

Streamlining Banks' Investments in Capital Market: RBI-SEBI Committee submits Report

September 2, 2000

- **Ceiling for Banks' Investment in Capital Market to be linked with Banks' total Outstanding Advances**
- **Banks with no Expertise to invest Two-thirds of Eligible Amount in Units of Mutual Funds**
- **Guidelines for IPO Financing by Banks**

The banks' exposure to capital market by way of investments in shares, convertible debentures and units of mutual funds may now be linked with their total outstanding advances and may be limited to 5 per cent of such advances. This has been recommended by the Committee comprising senior executives of the Reserve Bank of India and the Securities and Exchange Board of India. The Committee was set up in pursuance of the Monetary and Credit Policy for the year 2000-2001 with the objective of evolving operative guidelines for a transparent and stable system of banks' investment and financing of equities. The Committee has, while finalising its report, had the benefit of discussions with the Chief Executives of select banks which have exposure to capital market. The Committee has also obtained feedback from other participants, including brokers. It submitted its report to the Reserve Bank on August 30, 2000.

Explaining the rationale behind its recommendation of linking banks' advances to shares, debentures etc., with total outstanding advances, the Committee has stated that the present norm of banks investing up to 5 per cent of their incremental deposits of the previous year in shares, debentures, etc., did not reflect the shift in the asset portfolio of banks from credit to investment. It has, therefore, recommended that the ceiling prescribed for banks' investments in shares, debentures, and units of mutual funds should be related to outstanding advances and not to incremental deposits of the previous year.

While suggesting the operative guidelines for banks' investments in the capital market, the Committee's approach has been to optimise the opportunities for banks to take advantage of the returns available from the capital market without exposing them to undue risks that arise due to volatility in the capital market. In view of the Committee, such a system of banks' investment and financing of equities would also contribute to a healthy development of financial markets.

The Committee has also suggested that banks which do not have in-house expertise in research in capital market may invest not less than 2/3 of their eligible amount in units of UTI and SEBI approved mutual funds. In an attempt to streamline the guidelines for banks' investment in the capital market, the Committee has, for the first time, also recommended guidelines for banks' financing of Initial Public Offerings (IPOs).

The following are the main recommendations of the Committee.

- (i) **Policy:** Since the capital market is exposed to constant price fluctuation, the banks' policy with regard to financing against shares should be one of risk minimisation. The

Committee has, therefore, recommended that the banks' policy in financing against shares should be such that they are not exposed to undue risks emanating out of volatility in capital market. The Committee has also made recommendations on margin prudential limits on exposure, etc., to minimise the risks due to price fluctuations.

- (ii) **Ceiling for banks' investment in capital market:** The Committee has recommended that the ceiling prescribed for banks' investments in shares, convertible debentures and units of mutual funds (other than debt funds) should be related to outstanding advances and not to incremental deposits of the previous year. The Committee has, therefore, recommended that within the overall exposure to sensitive sectors, a bank's exposure to capital market by way of investments in shares, convertible debentures and units of mutual funds (other than debt funds), may be limited to 5 per cent of their total outstanding advances. The recommendation follows the Committee's view that the existing norm of 5 per cent of the incremental deposits of the previous year for investments in shares, etc., did not reflect the shift in the asset portfolio of banks from credit to investment.
- (iii) **Flexibility to invest in units of mutual funds:** The Committee has recommended that banks which do not have in-house expertise in capital market, may invest, not less than two-third of the eligible amount, in units of UTI or SEBI approved mutual funds. The balance one-third of the eligible amount may be deployed directly by the banks in listed equity shares.
- (iv) **Financing IPOs:** According to the Committee, the terms and conditions for financing of initial public offerings (IPOs) should be the same as those applicable to advances against shares to individuals. The ceiling on the amount of advances as also margin as applicable to advances against shares to individuals, should apply mutatis mutandis to financing of IPOs. The maximum amount of finance extended to an individual against IPOs should, however, be Rs.10 lakh, as applicable to advances against physical shares. Corporates should not be given advances for IPOs. Banks should also not extend finance to NBFCs in any form for on-lending to individuals for IPOs. Finance extended by a bank for IPOs should be reckoned as an exposure to the capital market.
- (v) **Margins :** Considering the fact that the minimum margin taken by banks depends upon the scrip and that margins higher than the minimum stipulated by the Reserve Bank are usually obtained keeping in view the price movements for the past six months, the Committee felt that the margins stipulated on advances against shares to individuals needed no review.
- (vi) **Bank Guarantee :** The Committee has recommended that the minimum margin of 25 per cent, inclusive of cash margin, should be stipulated for issue of guarantees on behalf of brokers. The maximum amount of margin to be obtained is, however, left to the boards of banks. The recommendation is made considering it is prudent for the banks to maintain adequate margin which will ensure that the brokers do not build up substantially leveraged position and at the same time, the banks minimize their risks.
- (vii) The Committee has recommended that the following may be excluded for reckoning the banks' aggregate exposure to capital market:
 - a) Advances against collateral security of shares,
 - b) Advances granted to individuals for personal purposes like education, housing, consumption, etc., against the security of shares,
 - c) Credit substitutes like commercial paper, etc., may not be considered as part of credit portfolio.

- (viii) The Committee has recommended that the board of each bank should lay down a prudential ceiling on the bank's total exposure to capital market, keeping in view its overall risk profile.

The recommendations made by the Committee are now being examined by the Reserve Bank of India. The Reserve Bank would welcome comments on the recommendations from banks, financial institutions and other market participants. For this purpose, it has placed the Report of the Committee on the RBI Website (www.rbi.org.in) Comments may be sent by September 15, 2000 to: Shri Amalendu Ghosh, Chief General Manager-in-Charge, Department of Banking Operations and Development, Reserve bank of India, Centre I, World Trade Centre, Cuffe Parade, Mumbai-400 005. Fax : 2183785.

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