CHAPTER V
CONCEPT OF UNIVERSAL BANKING — CONCEPTUAL FRAMEWORK AND PRACTICE

Universal banking is a nomenclature given to a new kind of banking function whereby a bank can afford all kinds of loans for all purposes for all kinds of customers. As such, any one can approach any bank branch for a credit. This enables the customers to avail credit from a bank for any purpose. Hence, an attempt has been made in this chapter to examine how the concept of universal banking enables the individuals to borrow from banks on the basis of personal purposes.

5.1 CONCEPT OF UNIVERSAL BANKING

Universal banking is 'one-stop shop' and is a combination of commercial banking and investment banking. It seeks to provide the entire gamut of financial products under one roof and reflects the global convergence between commercial banks, investment banking and insurance companies. The convergence is an attempt by banks to fulfill the lifelong needs of the customer by following the cradle-to-grave concept. Universal Banking is not restricted by the boundary walls of its branches, but even extends to overseas as regards its operations.

Universal Banking covers formal banking of receipt of deposits, advances, merchant banking, underwriting, investing and trading in all types of securities, advisory services on mergers and acquisitions by the corporate sector and so on. The wide range of services offered also includes insurance. By entering into insurance sector, the concept of Universal Banking has been further broadened. Global experience with Universal Banking has been varied. Universal banking has been prevalent
in different forms in many European countries, such as Germany, Switzerland, France, Italy etc.

The main advantage is that it results in economy, efficiency, lower cost and higher output. But there is a fear that because of their sheer size they might gain a monopoly, which is undesirable for the economy. Also there can be conflict of interest because of the combination of all types of financial activities.

5.2 UNIVERSAL BANKING IN INDIA

The Narasimham Committee's Report (1998) recommended the conversion of Development Financial Institutions (DFIs), into Universal Banks. Further, the Working Group under the Chairmanship of S H Khan on "Harmonizing the Role and Operations of Development Financial Institutions and Banks" (December 1997) has also made it more explicit by recommending for a progressive movement towards Universal Banking for the DFIs. Taking a cue, ICICI an erstwhile DFI took the lead and became a Universal Bank by merging itself with its own subsidiary ICICI Bank Ltd in 2002. IDBI also decided to become Universal Bank and the Government has already announced that IDBI would be merged with its own subsidiary IDBI Bank Ltd. Universal Banking has its own set of problems from the regulatory and supervisory point of views. The success of Universal Banking depends upon coordination among all the existing supervisory and regulatory authorities, viz., SEBI, RBI and IRDA including regulatory wings in the Central Government supported by necessary legislations.

The concept of Universal Banking emerged in the year 2002, when ICICI gave a presentation to RBI to discuss the time frame and possible options for transforming itself into a universal bank. The RBI also spelt out
to the Parliamentary Standing Committee on Finance, its proposed policy to enable domestic financial institutions to become universal banks. The following Development Financial Institutions have started converting themselves into universal banks.

- Industrial Credit and Investment Corporation of India (ICICI)
- Industrial Development Bank of India (IDBI)
- Export Import Bank (EXIM Bank)
- Industrial Finance Corporation of India (IFCI)
- Industrial Investment Bank of India (IIBI)

DFIs which have traditionally been engaged in the medium to long-term financing have recently started undertaking short-term lending including working capital finance. They have also been allowed to accept short to medium-term deposits in the form of term deposits and CDs, within limits. DFIs have also set up subsidiaries for undertaking banking and various other activities. For instance, IDBI and ICICI have already set up banking subsidiaries and mutual funds, besides setting up subsidiaries in the field of investor services, stock broking registrars' services. IFCI has also set up a commercial bank.

5.3 APPROACHES TO UNIVERSAL BANKING BY RBI

Major areas requiring attention are the status of financial sector reforms, the state of preparedness of the concerned institutions, the evolution of the regulatory regime and above all a viable transition path for institutions which are desirous of moving in the direction of universal banking. It has been proposed to adopt the following broad approaches for considering proposals in this area.
• The principle of "Universal Banking" is a desirable goal and some progress has already been made by permitting banks to diversify into investments and long-term financing and the DFIs to lend for working capital, etc. Any conglomerate should be subject to supervision and regulation.

• The DFIs would continue to have the option to transform into Universal Bank provided the prudential norms as applicable to banks are fully satisfied.

• The regulatory framework of RBI in respect of DFIs would need to be strengthened.

5.4 OPERATIONAL AND REGULATORY ISSUES

Following are the salient operational and regulatory issues addressed to the financial institutions for conversion into a Universal Bank.

1. Compliance with the cash reserve ratio and statutory liquidity ratio requirements would be mandatory for a Financial Institution.

2. Any activity of a DFI currently undertaken but not permissible for a bank under Section 6(1) of the Banking Regulation Act, 1949 (B.R.Act), has to be stopped or divested.

3. Any immovable property acquired by a DFI would be required to be disposed of within a maximum period of 7 years from the date of acquisition, in terms of Section 9 of the B. R. Act.

4. The DFIs have 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.

5. The floating charge of a DFI should be ratified by the Reserve Bank of India under Section 14(A) of the B. R. Act.
6. If any of the existing subsidiaries of a DFI is engaged in an activity not permitted under Section 6(1) of the B R Act, delinking of such subsidiary / activity from the operations of the universal bank would become necessary.

7. A DFIs 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, would need to divest such excess holdings to secure compliance with the provisions of Section 19(2) of the B.R. Act, which prohibits a bank from holding shares in a company in excess of these limits.

8. All DFIs shall have to fulfil Priority Sector norms as applicable to commercial banks.

9. A DFIs would be required to obtain a banking license from RBI under Section 22 of the B. R. Act, for carrying on banking business in India.

10. A DFIs would also be required to comply with the present 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.

11. A DFIs 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 B R Act.

12. A DFIs will be required to publish its annual balance sheet and profit and loss account in the forms prescribed for a banking company under Section 29 and Section 30 of the B. R. Act.

13. The appointment and remuneration of the existing Chief Executive Officers would have to be reviewed with the approval of RBI in terms of the provisions of Section 35 B of the B. R. Act.
14. A DFIs 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.

15. The newly converted bank 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.

16. The present prudential norms of RBI for the all-India financial institutions would no longer be applicable to newly converted banks but the norms as applicable to commercial banks would be attracted.

5.5 REQUIREMENT OF PRUDENTIAL NORMS

The purpose of prudential system of recognition of income, classification of assets and provisioning of bad debts is to ensure that the books of the commercial banks reflect their financial position more accurately and in accordance with internationally accepted accounting practices. These help in more effective supervision of banks. Prudential Norms required banks to make 100 percent provision for all non-performing assets (NPAs).

5.6 UNIVERSAL BANKING AND INSURANCE

Banks and insurance companies have shown common interest for a number of reasons. Commercial banks can use their distribution network to sell all types of insurance, particularly life insurance, to their traditional customers. Most importantly, the combining of banking and insurance activities raises the serious problem of the dual regulation to which they are subject and this requires close coordination between the agencies reg-
ulating them. At present, Indian banks (newly converted DFIs and existing commercial banks) are regulated by both RBI and IRDA.

5.7 CONFLICTS OF INTEREST FOR A BANK UNDER UNIVERSAL BANKING

Conflicts of interests arise mainly because of the multiple roles performed by the Universal Banks. Being both lender and underwriter of a particular instrument of the same company, banks have the privilege access to the insider information of the company and such access is feared to be misused by the banks for their own advantage at the expense of depositors or the investors.

Conflicts of interests could take the following forms which however, are not entirely mutually exclusive, viz., (1) promote the issue which it underwrites though the bank was well aware of the company's actual weakness; (2) as a fund manager, sell all the unsold securities to the account holders merely to shift the risks; (3) transfer the 'risk of default by its borrower firm' to outside investors by issuing securities to repay its own loans and (4) access to insider information of the borrowing unit for bank's own convenience.

5.8 STABILITY OF THE SYSTEM

Soundness and stability always remain to be the uppermost concern of banking and financial system. For banks are more 'fragile' than the non-banking organizations for several reasons; of which, the most important being that failure of an individual bank would be detrimental to the entire banking system and which in turn has serious macroeconomic implications. Banks are highly leveraged institutions in the sense that their entire business is based on the borrowed funds which are disproportionate to the owned funds or capital.
As universal banks have exposure to equity market, it was often pointed out to be highly risky. Besides, such risks arise at relatively a very short spell of time compared with the risks arising out of the traditional lending business, sparing little time to repair the system. Moreover, as Universal Banks in general are larger in size, any failure of one bank could have a 'knock on' effect on the entire system through 'contagion' as the theory of 'too big to fail has lost its relevance.

However, Santos (1998) who conducted a comprehensive review on the subject came to the conclusion that a number of empirical studies surveyed gave mixed results disproving that banks conducting securities trading were highly risky. Thus, experience world over did not yield a conclusive evidence on adverse impact of universal banking on systemic stability.

5.9 CONCLUSION

RBI has stated that the movement towards universal banking should foster stability and efficiency of the financial system, but by itself it cannot provide a viable or sustainable solution to the operational problems of individual institutions arising from low capitalization, high level of NPAs, large asset-liability mismatches, liquidity, etc. However, in a market driven economy, to face the competition, one factor is the size and hence, the entry of Universal Banks is inevitable for the overall economic development of our country. No doubt it is clear that we are slowly but surely moving from a regime of 'large number of small banks' to 'small number of large banks'. This paradigm is achieved with the concept of Universal Banking which certainly strengthens the banking sector.
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