

UNIVERSAL BANKING. THE INDIAN PERSPECTIVE CHAITANYA, Krishna V *

Abstract

Ever since the financial sector reforms were introduced in early 90's the banking sector saw the emergence of new generation of private sector banks. These banks gained at most popularity as they have technology edge and better business models when compared to public sector banks and the most important thing is they are able to attract more volumes simply because they meet their customers requirements under one roof. If the newer players can do that then why can't the bigger players like the Financial Institutions (FIs) try their hands on it? Here comes the concept of universal banking, its emergence, merits and related issues. The present paper focuses on understanding the concept of universal banking in India and attempts to explain the regulatory role, regulatory requirements, key duration and maturity distinction and lastly the optimal transition path. The paper also gives an overview of the international experience and argues in favor of developing a strong domestic financial system in order to compete in the global market.

JEL classification: G1

Key words: Commercial banks, Financial Institutions & Reserve Bank of India.

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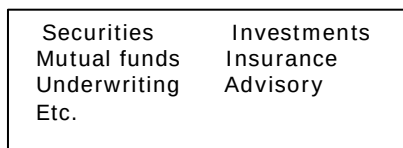
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1. Introduction

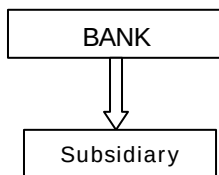
Universal Banking, means the financial entities – the commercial banks, Financial Institutions, NBFCs, - undertake multiple financial activities under one roof, thereby creating a financial supermarket. The entities focus on leveraging their large branch network and offer wide range of services under single brand name. Universal banking generally takes one of the three forms:

- a. In-house Universal banking. Eg. Germany, Switzerland.

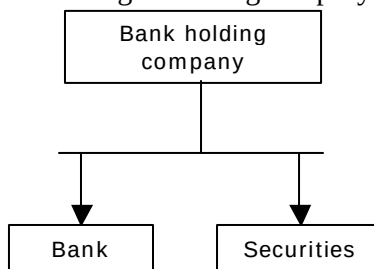
BANK



- b. Through separately capitalized subsidiaries. Eg. England, Japan.



- c. Operations carried through a holding company¹. Eg. USA, Japan².



¹ A corporation that owns the securities of another, in most cases with voting control.

² See, Dr. Nair, "Universal Banking", Indian Management, 1999.

In general, Universal Bank is a name given to banks engaged in diverse kind of banking business which includes not only services related to savings and loans but also investments, offering wide range of financial services, beyond commercial banking and investment banking, insurance etc. If specialized banking is the one end universal banking is the other. This is most common in European countries and this concept is widely popular in countries like USA but is about to take-off officially in India, as the definition of Universal Banking is yet to be established clearly and conclusively.

A narrow view of Universal banking could be activities pertaining to lending plus investments in bonds and debentures. A broader view could include a basket of all the financial activities including insurance.

The characteristics of Universal Banking heavily depend of two most important factors, namely:

- The specific country's diversification rules and regulations.
- The strengths of individual banks in enlarging the scope of the activities in the various segments of financial services industry.

Universal Banking Defined

Universal banking refers to the combinations of commercial banking and investment banking including securities business. Universal Banking is defined as

(Saunders, Anthony. A and Walter Ingo, 1994) *"the conduct of range of financial services comprising deposit taking and lending, trading of financial instruments and foreign exchange (and their derivatives) underwriting of new debt and equity issues, brokerage investment management and insurance"*.

Universal banking helps service provider to build up long-term relationships with clients by catering to their different needs. The client also benefits as he gets a whole range of services at lower cost and under one roof.

International Scenario

Federal Republic of Germany, Switzerland are generally known to be the home of universal banking. Factors like technological up gradation, wide spread of applications, increasing competition in financial sector etc, are the driving forces in these nations. In few other European countries, almost all other banking and non-banking services are carried out by financial institutions. For instances, in Germany, commercial and investment banking activities are preformed by a single entity, but separate subsidiaries are required for other activities. In UK a separate subsidiaries of commercial banks involve in providing wide range of activities.

What the USA follows is an extreme model, where the commercial banks are prevented legally from combining their normal lending functions with investment operations, where they are separated by several legislative acts, including the Glass-Steagall Act³ of 1933. However, at present USA is having a re-look at the position. Much of the international debate on universal banking has been centered around the restriction on diversification of the type.

Indian Scenario

Since the financial sector reforms, the traditional difference between commercial banks and various other service providers' including financial institutions has been reducing.

2. Commercial banks

Traditionally, the commercial banks in India were largely into the core banking business of accepting deposits and providing working capital funds to agriculture and allied, trade and industry sectors. In early 90's the financial sector in India was crying out for reforms. Things started changing ever since the process of liberalization hit

³ 1933 congressional law, in USA, prohibited commercial banks from owning brokerages. However, latter rules has softened, and many banks now own discount brokers, sell mutual funds, and participate in underwriting.

the Indian shores, the banking sector saw the emergence of new-generation private sector banks. Public sector banks which played a useful role earlier on are now facing deterioration in their performance.

For very long, the banks in India were not allowed to have access to stock markets. So their dealing in other securities were minimal. But the financial sector reforms changed it all, Indian banks started to deal on the stock market but their bitter experience with scams, they became averse to deal in equities and debentures. Off late, commercial banks in India have been permitted to undertake a range of in-house financial services. Some banks have even setup their own subsidiaries for their investment activities. Subsidiaries include in the area of merchant banking, factoring, credit cards, housing finance etc.

At present, Indian banks are engaged in credit, consumer finance, savings, money and capital, advisory services and recently insurance market. Therefore, the Indian banks are already moving in the direction of Universal banking, undertaking all the financial services under one cover.

3. Financial Institutions

In India, The Financial Institutions were established and developed by the Government of India and Reserve Bank of India⁴ (RBI) to meet specific needs of industry and were traditionally engaged in long term financing, as their main objective was to take care of the investment needs of industries and to contribute to a better industrial climate.

⁴ The central Bank of India & apex of the Indian banking system.

Important Activities Of Banks And Financial Institutions

	COMMERCIAL BANKING OR SIMILAR IN NATURE	INVESTMENT BANKING	OTHER FINANCIAL SERVICES
Banks	Accepting chequable deposits Granting loans and advances	Investments in securities Underwriting of issues Loan syndication	Factoring, Leasing, Hire- purchase, Mutual funds, Credit-cards, Merchant- banking, housing finance
Fis	Granting long- term loans and Advances, Granting short- term Loans advances / working capital Finance, accepting term- deposits and issuing CDs etc.	Underwriting & subscribing directly to shares / bonds of corporates.	Commercial banking, credit rating, Brokerage, H.F, M.Fs, project consultancy, Registrar Services, etc.

Notes:

- Source: www.rbi.org.in. - The activities are performed either directly or through subsidiaries. - Fis: Financial Institutions. - CDs: Certificate of Deposits. - M.Fs: Mutual Funds. - H.F: Housing Finance

They had, over the time, built up expertise in merchant banking, project evaluation and also started giving working capital finance. Recently, they were allowed to accept medium-term deposits within the specified limits. Off late, Financial Institutions where also permitted to combine their traditional activities with investment banking activities with certain moderate restrictions. Most of Financial Institutions have floated banks, institutions and mutual fund subsidiaries. Ownership changes took place, several institutions went public, organization structure itself got transformed.

Indian Perspective On Universal Banking

In order to bring out an efficient and effective financial system in India, the RBI constituted a Working Group in December 1997 under the Chairmanship of Mr. S.H. Khan to review the role, structure and operations of Financial Institutions and Commercial banks and give the measures for harmonizing the lending and working capital operations of both banks and Financial Institutions.

In January 1999, RBI released a discussion paper on *Harmonizing the role and operations of Financial Institutions and Banks*⁵, in order to bring in a clear-cut clarity on the roles of banks and Financial Institution.

The findings of the discussion paper are:

- The process of providing various innovative services by both banks and Financial Institutions should continue either through in-house or through subsidiaries.
- The approach towards universal banking should be guided by international experience and domestic requirements.
- Transformation of a Financial Institutions into bank should be considered after a period of five years.
- In the meanwhile, Financial Institutions should be allowed to remain as how they are and should focus on their expertise area.
- If any Financial Institutions intends to convert into a bank, in such case it should comply with all the regulatory, prudential requirements which are applicable for a bank.

However, some experts do argue that the approach is very slow, while some call for steady approach. The debate of universal banking is very much on in India⁶. The question to be answered is should India have universal banking and if so when? Much has been written about it domestically, however, following are the important issues that are key in Indian context.

⁵ For detailed report on the paper, see www.rbi.org.in.

⁶ In the year 1999-2000 Monetary & Credit Policy (Mid-term review) RBI acknowledged the principle of Universal Banking is a 'desired goal'.

- i. Regulatory burden
- ii. Distinction between maturity and duration
- iii. Optimum Transition path

i. Regulatory burden:

One of the major problems associated with universal banking is the issue of regulation. Financial Institutions in India are governed by separate Acts and banks are regulated and governed by RBI and Banking Regulation Act⁷. Financial Institutions in India have commercial banks as their subsidiaries, but due to the separation of regulation, the Financial Institutions cannot have direct access to the resource base of its subsidiary bank. Without any doubt, the regulatory burden for all participants in the entire financial system should be equalized in order to ensure that no participant might end up having a disadvantage relative to any other.

ii. Distinction between Maturity and Duration

(Nachiket Mor, 1999), opines “another issue of debate is between long and short term. Somehow Financial Institutions are the suppliers of term finance, where the maturity is clearly specified which could be between 3 years to 7 years, where as banks are providers of short-term finance where, in reality bank finance in a way amounts to financing in perpetuity, since there are in general no definite maturity dates. Usually the deposit base of the banks have short duration but with a variably high interest rates but its not the case with Financial Institutions. Their funds have a longer duration with less interest rates.”

The interim report of S H Khan committee has argued that the distinction between commercial and investment banking have become increasingly blurred with banks providing both working capital and term loans to corporates but Financial Institutions can provide only term loans as they cannot accept short term deposits. The committee further argued that Financial Institutions should be given banking licenses eventually and until then they should be

⁷ It is an Act to consolidate and amend the law relating to banking in India. It extends to the whole of India.

allowed to establish 100 percent banking subsidiaries while they continue to play their present role.

iii. Optimal Transition path

Viable transition path is one of the major areas of concern for institutions which are desirous of moving in the direction of universal banking. The transition path contains several operational and regulatory issues for information and guidance of Financial Institutions. The S H Khan working group and the discussion paper on the subject prepared by RBI eventually felt that Financial Institutions should transform themselves into commercial banks but in a phased manner. The committee also recommended that Financial Institutions can have 100 percent owned banking subsidiaries, which would be extremely beneficial to them. If this happens, then it would allow Financial Institutions to gain expertise in the area of commercial banking which would in turn help the Financial Institutions if they are seriously looking at the prospect of converting into a commercial bank. Also the 100 percent subsidarisation allows banks to have a full access to capital base of Financial Institutions and gain substantial knowledge in the area of project financing.

The RBI has asked Financial Institutions, which are interested to convert itself into a universal bank, to submit their plans for transition to a universal bank for consideration and further discussions. Financial Institutions need to formulate a road map for the transition path and strategy for smooth conversion into a universal bank over a specified time frame. The plan should specifically provide for full compliance with prudential norms as applicable to banks over the proposed period.

Why convert into bank?

Financial Institutions in India are exploring opportunities to convert themselves into banks for the following reasons:

- High cost of funds, which is over 12 percent in case of a Financial Institutions and just over 6 percent in the case of a commercial bank.
- Increasing competition, due to increase in various new players like the insurance companies, mutual fund entities etc.

- Low demand for long-term funds, due to absence of heavy project investments especially in the area of infrastructure.
- High level of Non Performing Assets.
- Increasing competition from Commercial banks in the retail financial market.
- Lower spreads due to extensive competition.
- High competition in the market to attract top rated borrowers at low rates.

In the year 2001, RBI released a paper on *Approach to Universal Banking*, containing the salient features on the regulatory and operation issues to be addressed by all the Financial Institutions which are intending to convert themselves into a universal bank⁸.

Concluding Remarks

The following are the steps suggested in-order to ensure that there is a smooth and effective implementation of universal banking in India:

- a. Equalize the net regulatory burden across the financial system (including banks, Financial Institutions, mutual funds, Non-Banking Finance Companies and Insurance companies).
- b. Lower the regulatory burden on the over regulated entities.
- c. Promote and encourage strong competition.
- d. Do not allow the merger of a weak bank with a viably strong Financial Institutions or vice-versa.
- e. Financial Institutions should be permitted to set up a 100 percent owned banking subsidiaries freely.
- f. Need is felt to re-examine the minimum level of Statutory Liquid Ratio (SLR) requirement in order to meet the best of international standards.
- g. Financial Institutions willing to convert themselves into a universal bank, should prepare a transition path, in-order to fully comply with the regulatory requirements of a bank.

⁸ For detailed report see at the end of the paper, The Salient operational and regulatory issues to be addressed by the FIs for conversion into a Universal Bank [RBI circular], April 2001.

All the above-mentioned if implemented, can be seen as encouraging steps towards development of an ultimate financial intermediation in India into universal banking.

In India already some groups like the HDFC, which is into commercial banking and insurance joint venture with Standard Assurance, ICICI that is into commercial banking, SBI - investment-banking division etc., have already started diversifying from their traditional activities through setting up subsidiaries and joint ventures. In a recent move, the Life Insurance Corporation (LIC) increased its stakes in Corporation Bank and is planning to sell insurance to the customers of the Bank. Corporation Bank itself has been planning to set up an insurance subsidiary since a long time. Even finance companies such as Sundaram Finance use the goodwill associated with their brand, and the years of information and insight, to offer a number of services under an umbrella brand. Few specialized Financial Institutions, like IDBI, IIBI, are now talking of turning into a universal bank. Also, Kotak Mahindra Finance, one of the largest NBFC in India, also converted itself from an NBFC into a bank, after acquiring a license to undertake banking business from RBI.

In a very recent move, RBI has approved the merger of IDBI and IDBI bank which will happen in the month of October 2005. It is said that the merged entity would be the fifth largest bank in India after, SBI, ICICI, Punjab National Bank and Canara Bank in terms of the total assets. The swap ratio is fixed at 1:1.42 and it is said that the government holding would come down 51.4 percent from the present 59 percent. Sources also revealed that the new entity would have two strategic units, namely IDBI banking, while the other would be IDBI development finance⁹.

Thus, the concept of Universal Banking is fast evolving in India and it is a process in which there is a complete breakdown of barriers

⁹ For more details, see, The Economic Times, dated: 21st January 2005, page No.1.

between categories of Financial Intermediaries such as commercial banks and Financial Institutions and NBFCs and thereby creating a one-stop shop for the clients.

Salient operational and regulatory issues to be addressed by the FIs for conversion into a Universal Bank [RBI circular]

a) Reserve requirements

Compliance with the cash reserve ratio and statutory liquidity ratio requirements (under Section 42 of RBI Act, 1934, and Section 24 of the Banking Regulation Act, 1949, respectively) would be mandatory for an FI after its conversion into a universal bank.

b) Permissible activities

Any activity of an FI currently undertaken but not permissible for a bank under Section 6(1) of the B. R. Act, 1949, may have to be stopped or divested after its conversion into a universal bank.

c) Disposal of non-banking assets

Any immovable property, howsoever acquired by an FI, would, after its conversion into a universal bank, be required to be disposed of within the maximum period of 7 years from the date of acquisition, in terms of Section 9 of the Banking Regulation Act.

d) Composition of the Board

Changing the composition of the Board of Directors might become necessary for some of the FIs after their conversion into a universal bank, to ensure compliance with the provisions of Section 10(A) of the B. R. Act, which requires at least 51% of the total number of directors to have special knowledge and experience.

e) Prohibition on floating charge of assets

The floating charge, if created by an FI, over its assets, would require, after its conversion into a universal bank, ratification by the Reserve Bank of India under Section 14(A) of the Banking Regulation Act, since a banking company is not

allowed to create a floating charge on the undertaking or any property of the company unless duly certified by RBI as required under the Section.

f) Nature of subsidiaries

If any of the existing subsidiaries of an FI is engaged in an activity not permitted under Section 6(1) of the B R Act, then on conversion of the FI into a universal bank, delinking of such subsidiary / activity from the operations of the universal bank would become necessary since Section 19 of the Act permits a bank to have subsidiaries only for one or more of the activities permitted under Section 6(1) of Banking Regulation Act.

g) Restriction on investments

An FI with equity investment in companies in excess of 30 per cent of the paid up share capital of that company or 30 per cent of its own paid-up share capital and reserves, whichever is less, on its conversion into a universal bank, would need to divest such excess holdings to secure compliance with the provisions of Section 19(2) of the Banking Regulation Act, which prohibits a bank from holding shares in a company in excess of these limits.

h) Connected lending

Section 20 of the Banking Regulation Act prohibits grant of loans and advances by a bank on security of its own shares or grant of loans or advances on behalf of any of its directors or to any firm in which its director/manager or employee or guarantor is interested. The compliance with these provisions would be mandatory after conversion of an FI to a universal bank.

i) Licensing

An FI converting into a universal bank would be required to obtain a banking license from RBI under Section 22 of the Banking Regulation Act, for carrying on banking business in India, after complying with the applicable conditions.

j) *Branch network*

An FI, after its conversion into a bank, would also be required to comply with extant branch licensing policy of RBI under which the new banks are required to allot at least 25 per cent of their total number of branches in semi-urban and rural areas.

k) *Assets in India*

An FI after its conversion into a universal bank, will be required to ensure that at the close of business on the last Friday of every quarter, its total assets held in India are not less than 75 per cent of its total demand and time liabilities in India, as required of a bank under Section 25 of the Banking Regulation Act.

l) *Format of annual reports*

After converting into a universal bank, an FI will be required to publish its annual balance sheet and profit and loss account in the in the forms set out in the Third Schedule to the B R Act, as prescribed for a banking company under Section 29 and Section 30 of the Banking Regulation Act.

m) *Managerial remuneration of the Chief Executive Officers*

On conversion into a universal bank, the appointment and remuneration of the existing Chief Executive Officers may have to be reviewed with the approval of RBI in terms of the provisions of Section 35 B of the Banking Regulation Act. The Section stipulates fixation of remuneration of the Chairman and Managing Director of a bank by Reserve Bank of India taking into account the profitability, net NPAs and other financial parameters. Under the Section, prior approval of RBI would also be required for appointment of Chairman and Managing Director.

n) *Deposit insurance*

An FI, on conversion into a universal bank, would also be required to comply with the requirement of compulsory deposit insurance from DICGC up to a maximum of Rs.1 lakh per account, as applicable to the banks.

o) Authorized Dealer's License

Some of the FIs at present hold restricted AD license from RBI, Exchange Control Department to enable them to undertake transactions necessary for or incidental to their prescribed functions. On conversion into a universal bank, the new bank would normally be eligible for full-fledged authorized dealer license and would also attract the full rigour of the Exchange Control Regulations applicable to the banks at present, including prohibition on raising resources through external commercial borrowings.

p) Priority sector lending

On conversion of an FI to a universal bank, the obligation for lending to "priority sector" up to a prescribed percentage of their 'net bank credit' would also become applicable to it.

q) Prudential norms

After conversion of an FI into a bank, the extant prudential norms of RBI for the all-India financial institutions would no longer be applicable but the norms as applicable to banks would be attracted and will need to be fully complied with.

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