Banking Sector Diversification and Rise of Universal Banks

In recent years, it has been seen that commercial banks are no longer restricted to providing traditional services of ‘accepting deposits and making advances’, but are engaged in diverse kinds of banking and financial business like insurance, mutual funds, investment banking, housing finance, factoring etc. Such banking entities which are offering various services under one-roof are referred to as Universal banks. In fact, Universal banks are financial conglomerates, which function as part of financial supermarkets (Gurusamy, 2009).

The concept of Universal banking is of recent origin in India and came to fore-front after the financial sector reforms. However, at the global level, Universal banks have been operating for quite some time in Germany, Austria and Switzerland. Universal banking has its origin in Germany where it originated in 1850s, while it existed in the US prior to 1920s.

In India, financial sector reforms which started in early 1990s have uprooted many of the outdated regulatory fences within which banks were required to operate (Rajadhyaksha, 2004). The first step in this respect was deregulation and opening up of the banking sector to private and foreign players. Licenses were granted to many foreign and new generation private sector banks. The All India Development Financial Institutions (DFIs) like the ICICI, IDBI etc. jumped into the fray of core commercial banking. Public sector banks were allowed to divest the controlling stakes of the Government by encouraging them to come up with Initial Public Offers (IPOs) and Public-Private Partnership (PPP) started elbowing out the predominantly State ruled organisational structures (Darshan, 2006).

With the organisation structural changes and increase in the number of players, competition, which was a non-entity in the Indian Banking context after 1969, set in. Competition in the banking sector reduced the profit-share of banks and forced individual banks to identify avenues to earn profit through diversified
activities – which do not fall under the purview of core banking. Competition also made banks to be more customer-centric and focus on customer satisfaction and retention. In view of these, a variety of banking and financial services are being offered by the banks to meet customers’ needs more effectively. Simultaneously, during this period i.e., 1990s, there was another silent revolution in the country – the advent of Information Technology. Information Technology enabled Services (ITeS) have facilitated banks to bring in a visible change in their service delivery process – making it less time consuming, less cumbersome, and more customer friendly. Thus, with increased competition in the banking sector and all these developments have forced banks to formulate business strategies with focus on customer needs and their satisfaction. This eventually led to the emergence of a new breed of organisations named Universal Banks – offering a variety of banking and financial products under an umbrella brand.

5.1. The Indian Situation and Diversification of Banking Business

Independent India follows a mixed economic system, where there is wide latitude for government participation (Cherunilam, 1994). The Government, since 1950s, had been regulating the economic activities of the country to ensure balanced economic development through Five-year plans. The objective of planned economic development is such that social orientation of banking was considered a must i.e., banks have to move into rural and far flung areas so as to ensure balanced economic growth and equitable distribution of wealth among the population. Accordingly as a part of this obligation of social banking, the domestic banks moved into rural areas and interior locations despite inadequate infrastructure and communication facilities. In this process of meeting social obligations as per government policies, the margins of banks on loans and advances narrowed down and their profitability badly affected. The banking system had such a low level of profitability and it appeared that in their effort of transfusion of money to treat financial anaemia of the economy, the banking system might itself become seriously sick (Suneja, 1994). It became clear that
the viability of the banking system was under a grave threat of an increasingly competitive business environment and that if the system was to continue to serve the social objectives, bank should be allowed to come out with new products to become commercially viable units, apart from taking various other steps to improve their productivity and profitability. In view of all these developments, the Government felt the necessity of economic liberalisation followed by financial reforms. Financial reforms have given banks enough freedom to start diversifying their activities into ancillary business or para banking apart from core banking activities.

Simultaneously, the foreign banks having operational presence in India were also caught up with the idea of diversification and product innovation to enhance their profitability and increase their market share. In view of innovative marketing strategies adopted by foreign banks and also due to increased competition in the domestic market, Indian commercial banks too came forward with aggressive marketing strategies, with focus into product innovation and diversification into ancillary business areas.

Another striking reason which made Indian banks to opt for diversification is the development of Capital Market. In fact, during early 1980s India witnessed an explosive growth of financial markets. According to Rajadhyaksha (2004), these developments in the Indian Financial sector allowed Companies and sometimes even customers to bypass banks and get money directly from those who save it – a process called disintermediation. This has also forced banks to enter new business in order to retain their precious customers through diversification and product innovation. In view of all these developments in India, banks were allowed to undertake para banking activities since 1983 (Ajit, 1997) through subsidiaries (such as leasing, merchant banking, mutual funds, capital markets activities, factoring, housing finance, etc) and in-house in fields such as money market mutual funds, credit cards, etc. Further, technology also played a crucial role in product innovation as well as in diversification in the banking sector. In fact, Information Technology (I.T) has paved the way to speed up the process of banking operations and it can be said that the introduction of
I.T in banking activities has made the transition path easier for commercial banks in the direction of Universal banking.

Thus, in response to national and international economic environment, there have been many significant changes in the economy of our country as well as in the banking sector. Therefore, the major factors behind changes in the activities of commercial banks are deregulation resulting in increased competition and innovation; disintermediation and its counterpart ‘securitisation’; and unprecedented technological advances and use of sophisticated communication in business operations resulting in globalisation of financial markets (Suneja, 1994). Apart from all these factors, the motive for which banks started entering into para banking activities include the need for a profit centre, diversification of earnings, maximisation of economies of scale, the desire to have leading market positions in all financial services, etc. (Ajit, 1997).

5.2. Definition of Universal Bank

Universal Banking, a concept that has gained a lot of credence in recent times, can be defined as a multi-purpose and multi-functional supermarket providing both banking and financial services through a single window. In simple words, a Universal Bank is a super store for financial products. Under one roof, Corporates can get loans and avail of other handy services, while individuals can bank and borrow.

As mentioned in the Discussion Paper by Reserve Bank of India, the term Universal banking in general refers to the combination of commercial banking and Investment banking i.e., issuing underwriting, investing and trading in securities. In a broad sense, however, the term Universal banking refers to those banks that offer a wide variety of financial services especially insurance (Reddy, 2000).

As per the World Bank, ‘In Universal Banking, large banks operate extensive network of branches, provide many different services, hold several claims on firms (including equity and debt) and participate directly in the Corporate
Governance of firms that rely on the banks for funding or as insurance underwriters (Katkar, 2006).

In simple words, Universal Banking means the financial entities – the commercial banks, Financial Institutions, NBFCs – that undertake multiple financial activities under one roof, thereby creating a financial supermarket (Chaitanya, 2005). The entities focus on leveraging their large branch network and offer wide range of services under single brand name.

5.3. Activities of Universal Bank

Presently, all the banking organisations are marching towards Universal banking and as such the distinction in the operations of Commercial banks, Development Financial Institutions and Non Banking Financial Companies (NBFC) is gradually blurring. The motive of these entities behind their transition towards Universal banks is to earn as much as profit by way of interest, fee-based income and commission through various diversified activities (Bhaskar, 2005). In this process, Universal banking adapts, adopts and achieves the basic objectives of business through technology.

Universal Banks are characterised by the presence in the breadth and depth of different segments of the financial market particularly debt market (Gurusamy, 2009). Banks in India are present in the following areas of the universal banking activity –

1. Credit market
2. Consumer finance market
3. Savings market
4. Money market
5. Capital market
6. Forex market
7. Commodities market
8. International banking
9. Advisory service market (merchant banking)
10. Investment banking
11. Insurance market
12. Factoring
13. Credit, Debit and Smart cards
14. Pension market
15. Project financing
16. Venture capital
17. On-line share broking
18. Internet banking
19. Telephone banking
20. Mobile banking
21. Securitisation

In India, most of the commercial banks are rendering almost all the activities mentioned above. Except for the ICICI Bank Limited, which enjoys the status of Indian Universal Banks, the other banks which are also rendering the above mentioned services, however, do not enjoy the same status.

5.4. Types of Universal Bank

There are four different types of Universal Banks in the world. They are as follows–

1. **Fully Integrated Universal Banks**: Fully integrated Universal banks are those banks which function as a single institutional entity offering a complete range of banking and financial products and services.

2. **Partly Integrated Financial Conglomerates**: It is an institutional set-up where the bank offers a range of services, with some of the services such as mortgage banking, leasing, and insurance being provided through wholly owned or partially owned subsidiaries.

3. **Bank Subsidiary Structure**: These are the banks that offer functions such as investment banking and insurance in addition to focussing on regular commercial banking functions.
4. **Bank Holding Company Structure**: Bank holding company structure is an institutional set-up where banking and financial products are offered through a financial holding company that owns both banking and non-banking subsidiaries that are legally separate.

The concept of Universal banking is based on two models. One is the **German Model**, in which banks carry comprehensive banking activities including commercial banking as well as other services such as securities and insurance. The other is the **British Model**. According to this model, universal banks by way of financial conglomerates offer full range of financial service in accordance with change of financial environment, pursuing diversification in securities and investment.

5.5. **Structure followed in India**

In India, the financial services sector has been witnessing a growth in the emergence of financial conglomerates. With increased competition in the financial sector, the banking as well as non-banking entities have felt the need to opt for diversification of their business line. In the process of offering both banking and financial products, they started to experiment with organisational structures hitherto unfamiliar in India.

However, it has been seen that in India, the Holding Company structure is being commonly followed. Internationally there are mainly two holding company models for bank related conglomerates viz., Bank Holding Company Model and Financial Holding Company Model.

(a) **Bank Holding Company Model**: Bank Holding Companies (BHCs) are companies that own or control one or more banks. In USA these are regulated by the Federal Reserve. These companies were first introduced in Bank Holding Company Act of 1956. These companies can make only limited investments in the non-banking companies.

(b) **Financial Holding Company Model**: Financial Holding Companies (FHCs) are companies that own or control one or more banks or non-
bank financial companies. In USA, FHCs were created by the Gramm-Leach-Bliley Act (GLBA) as a way to expand the financial services activities of BHCs. GLBA permits banks, securities firms and insurance companies to affiliate with each other through the FHC structure. FHCs can engage in activities other than banking as long as they are financial in nature. The most important of these are securities underwriting and dealing, insurance underwriting, insurance agency activities and merchant banking. The requirement to have bank in the financial group is pre-requisite for qualifying as an FHC in USA.

In India, as per Reserve Bank of India, there are major motivations for banks/financial institutions to opt for BHCs/FHCs.

(a) First, in terms of existing instructions of RBI, a bank’s aggregate investment in the financial services companies including subsidiaries is limited to 20% of the paid up capital and reserves of the bank. In a BHC/FHC structure, this restriction will not apply as the investment in subsidiaries and associates will be made directly by the BHC/FHC. Once the subsidiaries are separated from the banks, the growth of the subsidiaries/associates would not be constrained on account of capital.

(b) Secondly, in the context of public sector banks, the Government holding through a BHC/FHC will not be possible in the existing statutes. However, if statutes are amended to count for effective holding then, the most important advantage in shifting to BHC/FHC model would be that the capital requirements of banks' subsidiaries would be de-linked from the banks’ capital.

(c) Thirdly, since the non-banking entities within the banking group would be directly owned by the BHC, the contagion and reputation risk on account of affiliates for the bank is perceived to be less severe as compared to the organisational structure where a bank is directly into the non banking business.
Thus, it is anticipated that due to the above motivational factors, financial entities offering diversified products would opt for Holding Company structure. In a banking or financial group, a holding company can be the parent of the group or an intermediate holding company. A multi-layered financial conglomerate may also have a few tiers of intermediate holding companies apart from the holding company at the top. The following are the holding company structures put forward by Reserve Bank of India –

A typical bank-centric organisation structure (also known as Bank Subsidiary Model) is shown in the Fig. 5.1 –

**Fig. 5.1 : A Typical Bank-centric Organisation Structure - Bank Subsidiary Model**

![Diagram of Bank Subsidiary Model]

**Source:** RBI Discussion Paper on Holding Companies in Banking Groups (2007, August)

Organisational structure of a typical FHC with a main banking subsidiary, other banking subsidiaries and other non-banking financial subsidiaries is given in figure below –

**Fig. 5.2 : A Financial Conglomerate with Holding Company at the top**

![Diagram of Financial Conglomerate Model]

**Source:** RBI Discussion Paper on Holding Companies in Banking Groups (2007, August)
A financial conglomerate with a parent holding company can also have an intermediate holding company. Generally, the organisational model involving intermediate holding companies has been mainly used by multinational corporations to take tax advantage by setting up the intermediate holding companies in tax havens. The intermediate holding companies have also been used for regulatory arbitrage. An intermediate holding company or companies are key building blocks for achieving a multilayered corporate structure. An intermediate holding company can find place in all the three basic types of conglomerates i.e., the Universal Bank, the Bank Subsidiary Model and the Bank Holding Company model.

**Fig. 5.3 : Financial Conglomerate with Holding Company at the top as well as an Intermediate Holding Company**

![Diagram of Financial Conglomerate with Holding Company at the top as well as an Intermediate Holding Company]

**Source:** RBI Discussion Paper on Holding Companies in Banking Groups (2007, August)

Of the above three alternative Holding Company Structures, the Bank Subsidiary Model (A typical bank-centric organisation structure as shown under Fig. 5.1) is currently followed in India.

**5.6. Difference between Universal Banking and Financial Conglomerates**

In recent years, the financial services sector in India has been witnessing a growth in the emergence of Financial Conglomerates. A financial conglomerate
is a company or a group of companies that have substantial interests in all sorts of financial businesses – banking, insurance, funds management, mutual funds and securities trading (Rajadhyaksha, 2004). However, Financial Conglomerates are different from Universal Banking in the sense that in respect of Financial Conglomerates various activities are undertaken through different subsidiaries, whereas in the case of Universal Banking, the bank is free to choose the activities it wants to carry out subject to certain regulations (Gurusamy, 2009).

As per Reserve Bank of India, a group would be designed as a ‘financial conglomerate’ if –

(a) any group entity coming under the jurisdiction of specified regulators (namely, RBI, SEBI and IRDA for the present and the Pension Fund Regulatory Authority may be included subsequently) and having a significant presence in the respective financial market segment, and

(b) the group is having operations in at least one more financial market segment.

Table 5.1 shows the financial market segments and the level of presence of a group to be designated as a Financial Conglomerate –

Table 5.1 : Significant Presence in the Respective Financial Market Segment

<table>
<thead>
<tr>
<th>Financial market segment</th>
<th>Significant presence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>Included in the top 70% of the segment in terms of asset base</td>
</tr>
<tr>
<td>Insurance Company</td>
<td>Turnover more than Rs.100 crore</td>
</tr>
<tr>
<td>Mutual Fund</td>
<td>Included in the top 70% of the segment in terms of asset under management</td>
</tr>
<tr>
<td>NBFC (deposit taking)</td>
<td>Included in the top 70% of the segment in terms of deposit base</td>
</tr>
<tr>
<td>NBFC (non-deposit taking)</td>
<td>Asset base more than Rs.2000 crores.</td>
</tr>
<tr>
<td>Primary Dealer</td>
<td>Included in the top 70% of the segment in terms of total turnover</td>
</tr>
</tbody>
</table>

The RBI has clarified that the above framework also covers entities having an overseas parent or holding company (e.g. Foreign banks) and satisfying the specified criteria.

5.7. **Universal Banking – A SWOT Analysis**

A SWOT analysis of Universal banking system as given below reveals to what extent these organisational structures would be beneficial to the country’s economy as a whole and the financial sector in particular.

**Strengths**

1. **Economies of scale and scope**: One of the main advantages of Universal banking is that such an entity can maximise economies of scale and scope by ‘bundling’ the production of financial services (Kannan, 2002). This would result in greater efficiency in the form of lower cost, higher output and better products.

2. **One stop shop**: A Universal bank would act as ‘one-stop shop’ for its customers. This would save a lot of transaction costs and increase the speed of economic activities and thereby enhance profitability of the bank through sale of different financial products. Moreover, customers would enjoy the benefit of getting various financial products under one-roof.

3. **Diversification with profit motive**: The main objective behind Universal banking is to earn as much profit by way of interest, fees based income and commission through various diversified activities (Bhaskar, 2005). Thus, banks are diversifying into allied areas of business with a motive to enhance profitability of the organisation. This is because synergies in joint production of financial and non financial services increase economic efficiency, reduce cost and increase earnings (Bhole, 2004).

4. **Optimum utilisation of resource**: A bank possesses the information on the risk characteristics of the clients, which it can use to pursue other
activities with the same clients (Sensarma, 2001). This eventually saves cost compared to the case of different entities catering to the different needs of the same clients. Moreover, a bank through its existing network of branches can opt for cross-selling their other products like insurance, mutual funds etc. to its clients. Again, as a part of its business operations, the bank would collect information pertaining to the market trends, risk and return associated with portfolios of Mutual Funds and it can provide these information to its clients also at no extra cost.

5. **Advantage of established Brand name:** A Universal bank, with an already established brand name, can sell different products like insurance, mutual funds etc. under the same brand through its existing network of branches. As such investment on building a new brand and product marketing would be very less and at the same time its brand reputation in the market would be a key driver in increasing the sales of its new diversified products.

6. **Positive message to the investors:** As a part of its business activities, Universal bank is going to hold stakes in other firms also. In such instances, it is going to send positive message to the investors because the lending bank is in a better position to monitor the firm’s activities.

**Weaknesses**

1. **More expensive:** In fact, diversification of banking activities need not always result in economies of scale and scope especially if banks are not of appropriate size (Herring & Litan, 2003; Karunagaran, 2005). Sometimes it turns out to be more expensive. This happens when sufficient number of transactions in each of the specialised financial activity is not even up to the ‘breakeven’ level.

2. **Loss of core competence:** When a bank offers a variety of products under an umbrella brand, there is a possibility that the multi-product bank would lose sight of their core competence and would face greater risk by participating in untested activities.
3. **Grey area of Universal Bank**: The transition path for DFI towards Universal banking is laden with obstacles. The stringent regulatory requirements laid down by the Reserve Bank of India for the DFIs are the major cause of hindrance in the transition process. The burning issue about universal banking had been about how the institution would go about garnering Rs 18,000 crore to meet statutory obligations and the degree of concessions they would be able to obtain from RBI about the magnitude of CRR, SLR and priority sector lending (Sen, 2002).

Moreover, there happen to be differences in regulatory requirements for a bank and DFI in the process of becoming a Universal bank. Unlike banks, DFIs are not required to keep a portion of their deposits as cash reserves.

4. **Problem in long term lending**: Project finance has been a domain of DFIs since long. In fact, DFIs were established by the Government to finance projects which had long gestation period. Such financing are done through long term funds. Therefore, a DFI transforming to a bank may not be of much benefit in lending long term funds as banks have access to short term resources and not to long term resources.

5. **The problem of NPA**: There exists a major problem of NPAs in the DFIs. The problem arose either due to improper use of the funds availed by borrower from the DFIs or due a sharp change in operating environment and poor project appraisals by the DFIs (Katkar, 2006). Whatever be the reason, the problem is likely to be aggravated if a DFI transforms itself into a Universal bank. This is because there is a chance that due to the sudden expansion in activities, it may fail to make thorough study of the actual need of the party concerned, the prospect of the business in which it is engaged, its track record, the quality of the management, etc. This may affect the loan recovery process and generate more NPAs.
Opportunities

1. **To increase operational efficiency:** Financial sector reforms have given banks a free hand in formulating their business plans. Presently the focus of banks is on profits rather than on the size of the balance sheet and as such banks are trying to tap lower cost funds by enhancing their fee based incomes. Moreover, as liberalisation brought in new opportunities for banks, it also increased competition in the banking sector. Thus, to face the increased competition and at the same time for sustenance, banks will need to improve their efficiency and productivity, which will lead to new products and better services (Katkar, 2006).

2. **To have significant presence in the global market:** When compared with other banks of the world in terms of total asset base and net worth, the Indian banks’ position is miserable. In fact, State Bank of India (ranked 380) is the only Indian bank to appear in the list of ‘Fortune 500’ (from the July 21, 2008 issue of Fortune magazine) based on sales, profits, asset and market value. Thus, it can be anticipated that pure traditional banking operations alone cannot take the Indian banks into the league of the Top 100 banks in the world. Therefore, there is a real need of universal banking that would offer a wide range of financial services in addition to the commercial banking functions and help in enhancing overall profitability.

3. **Financial Inclusion:** There are certain sectors in the economy and certain stratum of the country’s population who are outside the banking net. Once banks and DFIs are transformed into a Universal Bank, with the help of retail and personal banking services it can reach those sections easily.

Threats

1. **Big Empires:** Mergers and acquisitions in the financial sector lead to the formation of Universal Banks. As for example, the reverse merger of ICICI with its bank led to the formation of India’s first Universal bank on March 31, 2002. Bhole (2004) has pointed out that diversification of
banking activities and their eventual transition towards Universal banking framework would aggravate the problem of concentration of financial and economic power, creation of financial and industrial oligopolies and conglomerates. This might maximise private commercial gains but not social benefits, as large combinations and their unrestricted growth do not lead to socially best allocation of resources.

Moreover, as Universal banks will be large banks, by their asset base, income level and profitability, there is a danger of 'price distortion'. It might take place by manipulating interests of the bank for the self interest motive instead of social interest. Eventually, there is a threat to the overall quality of the products of the bank. Again there is possibility of turning all the strengths of the Universal Banking into weaknesses. For example, the strength of ‘economies of scale’, which a Universal Bank would enjoy may lead to over expansion which may in turn result into the degradation of qualities of bank products as well as service efficiency.

Thus, in spite of certain malice associated with this type of organisational structures in an economy, Universal banking proves to have enough potential for strengthening the financial sector. With most of the banks turning to the global market, the key to sustenance would be diversification of its product-mix and enhancing efficiency in rendering services with focus on customers’ needs and their satisfaction.

5.8. The Need of Universal Banking

In India, the concept of Universal banking has gained the momentum only after the second Narasimham Committee Report (1998) which recommended that the Development Financial Institutions, over a period of time should convert themselves into banks (implicitly Universal banks) and that there should eventually be only two forms of intermediation – Banking companies and Non Banking Financial Companies. Moreover, this was followed by a Working Group chaired by S.H.Khan on ‘Harmonising the Roles and Operations of
Development Financial Institutions and Banks’ (1998), which made it more explicit by recommending for a progressive movement towards Universal banking for the DFIs.

In fact, the pressure in favour of Universal banking comes from the DFIs, with the banks being noticeably reticent in the matter (Rao, 2004). One of the main reasons for which DFIs are making a move towards Universal banking is due to the fact that long term resources are not available to them. To be more specific, the long-term resources earlier provided to the DFIs by the Government are no longer available. In such a circumstance, the DFIs only have access to short-term resources to fund term loans and as such they are confronted with the problem of Asset-Liability mismatch. This is because their assets are long term while their liabilities are short term. In order to overcome such a problem, the DFIs have little option but to go in for increasing the amount of short-term lending. The obvious step is to transform the DFI into a Universal bank.

Moreover, economic growth of country requires a sound infrastructure and for infrastructure projects, long term lending is absolutely necessary. This is the reason why DFIs are set up by the Government. These DFIs should be allowed greater access to long term funds either from insurance companies or from provident funds so that they can finance projects with term loans. In contrast to this, a commercial bank with its insufficient asset base and net worth is not able to fund a large project like Greenfield and Brownfield projects solely. In many occasions, to overcome this problem, they form a consortium of lender (especially with other nationalised banks) for funding those projects. Thus, it implies that there is a need of developing a strong and stable financial sector to cater the need of the infrastructure as well as corporate sector. This is possible only when banks/ financial institutions have strong capital/asset base. Thus, it fortifies the need for Universal Banking.

5.9. Universal Banking in India

The explosive growth of the financial market since early 1980s has resulted in the process of disintermediation (Rajadhyaksha, 2004). As a result of the
disintermediation process, there had been exciting and progressive changes in the banking business (Suneja, 1994) and Indian banks have resorted to diversification in a big way. Moreover, the disintermediation process has been followed by financial sector reforms, which was initiated in early 1990s after the First Narasimham Committee recommendation. In fact, disintermediation process and reforms in the financial sector paved the way for diversification of business activities in the banking sector. Today, the financial services industry has become entirely market oriented (Suneja, 1994). Innovation of new services and development of new instruments have become an integral and essential part of this market.

In India, although there is no legislative distinction between Commercial banking and Investment banking or any explicit legislative restriction for the banks to operate in investment banking activities, the banks have traditionally been maintaining the ‘arms length’ distance from investment banking (Karunagaran, 2005). In fact, in India, DFIs and RFIs were meeting needs of specific sectors of the economy and also providing long-term resources at concessional terms, while the commercial banks in general, by and large, were confined to their core banking function of accepting deposits and providing working capital finance to industry, trade and agriculture. However, with the financial sector reforms beginning in 1990s, banks were given abundant freedom to go much beyond their traditional conservative commercial banking and this has facilitated banks in providing a host of financial products to meet customer needs. At the same time, there has been blurring of distinction between the commercial banking and investment banking.

In sequel to these developments, the Reserve Bank of India constituted on December 8, 1997, a Working Group under the Chairmanship of Mr. S.H. Khan to bring about greater clarity in the respective roles of banks and financial institutions for greater harmonisation of facilities and obligations. Also report of the Committee on Banking Sector Reforms or the Second Narasimham Committee (NC) has major bearing on the issues considered by the Khan Working Group.
Later in the year 2000, the issue of universal banking resurfaced after ICICI gave a presentation to RBI to discuss the time frame and possible options for transforming itself into a Universal bank. Reserve Bank of India also spelt out to Parliamentary Standing Committee on Finance, its policy for universal banking. Eventually the first Indian Universal bank was born on March 31, 2002 with the ICICI Bank formally given the recognition by the Reserve Bank of India. Another mega financial institution, IDBI has also adopted the same strategy, and has transformed itself into a universal bank (Leeladhar, 2005). Simultaneously, Export Import Bank (EXIM Bank), Industrial Finance Corporation of India (IFCI) and Industrial Investment Bank of India (IIBI) also plunged into the race of becoming Universal banks but things did not materialise.

It is quite interesting to note that in India, although many of the banks are offering a host of banking and financial services like a universal bank but they formally do not enjoy the status similar to the ICICI Bank. For example, the State Bank of India (SBI) – the largest bank in India has been offering similar services like the ICICI Bank and when compared to it in terms of assets, the ICICI Bank is second next to it, but it is yet to acquire the status of Universal bank. This is because for conversion into a Universal bank, an organisation (banks as well as DFIs) need to apply to the Government formally and at the same time it should meet all the regulatory issues laid down by the Government of India.

5.10. Government of India Regulations on Universal Banking

The Indian financial sector has seen major changes over the past decade. With product boundaries between banking, securities and insurance sectors becoming thin and blurred, banks have begun to move towards Universal banking structure (Sharma & Vashishtha, 2007). At the same time, competitive pressures have resulted in a growing number of mergers, the emergence of financial conglomerates, growing instances of regulatory arbitrage and overlapping and duplicacy of regulations. These changes have important implications for both financial intermediaries and financial regulators. Moreover, the financial services industry, historically, has been one of the most highly segmented and
most regulated (Sundararajan & Baldwin, 2005). The sector comprising of banks, securities and insurance firms, is highly segmented in the sense that it offers products with distinct liquidity, maturity and risk characteristics. Therefore, to ensure financial stability, minimise systemic risk, promoting efficient, transparent and fair markets, and protecting depositors, investors and insurance policy holders, the sector has to be regulated by the Government.

Financial sector reforms in early 1990s brought in a radical change in the Indian Banking sector. With the recommendations given by Second Narasimham Committee in 1998 and followed by the recommendations given by S.H. Khan Committee in the same year, DFIs were encouraged to transform into either Non Banking Financial Companies or Universal banks. In view of this, the Reserve Bank of India has forwarded the following salient operational and regulatory issues to be addressed by the Financial Institutions for conversion into a Universal Bank.

Table 5.2 : Salient Operational and Regulatory Issues to be Addressed by the FIs for Conversion into a Universal Bank [RBI circular]

<table>
<thead>
<tr>
<th>The salient operational and regulatory issues to be addressed by the FIs for conversion into a Universal Bank as per RBI Circular are as follows –</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. <strong>Reserve requirements</strong>: 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.</td>
</tr>
<tr>
<td>2. <strong>Permissible activities</strong>: 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.</td>
</tr>
<tr>
<td>3. <strong>Disposal of non-banking assets</strong>: 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.</td>
</tr>
<tr>
<td>4. <strong>Composition of the Board</strong>: Changing the composition of the Board of</td>
</tr>
</tbody>
</table>
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.

5. **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.

6. **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.

7. **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.

8. **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.

9. **Licensing:** An FI converting into a Universal Bank would be required to obtain a banking license from RBI under Section 22 of the Banking...
10. **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.

11. **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.

12. **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 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.

13. **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.

14. **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.

15. **Authorised 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 authorised 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.

16. **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.

17. **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.


5.11. **Conclusion**

The rise of Universal banking or the universalisation of banking is the anticipated result of rapid expansion of banks and their diversification into new financial and ancillary banking services. With financial sector reforms and increase in competition in the Indian Financial System, presently the business focus of the large entities that would emerge would be on profitable lines, such as trade finance, credit cards, consumer finance, foreign exchange dealings, treasury and stock market operations, where the payback period is short and risk is less compared to the traditional project and working capital financing (Srinivasan, 2000). However, with increased growth, there would be a marked reluctance to enter the smaller end of retail banking. The small borrowers, especially in the rural areas, would find it difficult to access the bank's services as they may not be significant to the banks’ business volumes or profits.

The success of Universal banking would depend to what extent the banking process is technology-driven. With implementation of Information Technology...
Act, 2000 by the Government, introduction of IT in the banking sector had been possible. Due to these developments, ‘Brick and Mortar’ banking has almost given way to ‘Click and Mouse’ banking (Darshan, 2006). Technology has paved the way to banks to minimise the human interface (and the associated staff costs) with the customer, through ATMs and virtual banking enabling the banks to reduce costs. However, in the rural areas, such technology-led cost reduction would not be possible because of the high infrastructure costs involved and the level of literacy necessary for customers to use the electronic interface. What this portends for rural banking does not seem to be in consonance with the national priorities.

Although the Government of India is toying with the idea of converting banks and DFIs into Universal Banks, the country would be benefited only when the benefits of such transition outweigh the costs. However, the focus of some banks on growth and increasing the balance-sheet size through increased profitability may be adverse to certain sectors of economic activity, and the likely economic costs thereof would be more than the gains of the positive impact on the benefiting banks and financial institutions. In fact, if reforms are warranted, then universal banking has to make adjustments and ensure that financial services are available to all sections of the population at affordable costs and at the same time it should be ensured that access to financial services should not become an elitist privilege.