Report of The Standing Technical Committee
of RBI and SEBI on Review of the
RBI Guidelines on `Bank Financing of Equities'

Executive Summary

1. As announced 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 on banks' investments in shares as also advances against shares and other connected exposures. The Report of the Committee was submitted to the RBI on April 12,2001.

2. The Committee observed that banks have by and large adhered to the RBI guidelines. However, a few banks had over-extended exposure by way of advances against shares in violation of the spirit of the RBI guidelines.

3. The total investment in shares of the 101 scheduled commercial banks aggregated Rs.8,771.60 crore as on January 31, 2001 and constituted 1.97% of outstanding domestic advances as on March 31, 2000 and was well within the norm of 5% of the domestic credit stipulated in the RBI Circular of November 10, 2000. The total investments in shares of all the banks aggregated Rs. 6,324.11 crore as on March 31, 2000 and constituted 1.42% of the domestic credit.

4. The total exposure of all the banks by way of advances against shares and debentures including guarantees, aggregated Rs. 5,600 crore, comprising fund based facilities of Rs. 3385 crore and non fund based facilities, ie., guarantees, of Rs. 2,215 crore, as on January 31, 2001 and constituted 1.32% of the outstanding domestic credit of the banks as on March 31, 2000.

5. The total exposure of banks by way of advances against shares- fund based and non fund based- obtained by RBI as on February 28, 2001 aggregated Rs. 8361.14 crore, as under:

					Amount in crore of Rupees
Group of banks	Fund based facilities	Non fund based facilities	Total	Percentage to total advances as on	
				31-3-2000	31-12-2000
Public sector banks (27)	796.87	1070.56	1867.44	0.53	0.49

Old private sector banks (23)	320.58	258.46	579.04	1.63	1.76
New private sector banks (8)	1768.58	2082.99	3851.57	17.09	15.30
Foreign banks (42)	1729.85	333.25	2063.10	5.49	4.77
Total	4615.87	3745.27	8361.14	1.88	1.76

It may be observed that the exposure to capital market by way of advances against shares of the public sector banks, old private sector banks and most of the foreign banks was small. The exposure to capital market of some of the new private sector banks and foreign banks was found to be on the higher side.

6. Under the extant RBI Guidelines, the responsibility for laying down prudential limits, including annual incremental limits, has been vested on the Boards of individual banks. While most of the banks had followed the prudential guidelines, the Committee observed that the Boards of a few new private sector banks were quite liberal in fixing the limits on exposure to capital market including issue of guarantees on behalf of brokers. The Boards of some of the banks also did not put in place adequate risk management systems for exposure to sensitive sector.

7. The banks' exposure to capital market takes the following three forms:

i) Direct investment in shares, etc., where the banks take the price fluctuation upon themselves.

ii) Advances against shares, which are subject to market risk but covered by stipulating margin requirements.

iii) Non-fund based facilities like guarantees where credit risk arises on account of non performance of the obligation.

In terms of the RBI Guidelines, banks are required to put in place adequate risk management systems for building up of exposure to capital market any of the above forms. The present RBI Guidelines envisage the banks clearly defining their role in financing the capital market through setting up of prudential limits on the above three forms of exposures.

8. Considering the exposure to capital market built up by a few banks as also the slackness in following up adequate prudential limits, the Committee is of the view that the aberrations in compliance of the guidelines, though by only a few banks, should be addressed. The Committee is of the view that there is no need to change the basic framework of the guidelines and a few parameters could be further strengthened to address the above situation. The Committee reiterates that the extent of exposure of banks to capital market should be in consonance with the expertise available in-house and risk management and internal control systems put in place by them. The Committee therefore, makes the following recommendations to take care of the aberrations observed in a few banks.

9. **<u>Ceiling on overall exposure to capital market :</u>**

In terms of the extant RBI Guidelines, 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 equity oriented mutual funds should not exceed 5% of its outstanding domestic credit as on March 31, of the previous year. Without changing the base for reckoning the banks' exposure to capital market, the Committee recommends that as a prudential measure, a bank's total exposure to capital market by way of investments in equity shares, convertible debentures, units of equity oriented mutual funds as also by way of advances against shares and debentures including issue of bank guarantees on behalf of stock brokers, should not exceed 5% of the bank's total advances as on March 31, of the previous year. The advances granted by a bank against the collateral security of shares, advances to individuals for personal purposes like education, housing, consumption etc., against the security of shares, should also be reckoned for the purpose of arriving at the above ceiling of 5%.

10. **<u>Ceiling on investments in shares, etc.</u>**

Within the above overall ceiling of 5% for the total exposure to capital market, the total direct investments in shares, convertible debentures and units of equity oriented mutual funds by a bank should not exceed 20% of its net worth, as hitherto.

11. **<u>Advances against shares and debentures</u>**

(1) **Advances to individuals :**

a) As per the extant guidelines, the maximum amount of finance that can be granted to individuals against shares is Rs. 10 lakh and Rs. 20 lakh against physical shares and dematerialized shares, respectively. The Committee is of the view that the distinction between dematerialized shares and physical shares for fixing the quantum of advance, should be done away with. The Committee recommends that the maximum amount of advances that can be granted to an individual against the security of shares and debentures, either in dematerialized or physical form, should not exceed Rs.10 lakh.

b) The Committee noted the volatility exhibited by the capital market during the recent period and the fact that some banks / financial entities had to offload shares to meet the dues. The Committee therefore, recommends that the margin requirements for dematerialsed shares and physical shares should be uniform and a minimum margin of 50% should be obtained by banks for advances against shares and debentures.

c) The Committee reiterates that the facility of advances to individuals against shares is meant to be used by genuine individual investors against adequate security. The Committee recommends that banks should put in place a proper mechanism to ensure that the guidelines issued by the RBI are followed both in letter and in spirit.

(ii) Financing of IPOs:

The maximum amount of finance that can be granted to an individual for IPOs (i.e., Rs.10 lakh) as at present, may remain unchanged. However, the minimum margin for IPO financing to individuals should be 50% on par with advances to individuals. The Committee reiterates that IPO financing should not be extended to corporates and that NBFCs should not be provided finance for further lending to individuals for IPOs. The finance extended by a bank for IPOs should be reckoned as an exposure to capital market.

(2) **Advances to stock brokers :**

The Committee reviewed the overall position of banks' exposure to stock brokers. The Committee reiterates that from the risk management point of view, a bank's exposure to stock brokers should be well diversified both in terms of the concentration of their broker clients and the scrips in which the brokers are trading. Taking into account all the relevant factors, the Committee recommends as under:

(i) The Board of Directors of each bank should fix within the overall ceiling of 5% both for investments and advances against shares [paragraph 9 above], a sub-ceiling for total advances to all the stock brokers and market makers (both fund based and non-fund based i.e., guarantees).

Banks having less expertise in dealing in capital market may fix a comparatively lower ceiling for advances against shares to stock brokers.

(ii) While sanctioning advances to stock brokers, the banks should take into account the track record and credit worthiness of the broker. As a prudent risk management practice, the banks, while sanctioning advances(including guarantees) to stock brokers, should keep in view the total leverage of the stock broker from the entire banking system. While processing proposals for loans to stock brokers, banks are advised to obtain details of facilities enjoyed by them and all their associated companies from other banks.

(iii) The Committee recommends that the total fund based and non-fund based (i.e., guarantees) facilities sanctioned by a bank to a single stock broking entity including its associates / inter connected companies, should not exceed the prudential norm of 10% of the sub ceiling for total advances to all the stock brokers prescribed in paragraph 11(2)(i) above. The stock broking entity for this purpose, would mean a company, firm, partnership or proprietary broking concern including membership of that entity in all the Stock Exchanges.

(iv) Taking into the account the volatility in equity prices, the Committee recommends that the margin on advances against shares and debentures to stock brokers and market makers should not be less than 50%.

(3) **Issue of guarantees on behalf of stock brokers :**

(i) The Committee recommends that banks should obtain a minimum margin of 50 % with a minimum cash margin of 25%, for issue of guarantees on behalf of any stock broking entity.

(ii) The banks should assess the risks involved in issue of bank guarantees on behalf of brokers and formulate with the approval of their Boards, a policy on issue of bank guarantees on behalf of broking entities, including a ceiling for the total amount for issue of guarantees to broking entities, collateral to be obtained, etc. within the overall ceiling prescribed in 11(2) (I) above.

12. **Risk Management and Internal Control Systems**

(i) The Committee recommends that as a prudent risk management policy, banks which do not have expertise in equity market, should not build up exposure to capital market as a portfolio.

(ii) While accepting shares as security either as primary or as collateral, for advances / issue of guarantees, banks should ensure that the shares are diversified and they are listed, easily marketable / tradable. Banks should also consider the volatility of the scrips and obtain higher margins, if necessary. Unlisted shares / debentures should not be counted for the purpose of margin requirements.

(iii) While considering credit facilities to stock brokers, banks should consider the broker's concentration in scrips and ensure that the broker deals in a number of scrips and that scrips dealt in are not excessively volatile.

(iv) The Board of each bank should frame appropriate policies and surveillance systems for monitoring and reviewing on an on – going basis, their exposure to capital market both by way of investments in shares and advances against shares and initiate appropriate action for minimizing the risks. Appropriate reporting systems may be put in place for reporting the exposure to their ALCO / Investment Committee giving details of investments, advances against shares, details of the shares/debentures taken as security, their face value / cost price, and present market value, the losses arising on account of the fall in prices, guarantees issued on behalf of brokers, etc, as at the end of each month.

(v) Considering the volatility noticed in the prices of equity shares, the Committee recommends that 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.

(vi) The Committee recommends that banks should obtain from the borrowers, the details of credit facilities availed by them or their associates / inter connected companies from other banks and ensure that high leverage is not built up by the borrower or his associates or interconnected companies with bank finance.

(vii) Banks should ensure that finance granted to borrowers for manufacturing and other purposes is not diverted to stock market. Appropriate monitoring system for ensuring end-use of the funds lent should be evolved for the purpose.

13. **Advances by Primary Co-operative Banks**

Taking into account the role expected of PCBs, their low net worth and the expertise available with them, the Committee recommends that PCBs should not be permitted to grant any credit facility either fund based or non-fund based (that is, guarantees) against the security of shares and other capital market instruments to individuals, stock broking entities or their associates or inter connected companies.

14. **Financing under ALBM / BLESS**

The Committee feels that it would be desirable to examine the issue of financing by banks under the ALBM / BLESS in the next half yearly review meeting of the Technical Committee as by then, the steps announced by the Hon'ble Finance Minister, viz., rolling settlements, demutualisation of the Stock Exchanges, etc., would be put in place.

16. **<u>Timeframe for bringing down the exposure</u>**

The Committee suggests that banks whose exposure to capital market by way of investment in shares and advances against shares are in excess of 5% of the total advances as on March 31, 2001 may be advised to bring down their exposure within the prudential ceiling now being prescribed by December 31, 2001.

17. **<u>Reporting to RBI</u>**

The RBI – SEBI Committee will review the guidelines after six months. Banks should submit to RBI the returns on investments in shares, debentures and units of equity oriented mutual funds as also advances against shares including guarantees, as at the end of each month so as to reach RBI by the 10th of the following month, as part of their OSMOS Returns. Banks should also bring to the notice of the RBI operational problems faced by them so that the Technical Committee could consider these at the time of the next half yearly review.

Report of The Standing Technical Committee of RBI And SEBI on Review of the RBI Guidelines on `Bank Financing of Equities'

<u>Background :</u>

Based on the recommendations of the Standing Technical Committee of the RBI and SEBI on "Bank Financing of Equities", the Reserve Bank of India had issued guidelines on bank financing of equities and investments in shares as part of the Mid-term Review of the Monetary and Credit Policy for the year 2000-2001 announced on October 10, 2000. The Mid-term Policy had announced that the Technical Committee would review the guidelines after six months in consultation with banks keeping in view their institutional set up, operational mechanism, the experience gained, etc. Accordingly, the RBI-SEBI Technical Committee has reviewed the guidelines on bank financing of equities and investments in shares issued by the Reserve Bank of India keeping in view the position of banks' investments in shares as also advances against shares and other connected exposures.

Methodology :

2. The Committee reviewed the policy formulated by the Board of Directors of banks, the ceilings prescribed by the Boards for exposure to capital market, the operational mechanism put in place as also the data reported by the banks in respect of investment in shares, advances against shares and guarantees issued on behalf of the brokers. The Committee observed that banks have by and large adhered to RBI guidelines. However, a few banks had overextended exposure by way of advances against shares, in violation of the spirit of the RBI guidelines. The Committee also took into account the abnormal decline observed in the prices of equity shares after the presentation of the Union Budget for the year 2001-2002 in the Parliament on February 28, 2001, leading to the payment problems by some brokers in the Calcutta Stock Exchange, the Stock Exchange, Mumbai and NSE. The Committee observed from the provisional data collected by Reserve Bank of India that bank guarantees amounting to Rs.69.29 crore had been invoked by the Calcutta Stock Exchange in order to meet the payment obligations of some of its members.

Extant guidelines:

3. In this background, the Committee revisited the guidelines issued by RBI on November 10, 2000 on bank financing of equities and investments in shares. The guidelines set out in the relative Circular on bank financing of equities and investments in shares are reproduced below in brief:

(i) Ceiling on banks' investments in shares and debentures :

a) Within the overall exposure to sensitive sectors, a bank's investment in shares, convertible debentures and units of equity oriented mutual funds should not exceed 5% of the bank's total outstanding domestic credit (excluding inter- bank lending and advances outside India) as on March 31 of the previous year.

b) The above ceiling for investments in shares, etc., is the maximum permissible ceiling and a bank's Board of Directors is free to adopt a lower ceiling, keeping in view its overall risk profile. Where the present outstanding investments in shares are relatively small and below the overall ceiling, the Board should lay down an annual ceiling for fresh investments in equities.

c) Banks may make investment in shares directly taking in to account the in-house expertise available within the bank as per the investment policy approved by the Board of Directors.

d) 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.

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

f) Investments in shares and debentures / bonds should as hitherto, be reckoned for the purpose of arriving at the prudential norm on single borrower and borrower – group exposure ceilings.

g) 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.

(ii) Financing of Initial Public Offerings (IPOs)

(a) Banks are permitted to 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% and 25% against physical and dematerialized shares, respectively) should be the same as those applicable to advances against shares to individuals. 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.

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

(iii) Issue of guarantees on behalf of brokers :

A minimum margin of 25% 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% as per the policy approved by their Board of Directors.

(iv) Advances against shares and debentures to individuals and share brokers :

(a) The terms and conditions for 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% and 25%, respectively within the overall policy approved by the Board, remain unchanged.

(b) Banks are free to provide need based credit facilities 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. Banks may decide on the basis of the commercial judgment, the quantum as well as margin on the finance provided to the stock brokers and market makers.

(c) 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, would continue to be within the overall ceiling of 5%.

(v) <u>Risk Management and internal control</u>

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% of its net worth.

f) In addition to the ceiling of 5% on investments, the 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.

(vi) Valuation and disclosure

Banks should mark to market their investment portfolio in equities like other investments as per the valuation norms prescribed by RBI. 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.

(vii) Review of Guidelines

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.

Banks' exposure to capital market –
Findings of the review :

4. The Reserve Bank of India had collected data on exposure to capital market by way of investments in shares as also advances against shares from all the 101 scheduled commercial banks. The total investment in shares of the 101 scheduled commercial banks aggregated Rs.8,771.60 crore as on January 31, 2001 and constituted 1.97% of outstanding domestic advances as on March 31, 2000 and was well within the norm of 5% of the domestic credit stipulated in the RBI Circular of November 10, 2000. The total investments in shares of all the banks aggregated Rs. 6,324.11 crore as on March 31, 2000 and constituted 1.42% of outstanding domestic advances..

5. The total exposure of all the banks by way of advances against shares and debentures including guarantees, aggregated Rs. 5,600 crore, comprising fund based facilities of Rs. 3385 crore and non fund based facilities, ie., guarantees, of Rs. 2,215 crore, as on January 31, 2001 and constituted 1.32% of the outstanding domestic credit of the banks as on March 31, 2000. The provisional figures as on February 28, 2001 revealed that the total advances against shares of all the banks aggregated around Rs.4,616 crore but the total financial guarantees issued on behalf

of stock brokers went up from Rs.2,215 crore in January, 2001 to Rs.3,745 crore which together with advances of Rs.4,616 crore, accounted for 1.76% of their domestic credit.

6. The position on the total exposure of banks by way of advances against shares – fund based and non fund based- obtained by RBI, as on February 28, 2001 was as under:

Amount in crore of Rupees.					
Group of banks	Fund based facilities	Non fund based facilities	Total	Percentage to total advances (excluding non fund based facilities) as on	
				31-3-2000	31-12-2000
Public sector banks (27)	796.87	1070.56	1867.44	0.53	0.49
Old private sector banks (23)	320.58	258.46	579.04	1.63	1.76
New private sector banks (8)	1768.58	2082.99	3851.57	17.09	15.30
Foreign banks (42)	1729.85	333.25	2063.10	5.49	4.77
Total	4615.87	3745.27	8361.14	1.88	1.76

It may thus be observed that the exposure to capital market by way of advances against shares of the public sector banks, old private sector banks and most of the foreign banks was small. The exposure to capital market of some of the new private sector banks and foreign banks was found to be on the higher side.

7. Under the extant RBI Guidelines, the responsibility for laying down prudential limits, including annual incremental limits, has been vested on the Boards of individual banks. The Committee examined whether the banks had laid down prudential ceilings for investments in shares and advances against shares; and formulated risk management systems, internal control mechanisms, etc., as prescribed in the RBI Guidelines. The Committee observed that the banks had generally followed the prudential norms prescribed in the RBI Guidelines. The banks' overall level of exposure to capital market was by and large well within the norms laid down by the RBI or their respective Boards. Although the exposure of each bank by way of investments in shares was within the prescribed norms, two banks had marginally crossed the ceiling for

investment in shares prescribed by RBI and one bank had exceeded the ceiling by about 3%. The total of such excess investments over the prescribed ceiling was around Rs.77 crore.

8. The banks' exposure to capital market takes the following three forms:

i) Direct investment in shares, etc., where the bank take the price fluctuation upon themselves.

ii) Advances against shares, which are subject to market risk but covered by margin requirements.

iii) Non-fund facilities like guarantees where credit risk arise on account of non performance of the obligation.

The RBI guidelines envisage that banks desirous of making investments in shares and advances against shares should build up adequate expertise in equity market by setting up a dedicated equity research department and formulate a transparent policy and procedure. The banks are also required to put in place appropriate risk management and internal control systems and review on an on-going basis, their investment in shares with a view to assessing risks due to volatility in asset prices. RBI Guidelines provided for the banks clearly defining their role in financing the capital market through setting up of prudential limits in any of the above forms. The Committee observed that in regard to advances against shares, the Boards of Directors of the banks have been given the freedom to lay down the ceilings on advances. However, the Boards of a few new private sector banks were quite liberal in fixing the limits on exposure to capital market including issue of guarantees on behalf of brokers. Despite a liberal ceiling fixed by the Boards, two banks had exceeded the ceiling for advances against shares. The Committee also observed a few instances of circumvention of the guidelines by granting loans to members of the same family / employees of the same corporate, against the security of shares or for IPOs. It was clear that the Boards of some of the banks did not have a prudent policy nor have they put in place adequate risk management systems for exposure to sensitive sectors.

9. The Committee observed that the banks have generally complied with the instructions contained in the RBI Circular of November 10, 2000. Considering the exposure to capital market built up by a few banks as also the slackness in following up adequate prudential limits, the Committee is of the view that the aberrations observed in compliance of the guidelines, though by only a few banks, should be addressed. The Committee is of the view that there is no need to change the basic framework of the guidelines, and a few parameters could be further

strengthened to address the above situation. The Committee reiterates that the extent of exposure of banks to capital market should be in consonance with the expertise available in-house and the risk management and internal control systems put in place by them.

Recommendations:

10. The Committee therefore, makes the following recommendations to take care of the aberrations observed in a few banks taking exposure to capital market recently:

11. **Ceiling on overall exposure to capital market :**

In terms of the extant RBI Guidelines, 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 equity oriented mutual funds should not exceed 5% of its outstanding domestic credit as on March 31, of the previous year. Without changing the base for reckoning the banks' exposure to capital market, the Committee recommends that as a prudential measure, a bank's total exposure to capital market by way of investments in equity shares, convertible debentures, units of equity oriented mutual funds as also by way of advances against shares and debentures including issue of bank guarantees on behalf of stock brokers, should not exceed 5% of the bank's total advances as on March 31, of the previous year. The advances granted by a bank against the collateral security of shares, advances to individuals for personal purposes like education, housing, consumption etc., against the security of shares, should also be reckoned for the purpose of arriving at the above ceiling of 5%.

12. **Ceiling on investments in shares, etc.**

Within the above overall ceiling of 5% for the total exposure to capital market, the total direct investment in shares, convertible debentures and units of equity oriented mutual funds by a bank should not exceed 20% of its net worth, as hitherto.

13. **Advances against shares and debentures**

(1) **Advances to individuals :**

The Committee reviewed the existing instructions on the quantum, margin, etc. on advances against shares and debentures to individuals, financing of IPOs, etc. The Committee also noted the practices followed by some individuals / corporates for circumventing the RBI guidelines on the ceiling on the maximum amount of finance for individuals or prohibition on advances to corporates for IPOs. Considering all the relevant factors, the Committee recommends as under:

(i) Advances against shares and debentures:

a) As per the extant guidelines, the maximum amount of advance against shares that can be extended to an individual is Rs. 10 lakh against physical shares and Rs. 20 lakh against dematerialized shares. The Committee noted that the higher amount of finance against dematerialised shares was provided as an incentive to increasingly switch over to dematerialisation of shares. Now that most of the corporates are issuing shares in the demat mode, the Committee is of the view that the distinction between dematerialized shares and physical shares for fixing the quantum on advance, should be done away with. The Committee accordingly recommends that the maximum amount of advance that can be granted to an individual against the security of shares and debentures, either in dematerialized or physical form, should not exceed Rs.10 lakh.

b) The Committee noted the volatility exhibited by the capital market during the recent period and the fact that some banks / financial entities had to offload shares to meet the dues. The Committee therefore, recommends that the margin requirements for dematerialised shares and physical shares should be uniform and a minimum margin of 50% should be obtained by banks for advances against shares and debentures.

c) The Committee reiterates that the facility of advances to individuals against shares is meant to be used by genuine investors against adequate security. The Committee recommends that banks should put in place a proper mechanism to ensure that the guidelines issued by the RBI are followed both in letter and in spirit.

(ii) Financing of IPOs:

The maximum amount of finance that can be granted to an individual for IPOs (i.e., Rs.10 lakh) as at present, may remain unchanged. However, the minimum margin for IPO financing to individuals should be 50% on par with advances against shares. The Committee reiterates that IPO financing should not be extended to corporates and that NBFCs should not be provided finance for further lending to individuals for IPOs. Finance extended by a bank should be reckoned as an exposure to capital market.

(2) **Advances to stock brokers :**

The Committee notes that as per the existing instructions of the RBI, the banks are free to provide credit facilities to stock brokers and market makers on the basis of their commercial judgement, within the policy framework approved by their Boards. The Committee reviewed the overall position of banks' exposure to stock brokers. The Committee noted that in the recent period, certain banks had high exposure to a few brokers and their associates who in turn, had concentrated exposure to a few particular scrips which were subjected to high volatility. The Committee reiterates that from the risk management point of view, a bank's exposure to stock brokers should be well diversified both in terms of number of broker clients and the scrips in which the brokers are trading. Taking into account all the relevant factors, the Committee recommends as under:

(i) The Board of Directors of each bank should fix within the overall ceiling of 5% both for investments and advances against shares [paragraph 11 above], a sub-ceiling for total advances to all the stock brokers and market makers (both fund based and non-fund based i.e., guarantees). Banks having less expertise in dealing in capital market may fix a comparatively lower ceiling for advances against shares to stock brokers.

(ii) While sanctioning advances to stock brokers, the banks should take into account the track record and credit worthiness of the broker. As a prudent risk management practice, the banks, while sanctioning advances(including guarantees) to stock brokers, should keep in view the total leverage of the stock broker from the entire banking system. While processing proposals for loans to stock brokers, banks are advised to obtain details of facilities enjoyed by the broker and all his connected companies from other banks.

(iii) The Committee noted that in some cases, the exposure of the banks, particularly the new private sector banks, to brokers and their inter-connected companies was relatively high. Considering the risks involved in such concentrated exposure, the Committee recommends that the total fund based and non-fund based (i.e., guarantees) facilities sanctioned by a bank to a single stock broking entity including its associates / inter connected companies, should not exceed the prudential norm of 10% of the sub ceiling for total advances to all the stock brokers prescribed in paragraph 13 (2) (i) above. The stock broking entity for this purpose, would mean a company, firm, partnership or proprietary broking concern including membership of that entity in all the Stock Exchanges.

(iv) Taking into the account the volatility in equity prices, the Committee recommends that the margin on advances against shares and debentures to stock brokers and market makers should not be less than 50%.

(3) **Issue of guarantees on behalf of stock brokers :**

(i) The Committee noted that during the recent developments in the Calcutta Stock Exchange, some banks were called upon to honour their commitments under the guarantees. The guarantees must be honoured by banks when invoked. It is therefore, necessary that margins must be high so that banks have adequate coverage of security for the guarantees issued. Accordingly, the Committee recommends that banks should obtain a minimum margin of 50 % with a minimum cash margin of 25%, for issue of guarantees on behalf of any stock broking entity.

(ii) The banks should assess the risks involved in issue of bank guarantees on behalf of brokers and formulate with the approval of their Boards, a policy on issue of bank guarantees on behalf of broking entities, including a ceiling for the total amount for issue of guarantees to broking entities, collateral to be obtained, etc.

14. **Risk Management and Internal Control Systems**

(i) The Committee recommends that as a prudent risk management policy, banks which do not have expertise in equity market, should not build up exposure to capital market as a portfolio.

(ii) While accepting shares as security either as primary or as collateral, for advances / issue of guarantees, banks should ensure that the shares are diversified and they are listed, easily marketable / tradable. Banks should also consider the volatility of the scrips and obtain higher margins, if necessary. Unlisted shares / debentures should not be counted for the purpose of margin requirements.

(iii) While considering credit facilities to stock brokers, banks should consider the broker's concentration in scrips and ensure that the broker deals in a number of scrips and that scrips dealt in are not excessively volatile.

(iv) The Board of each bank should frame appropriate policies and surveillance systems for monitoring and reviewing on an on – going basis, their exposure to capital market both by way of investments in shares and advances against shares and initiate appropriate action for minimizing the risks. Appropriate reporting systems may be put in place for reporting the exposure to their ALCO / Investment Committee giving details of investments, advances against shares, details of the shares/debentures taken as security, their face value / cost price, present market value, and the losses arising on account of the fall in prices, guarantees issued on behalf of brokers, etc, as at the end of each month.

(v) Considering the volatility noticed in the prices of equity shares, the Committee recommends that 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.

(vi) The Committee notes that a Credit Information Bureau is being set up and once the Bureau becomes operational, it will provide an institutional mechanism for sharing of credit information among banks and financial institutions. The Committee recommends that till the Bureau becomes operational, while granting advances against shares / debentures, banks should obtain from the borrowers, the details of credit facilities availed by them or their associates / inter connected companies from other banks and ensure that high leverage is not built up by the borrower or his associates or interconnected companies with bank finance.

(vii) Banks should ensure that finance granted to borrowers for manufacturing and other purposes is not diverted to stock market. Appropriate monitoring system for ensuring end-use of the funds lent should be evolved for the purpose.

15. <u>**Advances by Primary Co-operative Banks**</u>

The Committee notes that as per the extant instructions issued by the Reserve bank of India, the Primary Co-operative Banks (PCBs) are not permitted to grant advances against shares / debentures to share and stock brokers. However, these banks are permitted to sanction loans against the security of shares and debentures to individuals subject to a ceiling of Rs.10 lakh per borrower against physical shares and Rs.20 lakh per borrower against dematerialized shares with margin requirements of 50% and 25%, respectively.

The PCBs have neither the expertise required for financing against capital market instruments nor effective risk management systems to safeguard against volatility in equity prices. The

Capital Adequacy Standards and Prudential Norms of PCBs are not on par with those applicable to banks. Their scale of operations and clientele are also limited. The Committee observes that one PCB had to be placed under an Administrator on account of its very high exposure to capital market. Taking into account the role expected of PCBs, their low net worth and the expertise available with them, the Committee recommends that PCBs should not be permitted to grant any credit facility either fund based or non-fund based (that is, guarantees) against the security of shares and other capital market instruments to individuals, stock broking entities or their associates or inter connected companies.

16. **Financing under ALBM / BLESS**

The Committee noted that the Hon'ble Finance Minister had announced certain measures towards improving the efficiency of the capital market such as, introduction of rolling settlements, de-mutualisation of Stock Exchanges, etc. The SEBI had also announced that banks would be allowed to extend on a temporary basis, collateralised funding under the ALBM / BLESS systems. The Committee feels that it would be desirable to examine the issue of financing by banks under the ALBM / BLESS in the next half yearly review meeting of the Technical Committee as by then, the steps announced by the Hon'ble Finance Minister, viz., rolling settlements, demutualisation of the Stock Exchanges, etc., would be put in place.

17. **Timeframe for bringing down the exposure**

The Committee suggests that banks whose exposure to capital market by way of investment in shares and advances against shares are in excess of 5% of the total advances as on March 31, 2001 may be advised to bring down the ir exposure within prudential ceiling now being prescribed by December 31, 2001.

18. **Reporting to RBI**

The RBI – SEBI Committee will review the guidelines after six months. Banks should submit to RBI the returns on investments in shares, debentures and units of equity oriented mutual funds as also advances against shares as at the end of each month so as to reach RBI by the 10th of the following month, as part of their OSMOS Returns. Banks should also bring to the notice of the RBI operational problems faced by them so that the Technical Committee could consider these at the time of the next half yearly review.

(G.P. Muniappan)	**(M.R. Srinivasan)**
(Pratip Kar)	**(D. Rawal)**

Mumbai

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