RBI Draft Circular on Forms of Business and Prudential Regulation for Investments

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Synopsis

These proposed regulations aim to ringfence the banks' core business from other risk bearing non-core businesses and provide operational freedom for making investments. These changes have been on the anvil for some time and follow a raft of regulatory measures on the banking system such as the proposed LCR norms, project financing norms, etc. The proposed regulations on no overlap in the lending activities and restrictions on investments may require certain banks, which have subsidiaries that are NBFCs/HFCs, to re-align their structures.

Overview

The Reserve Bank of India (RBI) released on October 04, 2024, the draft circular on 'Forms of Business and Prudential Regulation for Investments'. It has invited comments on the same from banks and other stakeholders by November 20, 2024. The circular would be applicable to the following entities.

- Scheduled Commercial Banks (SCBs) (excluding Regional Rural Banks)
- Non-Banking Financial Company (NBFCs) (including Housing Finance Company (HFC) - group entities of SCBs
- Non-Operative Financial Holding Companies

Key Highlights of the Draft Circular:

Forms of Business

- Core business of the bank viz. acceptance of deposits and lending would be carried out by the bank itself. Meanwhile, businesses such as factoring, primary dealership, credit card business, housing finance, equipment leasing and hire purchase, could be executed by the bank directly or through a separate group entity (associate/joint venture/subsidiary) subject to fulfilment of relevant conditions.
- Certain non-lending businesses like mutual fund business, insurance business, pension fund management, investment advisory services, portfolio management services and broking services or other such risk-sharing activities that require ring-fencing, shall not be carried out through a separate department of the bank but will have to be done only through a separate group entity.
- The circular prevents multiple entities within a bank group from undertaking same business or having same category of license or registration from any financial sector regulator. Further, there shall be no overlap in lending activities undertaken by the bank and its group entities.
- In case of existing NBFC and HFC, entities in the group will be subject to regulations applicable to scale based Upper Layer NBFCs and restrictions on loans and advances applicable to banks.
- Further, RBI has emphasised that no group entity can be used to circumvent applicable regulations or any guidelines to carry on any prohibited business activity. Further, the RBI plans to tighten norms regarding banks' equity investments.

Prudential Regulation for Banks' Investments

Investment by a bank in any group entity or in other financial/non-financial services company or other equity investments, including overseas investments, would be subject to the prudential limits mentioned below and would be in conjunction with Exposure Norms and Large Exposure Framework as applicable to banks. Further, investment by Small Finance Banks and Payments Banks shall also be subject to their respective licensing guidelines/conditions and operating guidelines.

Limits on Investments:

Bank's Paid-up Capital and Reserves:

- Any individual equity investment by a bank in any company, to not exceed 10%
- The aggregate of equity investment in factoring subsidiaries and factoring companies shall not exceed 10%.
- The aggregate equity investments to not exceed 20% of the bank's paid-up share capital and reserves

Meanwhile, the following investments would be excluded while calculating the aggregate investment for compliance with the limit of 20% of paid-up capital and reserves

- Investments held under 'Held for Trading' category
- Investments in excess of 10% in non-financial companies provided the acquisition is through restructuring of debt or to protect the banks' interest on loans/investments

Investee Company's Equity Capital:

- Not hold more than 10% in the equity of a deposit taking NBFC, excluding an HFC.
- Not invest more than 10% in the capital of a REIT/InvIT subject to the overall 20% investment ceiling.
- Not hold more than 20% in the equity capital of any non-financial services company. However, investments up to 30% (subject to relevant compliance) would be permitted as under:
    - The investee company is engaged in non-financial activities permissible for banks subject to prior approval of RBI.
    - Acquisition is via a restructuring of debt or to protect the banks' interest on loans/investments. The bank shall submit a time bound action plan for disposal of such shares, within 30 days of such acquisition.
- Not invest in a Category III AIF. Investment by a bank's subsidiary in a Category III AIF shall be as the SEBI regulatory norms.
- Not sponsor more than one Asset Reconstruction Company (ARC). Further, aggregate shareholding would be less than 20% of the equity capital of the ARC.
- Not hold more than 30% of the equity capital of the investee company. For the purpose of calculating aggregate shareholding, investments made individually or collectively would be included.
- Not hold directly or indirectly through a trustee company or otherwise hold shares in any company (other than those specifically permitted), whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is less.

Requirement of prior approval of Department of Regulation, RBI:

- Invest in excess of 20% in the equity capital of any financial services company/ Category I or II AIF.
- Invest in excess of 20% in the equity capital of any non-financial services company either individually or collectively by the bank group including investments made by mutual funds managed by Asset Management Companies controlled by the bank.
- Additional investment in any group entity.

Prior approval shall not be required for investments wherein the aggregate shareholding is less than 20% of the equity capital, subject to the following conditions:

i. The bank's CRAR shall not be less than the minimum prescribed capital
ii. The bank should have reported net profit in the preceding two financial years;
iii. The aggregate of equity investments made by the bank in the current financial year shall not exceed the net profit reported in the preceding financial year.

CareEdge View

These changes have been on the anvil for some time and follow a raft of regulatory measures on the banking system such as the proposed LCR norms, project financing norms, etc.

The proposed regulation on single entity within a bank group (the bank and its group entities) undertaking a particular form of permissible business and no overlap in the lending activities undertaken by the bank and its group entities are broadly intended at curbing regulatory arbitrage and may require certain banks, which have subsidiaries that are NBFCs/HFCs, to re-align their structures.

In some cases, both the bank and the NBFC subsidiary provide loans under similar asset classes, but the products offered in terms of size and the customer segmentation of the bank and NBFC are different, further clarity is required on whether these NBFCs in the banking group would be allowed to continue the business in the current form.

While mutual fund business, insurance business, pension fund management and broking services are largely done through separate entities, few banks will have to re-align their investment advisory services and portfolio management services under identified entity under the group. Typically, banking groups offer these products are additional products for bank customers and offering the products through separate entities may reduce the cross subsidisation of deposits and fee-based products for banks impacting the bottom line. This is also likely to aggravate issues of data sharing across entities and may entail additional operational inconvenience such as increased/ multiple KYC norms for customers.

Under this circular, a bank including its group entities (including investments made by mutual funds managed by Asset Management Companies controlled by the bank) are restricted from holding more than 20% of the equity capital of an investee. This is slightly complicated as investments are made by the mutual fund scheme on behalf of its unitholders and not on behalf of the sponsor. This would require additional clarity from the regulator.

Furthermore, the circular requires a group-wide capital management policy, consequently, ICAAP norms may have to also be monitored on a group basis.

This is a draft circular from regulator and gives broad level directions with finer points yet to be detailed. The circular provides a window of two years from applicability of the circular to comply with the revised guidelines. Implementation of this circular on an as is basis would increase the cost and cause customer inconvenience besides significant realignment of the group structures.

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