may be excluded from the purview of the exposure ceiling.*

#### **2.3.2 Measurement of Credit Exposure of Derivative Products**

At present, derivative products such as Forward Rate Agreements (FRAs) and Interest Rate Swaps (IRSs) are also captured for computing exposure by applying the conversion factors to notional principal amounts as per the original exposure method prescribed in Annexures 1 and 2 of our circular MPD.BC. 187/07.01/279/1999-2000 dated July 7, 1999. It has been decided that, effective from April 1, 2003, banks should also include forward contracts in foreign exchange and other derivative products like currency swaps, options, etc. at their replacement cost value in determining individual/group borrower exposure. The methodology to be adopted by banks for arriving at the replacement cost value is given below.

Banks may adopt, effective from April 1, 2003, either of the two methods viz. (i) Original Exposure Method, and (ii) Current Exposure Method consistently for all derivative products, in determining individual / group borrower exposure.

Under the Original Exposure Method, credit exposure is calculated at the beginning of the derivative transaction by multiplying the notional principal amount with a conversion factor. In order to arrive at the credit equivalent amount using the Original Exposure Method, a bank would apply the following credit conversion factors to the notional principal amounts of each instrument according to the nature of the instrument and its original maturity:

Original Maturity	Conversion factor to be applied on Notional Principal Amount	
	Interest Rate Contract	Exchange Rate Contract
Less than one year	0.5%	2.0%
One year and less than two years	1.0%	5.0% (2% +3%)
For each additional year	1.0%	3.0%

The other method (Current Exposure Method) to assess the exposure on account of credit risk on interest rate and exchange rate derivative contracts is to calculate periodically the current replacement cost by marking these contracts to market, thus capturing the current exposure without any need for estimation and then adding a factor (“add-on”) to reflect the potential future exposure over the remaining life of the contract. Therefore, in order to calculate the credit exposure equivalent of off-balance sheet interest rate and exchange rate instruments under Current Exposure Method, a bank would sum:

- (i) the total of replacement cost (obtained by “marking to market”) of all its contracts with positive value (i.e. when the bank has to receive money from the counter party), and
- (ii) an amount for potential future changes in credit exposure calculated on the basis of the total notional principal amount of the contract multiplied by the following credit of conversion factors according to the residual maturity:

Residual Maturity	Conversion factor to be applied on Notional Principal amount	
	Interest Rate Contract	Exchange Rate Contract
Less than one year	Nil	1.0%
One year and over	0.5%	5.0%

Banks should mark to market the derivative products at least on a monthly basis and they may follow their internal methods of determining the marked to market value of the derivative products.

Banks would not be required to calculate potential credit exposure for single currency floating / floating interest rate swaps. The credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

Banks are encouraged to follow the Current Exposure Method which is an accurate method of measuring credit exposure in a derivative product. In case a bank is not in a position to adopt the Current Exposure method, it may follow the Original Exposure

Method. However, its endeavour should be to move over to Current Exposure Method in course of time.

### 2.3.3 Credit exposure

Credit exposure comprises of the following elements:

- (a) all types of funded and non-funded credit limits.
- (b) facilities extended by way of equipment leasing, hire purchase finance and factoring services.
- (c) advances against shares, debentures, bonds, units of mutual funds, etc. to stock brokers, market makers.
- (d) bank loan for financing promoters contributions.
- (e) bridge loans against equity flows/issues.
- (f) financing of Initial Public Offerings (IPOs).

### 2.3.4 Investments exposure

Investments exposure comprises of the following elements:

- (a) investments in shares and debentures of companies acquired through direct subscription, devolvement arising out of underwriting obligations or purchased from secondary markets or on conversion of debt into equity.
- (b) investment in PSU bonds through direct subscription, devolvement arising out of underwriting obligations or purchase made in the secondary market.
- (c) investments in Commercial Papers (CPs) issued by Corporate Bodies/PSUs.
- (d) the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, provides, among others, sale of financial assets by banks / FIs to Securitisation Company (SC)/ Reconstruction Company(RC). Banks' / FIs' investments in debentures/ bonds / security receipts / pass-through certificates (PTCs) issued by a SC / RC as compensation consequent upon sale of financial assets will constitute exposure on the SC / RC. As only a few SC/RC are being set up now, banks' / FIs' exposure on SC / RC through their investments in debentures / bonds / security receipts / (PTCs) issued by the SC / RC may go beyond their prudential exposure ceiling. In view of the extra ordinary nature of event, banks / FIs will be allowed, in the initial years, to exceed prudential exposure ceiling on a case-to-case basis.

*The investment made by the banks in bonds and debentures of corporates which are guaranteed by a PFI<sup>Å</sup> (as per list given in Annexure 1) will be treated as an exposure by the bank on the PFI and not on the corporate.*

### **2.3.5 Capital Funds**

Capital funds for the purpose will comprise of Tier I and Tier II capital as defined under capital adequacy standards.

### **2.3.6 In the case of *Indian Banks***

**Tier I Capital** consists of

- (i) Paid up capital, statutory reserves, and other disclosed free reserves, if any.
- (ii) Capital reserves representing surplus arising out of sale proceeds of assets.
- (iii) Less: equity investments in subsidiaries, intangible assets and losses in the current period as well as those brought forward from the previous years.
- (iv) In the case of public sector banks which have introduced Voluntary Retirement Schemes (VRS), in view of the extra-ordinary nature of the event, the VRS related Deferred Revenue Expenditure would not be reduced from Tier I capital.
- (v) The infusion of capital either through domestic issue or overseas float, after the published balance sheet date will also be taken into account for determining the exposure ceiling. Other accretion to capital funds by way of quarterly profits etc. would not be eligible for determining the ceiling. Banks are also prohibited from taking exposure in excess of the ceiling in anticipation of capital at a future date.

**Tier -II capital** consists of

- (i) Undisclosed reserves and cumulative perpetual preference shares.
- (ii) Revaluation reserves (discounted at 55% for determining their value for inclusion in Tier-II capital).
- (iii) General Provision and loss reserves, general provisions on 'Standard Assets' and 'Investment Fluctuation Reserves' (subject to an overall ceiling of 1.25% of total risk weighted assets).

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<sup>Å</sup>With the merger of ICICI Ltd. with ICICI Bank Ltd. effective from 30.03.2002, the entire liabilities of ICICI Ltd. have been taken over by ICICI Bank Ltd. As per the scheme of merger all loans and guarantee facilities to ICICI Ltd. provided by Government would be transferred to the merged entity. Similarly, the investments made in erstwhile ICICI Ltd. by banks would be treated outside the ceiling of 5% till redemption.

- (iv) Excess provision towards investments held in “Investment Fluctuation Reserve Account”.
- (v) Hybrid Debt Capital Instruments and Subordinated Debt (subject to appropriate discount at rates depending on period to maturity).
- (vi) **vi.** Subordinated Debt instruments eligible to be reckoned as Tier II capital will be limited to 50 percent of Tier I capital. However, in the case of public sector banks, the bonds issued to the VRS employees as a part of the compensation package (net of the un-amortised VRS Deferred Revenue expenditure) could be treated as Tier II capital subject to compliance with the terms and conditions stipulated in Master Circular dated 5 July 2002.
- (vii) Tier II elements should be limited to a maximum of 100 percent of total Tier I elements for the purpose of compliance with the norms.

### 2.3.7 In the case of *Foreign banks* operating in India

**Tier-1 capital** consists of the following:

- (i) Interest Free funds from Head Office kept in separate account in Indian books to meet the capital adequacy norms.
- (ii) Statutory reserves kept in Indian books.
- (iii) Remittable surplus retained in Indian books which are not repatriable so long as the bank functions in India.
- (iv) Capital reserves representing surplus arising out of sale of assets in India held in a separate book and not repatriable so long as the bank functions in India.
- (v) Interest free funds remitted from abroad for the purpose of acquisition of property and held in separate account in Indian books.
- (vi) The net credit balance, if any, in the inter-office account with Head Office/overseas branches will not be reckoned as capital funds. However, any debit balance in Head Office account will have to be set-off against the capital.

**Tier-II capital**

- (i) To the extent relevant, elements of Tier -II capital as indicated in respect of Indian banks would be eligible. The foreign banks are allowed borrowings in foreign currency as subordinated debt. The total amount of HO borrowings in foreign currency will be at the discretion of the foreign bank. However, the amount eligible for inclusion in Tier II capital as subordinated debt will be subject to a maximum ceiling of 50% of the Tier I capital maintained in India.
- (ii) The elements of Tier I & Tier II capital do not include foreign currency loans granted to Indian parties.



### **2.3.8 Group**

The concept of 'Group' and the task of identification of the borrowers belonging to specific industrial groups is left to the perception of the banks/financial institutions. Banks/financial institutions are generally aware of the basic constitution of their clientele for the purpose of regulating their exposure to risk assets. The group to which a particular borrowing unit belongs, may, therefore, be decided by them on the basis of the relevant information available with them, the guiding principle being commonality of management and effective control.

- 2.3.9 In the case of a split in the group, if the split is formalised, the splinter groups will be regarded as separate groups. If banks and financial institutions have doubts about the *bona fides* of the split, a reference may be made to RBI for its final view in the matter to preclude the possibility of a split being engineered in order to prevent coverage under the Group Approach.

### **2.4 Review**

An annual review of the implementation of exposure management measures may be placed before the Board of Directors before the end of June and a copy each of such review may be furnished for information to the Chief General Manager-in-Charge, Department of Banking Operations and Development, Central Office, Reserve Bank of India, World Trade Centre, Mumbai and to the concerned Regional Offices of the Department.

## **3. Credit Exposure to Industry and Certain Sectors**

### **3.1 Internal Exposure Limits**

#### **3.1.1 Fixing of sectoral limits**

Apart from limiting the exposures to individual or Group of borrowers, as indicated above, the banks may also consider fixing internal limits for aggregate commitments to specific sectors e.g. textiles, jute, tea, etc. so that the exposures are evenly spread over various sectors. These limits could be fixed by the banks having regard to the performance of different sectors and the risks perceived. The limits so fixed may be reviewed periodically and revised, as necessary.

Banks with large exposure to corporates should monitor and review on a monthly basis through a suitable reporting system, the unhedged portion of foreign currency exposures of corporates with relatively large foreign currency exposures.

#### **3.1.2 Exposure to Real Estate**

Banks should frame comprehensive prudential norms relating to the ceiling on the total amount of real estate loans, single/group exposure limits for such loans, margins, security, repayment schedule and availability of supplementary finance and the policy should be approved by the bank's Board.

**3.1.3** While framing the bank's policy, the guidelines issued by the Reserve Bank should be taken into account. Banks should ensure that the bank credit is used for productive construction activity and not for activity connected with speculation in real estate.

### **3.2 Exposure to Leasing, Hire Purchase and Factoring Services**

**3.2.1** Banks should maintain a balanced portfolio of equipment leasing, hire purchase and factoring services vis-à-vis the aggregate credit. Their exposure to each of these activities should not exceed 10 percent of total advances.

### **3.3 Exposure to Indian Joint Ventures/Wholly-owned Subsidiaries Abroad**

**3.3.1** Banks are allowed to extend credit/non-credit facilities (viz. letters of credit and guarantees) to Indian Joint Ventures/Wholly-owned Subsidiaries abroad. Banks are also permitted to provide at their discretion, buyer's credit/acceptance finance to overseas parties for facilitating export of goods & services from India.

**3.3.2.1** The above exposure will, however, be subject to a limit of 10 per cent of banks' unimpaired capital funds (Tier I and Tier II capital), subject to the following conditions:-

- (i) Loan will be granted only to those joint ventures where the holding by the Indian company is more than 51%.
- (ii) Proper systems for management of credit and interest rate risks arising out of such cross border lending are in place.
- (iii) while extending such facilities, banks will have to comply with Section 25 of the Banking Regulation Act, 1949, in terms of which the assets in India of every banking company at the close of business on the last Friday of every quarter shall not be less than 75 percent of its demand and time liabilities in India. In other words, aggregate assets outside India should not exceed 25 percent of the bank's demand and time liabilities in India.
- (iv) The resource base for such lending should be funds held in foreign currency accounts such as FCNR (B), EEFC, RFC etc. in respect of which banks have to manage exchange risk.
- (v) Maturity mismatches arising out of such transactions are within the overall gap limits approved by RBI.
- (vi) All existing safeguards / prudential guidelines relating to capital adequacy, exposure norms etc. applicable to domestic credit / non-credit exposures are adhered to.

The above facility is subject to review in April 2004.

Further, the loan policy for such credit / non-credit facility should be, inter alia, in keeping with the following;

- (a) Grant of such loans is based on proper appraisal and commercial viability of the projects and not merely on the reputation of the promoters backing the

project. Non-fund based facilities should be subjected to the same rigorous scrutiny as fund based limits.

- (b) The countries where the joint ventures / wholly owned subsidiaries are located should have no restrictions applicable to these companies in regard to obtaining foreign currency loans or for repatriation etc. and should permit non-resident banks to have legal charge on securities / assets abroad and the right of disposal in case of need.

**3.3.3** The banks should also comply with all existing safeguards/prudential guidelines relating to capital adequacy, and exposure norms indicated in paragraph 2.1.1, *ibid*.

### **3.4 Banks' exposure to the Capital Markets**

The detailed instructions on Bank Finance against Shares and Debentures are given separately in the Master circular DBOD. No. DIR. BC. 90/13.07.05/98 dated 28 August 1998 on Bank Finance against shares and debentures -- Master Circular read with Circular DBOD. No. BP. BC. 119/21.04.037/2000-01 dated 11 May 2001. The salient features are given below for ready reference.

#### **3.4.1 Statutory Limit on Shareholding in Companies**

In terms of Section 19(2) of the Banking Regulation Act, 1949, no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30 percent of the paid-up share capital of that company or 30 percent of its own paid-up share capital and reserves, whichever is less, except as provided in sub-section (1) of Section 19 of the Act. Shares held in demat form should also be included for the purpose of determining the exposure limit. This is an aggregate holding limit for each company. While granting any advance against shares, underwriting an issue of shares, or acquiring any shares on investment account or even in lieu of debt of any company, these statutory provisions should be strictly observed.

#### **3.4.2 Regulatory Limits**

The bank's aggregate exposure to the capital markets covering direct investment by a bank in equity shares, convertible bonds and debentures and units of equity oriented mutual funds; advances against shares to individuals for investment in equity shares (including IPOs), bonds and debentures, units of equity-oriented mutual funds etc and secured and unsecured advances to stockbrokers and guarantees issued on behalf of stockbrokers and market makers; should not exceed 5 per cent of their total outstanding advances (including Commercial Paper) as on March 31 of the previous year. This ceiling of 5 per cent prescribed for investment in shares would apply to total exposure including both fund based and non-fund based to capital market in all forms. Within this overall ceiling, banks investment in shares, convertible bonds and debentures and units of equity oriented mutual funds should not exceed 20 percent of its networth. The banks are required to adhere this ceiling on an ongoing basis.

#### **3.4.3 Advances against Shares to Individuals**

Loans at all the offices of a bank, against the security of shares, debentures and PSU bonds to individuals, if held in physical form should not exceed the limit of Rs. 10 lakh per individual borrower (Rs 20 lakhs per individual borrower, if the securities are held in demat form). The maximum amount of finance that can be granted to an individual for financing his subscription to an Initial Public Offering (IPO) is Rs. 10 lakh. Finance extended by a bank for IPOs is also reckoned as an exposure to capital market and reckoned within 5% ceiling indicated in para 3.4.2 above. Advances against units of mutual funds including units of Unit-64 scheme would attract the quantum and margin requirements as applicable to advances against shares and debentures wherever stipulated.

**3.4.4** Banks should formulate with the approval of their Boards the Lending Policy for grant of advances to individuals against shares, debentures, bonds keeping in view RBI guidelines. As a prudential measure, the banks may also consider laying down appropriate aggregate sub limits of such advances.

#### **3.4.5 Advances against Shares to Stock Brokers and Market Makers**

Banks are free to provide credit facilities to stockbrokers 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 of their total outstanding advances (including Commercial Paper) as on March 31 of the previous year 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.

#### **3.4.6 Margins on advances against shares / issue of guarantees**

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.

#### **3.4.7 Arbitrage operations**

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

#### **3.4.8 Margin Trading**

Banks may extend finance to stockbrokers for margin trading in actively traded scrips forming part of the NSE Nifty and the BSE Sensex, within the overall ceiling of 5% prescribed for exposure of banks to capital market.

### 3.5 Bank Loans for Financing Promoter's Contributions

- 3.5.1 Loans sanctioned to corporates against the security of shares (as far as possible demat shares) for meeting promoter's contribution to the equity of new companies in anticipation of raising resources, should be treated as bank's investments in shares which would thus come under the ceiling of 5 per cent of the bank's total outstanding advances (including Commercial Paper) as on March 31 of the previous year prescribed for bank's total exposure including both fund based and non-fund based to capital market in all forms.
- 3.5.2 These loans will also be subject to individual/group of borrowers exposure norms as well as the statutory limit on shareholding in companies detailed above.
- 3.5.3 In the context of Government of India's programme of disinvestments of its holdings in some public sector undertakings (PSUs), it has been clarified to banks that they can extend finance to the successful bidders for acquisition of shares of these PSUs, subject to certain conditions. If on account of banks' financing acquisition of PSU shares under the Government of India's disinvestment programmes, any bank is likely to exceed the regulatory ceiling of 5 per cent on capital market exposure in relation to its total outstanding advances as on March 31 of the previous year, such requests for relaxation of the ceiling would be considered by RBI on a case by case basis, subject to adequate safeguards regarding margin, bank's exposure to capital market, internal control and risk management systems, etc. The relaxation would be considered in such a manner that the bank's exposure to capital market, in all forms, net of its advances for financing of acquisition of PSU shares shall be within the regulatory ceiling of 5 per cent.

RBI would also consider relaxation on specific requests from banks in the individual / group credit exposure norms on a case by case basis ( in the format prescribed in terms of circular DBOD No. BP. 2724/21.03.054/2000-01 dated 28 May 2001), provided that the bank's total exposure to the borrower, net of its exposure due to acquisition of PSU shares under the Government of India disinvestments programme, should be within the prudential individual / group borrower exposure ceiling prescribed by RBI.

- 3.5.4 Under the refinance scheme of Export Import Bank of India, (EXIM Bank) the banks may sanction term loans on merits for eligible Indian promoters for acquisition of equity in overseas joint ventures/ wholly owned subsidiaries, provided the term loans have been approved by the EXIM Bank for refinance.

### 3.6 Risk Management and Internal Control System

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) Formulate a transparent policy and procedure for investment in shares, etc., with the approval of the Board.
- (ii) The banks should build up adequate expertise in equity research by establishing a dedicated equity research department, wherever warranted by their scale of operations.

b) **Investment Committee**

The decision in regard to direct investment in shares, convertible bonds and debentures should be taken by an 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, banks should obtain 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.) in order to ensure that high leverage is not built up by the borrower or his associate or inter-connected companies with bank finance.

**3.6.1 Audit committee**

- (i) 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 and ensure that the guidelines issued by RBI are complied with and adequate risk management and internal control systems are in place;

- (ii) 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;
- (iii) 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.

### **3.6.2 Valuation and Disclosure**

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.

### **3.7 Bridge Loans**

- 3.7.1** Banks have been permitted to sanction bridge loans to companies for a period not exceeding one year against expected equity flows/issues. Such loans should be included within the ceiling of 5 per cent of the banks' total outstanding advances (including Commercial Paper) as on March 31 of the previous year prescribed for total exposure including both fund based and non-fund based to capital market in all forms.
- 3.7.2** Banks should formulate their own internal guidelines with the approval of their Board of Directors for grant of such loans, exercising due caution and attention to security for such loans.
- 3.7.3** Banks may also extend bridge loans against the expected proceeds of Non-Convertible Debentures, External Commercial Borrowings, Global Depository Receipts and/or funds in the nature of Foreign Direct Investments, provided the banks are satisfied that the borrowing company has already made firm arrangements for raising the aforesaid resources/funds.

### **3.8 Bank finance to employees to buy shares of their own companies**

Banks may provide finance to employees of companies to buy shares of their own companies. The advance may be granted upto 90 percent of the purchase price of the shares but not exceeding Rs. 50,000/- or six months' salary of the employees, whichever is less.

### **4. Exposure norms for investments**

- 4.1** Banks exposure to capital market as detailed in paragraph 3.4.2 above should be within the overall ceiling of 5 per cent of the banks total outstanding advances (including Commercial Paper) as on March 31 of the previous year. Within this

overall ceiling, banks investment in shares, convertible bonds and debentures and units of equity-oriented mutual funds should not exceed 20 per cent of its net worth. The banks are required to adhere to the ceiling on an ongoing basis and should exercise care to see that the limit is not exceeded.

**4.1.1** For the purpose of reckoning compliance with the ceiling for investments prescribed above, the following items are to be included –

- (i) direct investment by a bank in equity shares, convertible bonds and debentures and units of equity oriented mutual funds the corpus of which is not exclusively invested in corporate debt.
- (ii) bank finance for financing promoter's contribution towards equity capital of new companies.
- (iii) bridge loans to companies.

**4.1.2** The investment ceiling exclude investment in -

- (i) the subordinated debts of other banks.
- (ii) preference shares,
- (iii) non-convertible debentures/bonds of private corporate bodies,
- (iv) equities/bonds of All-India Financial Institutions  
(as per list given in *Annexure 2*),
- (v) bonds issued by Public Sector Undertakings,
- (vi) units of Mutual Funds under schemes where corpus is invested exclusively in debt instruments,
- (vii) venture capital including units of dedicated venture capital funds meant for Information Technology, and
- (viii) investments in Certificate of Deposits (CDs) of other banks/ financial institutions.

**4.1.3** *However, all these categories of investments are to be taken into consideration for the purpose of arriving at the prudential norm of credit exposure for single borrower and group of borrowers as stipulated in paragraph 2.1.1 above.*

**4.1.4 Banks Investment in the Bonds of a Corporate**



For the purpose of calculation of exposure norm, investments made by the banks in bonds and debentures of corporates, which are guaranteed by a PFI<sup>A</sup>, as per list given in *Annexure I*, will be treated as an exposure by the bank on the PFI and not on the corporate.

- 4.1.5** Guarantees issued by the PFI to the bonds of corporates will be treated as an exposure by the PFI to the corporates to the extent of 50 percent being a non-fund facility, whereas the exposure of the bank on the PFI guaranteeing the corporate bond will be 100 percent. The PFI before guaranteeing the bonds/debentures should, however, take into account the overall exposure of the guaranteed unit to the financial system.

#### **4.1.6 Banks Investment in Subordinated Debt Instruments**

A high level of cross holding of subordinated debt instruments (issued by banks and financial institutions to raise Tier II capital) among banks and financial institutions, does not necessarily lead to accretion of capital to the financial system. As such, a bank's investment in Tier II bonds issued by other banks and financial institutions shall be permitted upto 10 percent of the investing bank's total capital. The total capital for this purpose will be the same as that reckoned for the purpose of capital adequacy.

#### **4.1.7 Banks' Investment in Venture Capital**

In order to encourage the flow of finance for venture capital, the banks investment in venture capital (including units of dedicated Venture Capital Funds meant for Information Technology) would be over and above the ceiling of 5 per cent of the banks total outstanding advances (including Commercial Paper) as on March 31 of the previous year. This would, however, be subject to the condition that the venture capital funds/ companies are registered with SEBI.

### **4.2 Underwriting of Corporate Shares and Debentures**

Generally, there are demands on the banks for underwriting the issues of shares and debentures. In order to ensure that there is no over exposure to underwriting commitments to earn fees, the guidelines detailed below should be strictly adhered to:

- (i) The statutory provision contained in Section 19(2) & (3) of the Banking Regulation Act, 1949 regarding holding of shares in any company as pledgee / mortgagee or absolute owner, should be strictly adhered to;
- (ii) The banks have to ensure that the shares/debentures including PSU equities and shares of other banks, Mutual Funds (the corpus of which is not

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<sup>⊗</sup> With the merger of ICICI Ltd. with ICICI Bank Ltd. effective from 30.03.2002, the entire liabilities of ICICI Ltd. have been taken over by ICICI Bank Ltd. As per the scheme of merger all loans and guarantee facilities to ICICI Ltd. provided by Government would be transferred to the merged entity. Similarly, the investments made in erstwhile ICICI Ltd. by banks would be treated outside the ceiling of 5% till redemption.

exclusively invested in corporate debt instruments), the units of UTI subscribed and/or devolving on them as a part of their underwriting obligations in any particular year comply with the ceiling prescribed for the banks' exposure to the capital markets.

- (iii) It may be noted that the limit placed is on the shares and debentures, that may be held in the banks own portfolio as a result of devolvement and not on the amount of underwriting that the banks may engage in. Normally, the amount of underwriting is a multiple of the amount which devolves finally.
- (iv) The underwriting exposure to any company which will include other funded and non-funded credit limits should not exceed 15 percent (upto 20 percent provided additional credit exposure is on account of infrastructure project) of capital funds of the banks in the case of a single company and 40 percent (up to 50 percent, provided the additional credit exposure is on account of extension of credit to infrastructure project) in the case of group of companies.
- (v) While taking up underwriting commitments, banks or their subsidiaries, should ensure that the aggregate of such commitments are included in the exposure limits fixed by the Reserve Bank.
- (vi) In the case of underwriting, the commitments under a single obligation should be fixed taking into account the owned funds of banks and the capacity to meet the commitments that may devolve and should not in any case exceed 15 percent of an issue.
- (vii) Banks should consider sub-underwriting for every underwritten issue so as to minimise chances of devolution on their own account. This is not mandatory. The need for and extent of such sub-underwriting is a matter of bank's discretion.
- (viii) As part of merchant banking activities, while taking up underwriting obligations, banks should carefully evaluate the proposals so as to ensure that the issues will have adequate public response and the prospect of devolution of such shares/debentures on the underwriting banks will be minimal.
- (ix) **ix.** Banks should ensure that the portfolio is diversified and that no unduly large underwriting obligations are taken up in the shares and debentures of a company or a group of companies. Banks should make enquiries regarding the other underwriters and their capacity to fulfil the obligations.

Banks should formulate within the above parameters, their own internal guidelines as approved by their Boards of Directors on investments in corporate shares/debentures of companies or group of companies including norms to ensure that excessive investment in any single company is avoided and that due attention is given to the maturity structure and quality of such investments.

### **4.3 Prohibitions on underwriting operations**

- 4.3.1** Banks should not underwrite issue of Commercial Paper by any Company, Primary Dealer or Satellite Dealer.
- 4.3.2** Banks should not extend Revolving Underwriting Facility to short-term Floating Rate Notes/Bonds or debentures issued by corporate entities.
- 4.3.3** An annual review covering the underwriting operations taken up during the year, with company-wise details of such operations, the shares/debentures devolved on the banks, the loss (or expected loss) from unloading the devolved shares/debentures indicating the face-value and market value thereof, the commission earned, etc. may be placed before their Boards of Directors within 2 months of the close of the fiscal year.

#### **4.4 Underwriting of bonds of Public Sector Undertakings**

The banks can play a useful role in relation to issue of bonds by Public Sector Undertakings (PSUs) by underwriting a part of these issues. Banks should subject the proposals for underwriting to proper scrutiny having regard to all the relevant factors and accept such commitments only on well reasoned commercial considerations with the approval of the appropriate authority.

The banks should formulate their own internal guidelines as approved by their Boards of Directors on investments in and underwriting of PSU bonds, including norms to ensure that excessive investment in any single PSU is avoided and that due attention is given to the maturity structure of such investments. Banks would also need to take into account that such investments are subject to risk weight and necessary depreciation has to be fully provided for. Such investments in PSU bonds including shares and debentures and subscription to Commercial Papers of PSUs should be reckoned for the purpose of arriving at prudential norms of credit exposure for single borrower and group of borrowers.

Banks should undertake an annual review of the underwriting operations relating to bonds of the public sector undertakings, with PSU-wise details of such operations, bonds devolved on the banks, the loss (or expected loss) from unloading the devolved bonds indicating the face-value and market value thereof, the commission earned, etc. and place the same to their Boards of Directors within two months from the close of the fiscal year.

With a view to enabling the banks to deploy their surplus funds more remuneratively, the banks will have the freedom to acquire PSU bonds including through underwriting devolvments without any ceiling.

#### **4.5 'Safety Net' Schemes for Public Issues of Shares, Debentures, etc.**

##### **4.5.1 'Safety Net' Schemes**

Reserve Bank had observed that some banks/their subsidiaries were providing buy-back facilities under the name of 'Safety Net' Schemes in respect of certain public issues as part of their merchant banking activities. Under such schemes, large exposures are assumed by way of commitments to buy the relative securities from the

original investors at any time during a stipulated period at a price determined at the time of issue, irrespective of the prevailing market price. In some cases, such schemes were offered *suo motto* without any request from the company whose issues are supported under the schemes. Apparently, there was no undertaking in such cases from the issuers to buy the securities. There is also no income commensurate with the risk of loss built into these schemes, as the investor will take recourse to the facilities offered under the schemes only when the market value of the securities falls below the pre-determined price.

Banks/their subsidiaries have therefore been advised that they should refrain from offering such 'Safety Net' facilities by whatever name called.

#### **4.5.2 Provision of buy back facilities**

In some cases, the issuers provide buy-back facilities to original investors upto Rs. 40,000/- in respect of non-convertible debentures after a lock-in-period of one year to provide liquidity to debentures issued by them. If, at the request of the issuers, the banks or their subsidiaries find it necessary to provide additional facilities to small investors subscribing to new issues, such buy-back arrangements should not entail commitments to buy the securities at pre-determined prices. Prices should be determined from time to time, keeping in view the prevailing stock market prices for the securities. Commitments should also be limited to a moderate proportion of the total issue in terms of the amount and should not exceed 20 percent of the owned funds of the banks/their subsidiaries. These commitments will also be subject to the overall exposure limits which have been or may be prescribed from time to time.

#### **5. Limits on exposure to unsecured guarantees and unsecured advances**

Banks have to limit their commitment by way of unsecured guarantees in such a manner that 20 percent of the bank's outstanding unsecured guarantees plus the total of outstanding unsecured advances do not exceed 15 percent of total outstanding advances. Guarantees counter-guaranteed by another bank need not be taken into account for the purpose of the norm. The detailed instructions in this regard are given in the Master circular on guarantees and co-acceptances.

#### **6. Application of prudential norms at group / on consolidated position**

In terms of guidelines for consolidated accounting and other quantitative methods to facilitate consolidated supervision, banks have inter-alia been advised that as prudential measure aimed at better risk management and avoidance of concentration of credit risks, in addition to adherence to prudential limits on exposures assumed by banks, consolidated banks should also adhere to the following prudential limits on:

- (i) Single and Group borrower exposures,
- (ii) Capital market exposures, and
- (iii) Exposures by way of unsecured guarantees and unsecured
- (iv) advances.

The operational details in this regard are furnished below.

- i) Exposure by the consolidated bank to a single borrower/ debtor should not exceed 15% of its capital funds. Exposure by the consolidated bank to a borrower/ debtor group should not exceed 40% of its capital funds. The aggregate exposure on a borrower/ debtor group can exceed the exposure norm of 40% by an additional 10% (i.e. up to 50%) provided the additional exposure is for the purpose of financing infrastructure projects. Computation of capital funds, exposure etc. would be on par with the methodology adopted for banks.
- ii) The consolidated bank's aggregate exposure to capital markets should not exceed 2 per cent of its total on-balance-sheet assets (excluding intangible assets and accumulated losses) as on March 31 of the previous year. This ceiling will apply to the consolidated bank's exposure to capital market in all forms, including both fund based and non-fund based, similar to the computation for the parent bank. Within the total limit, investment in shares, convertible bonds and debentures and units of equity-oriented mutual funds should not exceed 10 percent of consolidated bank's net worth.
- iii) The norms relating to unsecured guarantees and unsecured funded exposures on the lines of the guidelines issued to banks vide circular DBOD.No.666/C.96/(Z)-67 dated May 3, 1967, as amended from time to time, are also extended to the consolidated bank.

For the purpose of application of prudential norms on a group wise basis, a 'consolidated bank' is defined as a group of entities, which include a licensed bank, which may or may not have subsidiaries.

**Annexure 1****Master Circular on Exposure Norms  
List of All-India Financial Institutions**

*(Counter party exposure and assignment of Risk weight- List of institutions guaranteeing bonds of corporates )*

*[Vide paragraph 2.3.4 & 4.1.4]*

1. Industrial Finance Corporation of India Ltd.
2. Industrial Development Bank of India
3. Industrial Investment Bank of India Ltd.
4. Tourism Finance Corporation of India Ltd.
5. Risk Capital and Technology Finance Corporation Ltd.
6. Technology Development and Information Company of India Ltd.
7. Power Finance Corporation Ltd.
8. National Housing Bank
9. Small Industries Development Bank of India
10. Rural Electrification Corporation Ltd.
11. Indian Railways Finance Corporation Ltd.
12. National Bank for Agriculture and Rural Development
13. Export Import Bank of India
14. Infrastructure Development Finance Company Ltd.
15. Housing and Urban Development Corporation Ltd.
16. Indian Renewable Energy Development Agency Ltd.

**Annexure 2****Master Circular on Exposure Norms  
List of All-India Financial Institutions**

*(Investment in equity/bonds by banks- List of FIs whose instruments are exempted from the 5 % ceiling)  
(Vide paragraph 4.1.2)*

1. Industrial Finance Corporation of India Ltd. (IFCI)
2. Industrial Development Bank of India (IDBI)
3. Tourism Finance Corporation of India Ltd. (TFCI)
4. Risk Capital and Technology Finance Corporation Ltd. (RCTC)
5. Technology Development and Information Company of India Ltd. (TDICI)
6. National Housing Bank (NHB)
7. Small Industries Development Bank of India (SIDBI)
8. National Bank for Agriculture and Rural Development (NABARD)
9. Export Import Bank of India (EXIM Bank)
10. Industrial Investment Bank of India (IIBI)
11. Discount and Finance House of India Ltd. (DFHI)
12. Unit Trust of India (UTI)
13. Life Insurance Corporation of India (LIC)
14. General Insurance Corporation of India (GIC)
15. Securities Trading Corporation of India Ltd. (STCI)
16. Infrastructure Development Finance Company Ltd. (IDFC)

**Appendix****Master Circular  
Exposure Norms****List of Circulars consolidated by the Master Circular**

1.	DBOD No. Dir.BC.	20/13.03.00/2002-03	dated 20.08.2002
2.	DBOD No. Dir.BC.	6/13.07.05/2002-03	dated 22.07.2002
3.	DBOD No. BP.BC.	17/21.04.137/2002-03	dated 16.08.2002
4.	-do-	48/21.03.054/2002-03	dated 13.12.2002
5.	DBOD No. Dir.BC.	63/13.07.05/2002-03	dated 29.01.2003
6.	DBOD No. FSC.BC.	66/24.01.022/2002-03	dated 31.01.2003
7.	DBOD No. BP.BC.	67/21.04.048/2002-03	dated 04.02.2003
8.	DBOD No. IBS	1147/23.61.01/2002-03	dated 06.02.2003
9.	DBOD No. BP.BC.	72/21.04.018/2002-03	dated 25.02.2003
10.	DBOD No. IBS.BC.	94/23.37.001/2002-03	dated 08.04.2003
11.	DBOD No. BP.BC.	96/21.04.048/2002-03	dated 23.04.2003