UNIVERSAL BANKING : EMERGING ISSUES

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The approach to universal banking should be guided both by international experience and domestic requirements. The global trends in banking are marked by the twin phenomena of consolidation and convergence. Even in those countries where there are legal or regulatory impediments to provide a combination of commercial, investment and other banking services, relaxation of restrictions is being contemplated at present. There has also been a blurring of boundaries among suppliers of various products and services. Some of these trends are already visible in India. Banks are already providing a range of financial services, such as investments, merchant banking, leasing and hire purchase and project finance, either in-house or through the subsidiary route. Likewise, Development Financial Institutions (DFIs) are already undertaking bank- like activities, such as short term non-project lending and retail deposit taking; either in-house or through the subsidiary route. The process of enabling both by banks and DFIs, the provision of diversified services, either in house or through the subsidiary route as a conglomerate, should continue, albeit, in a gradual and orderly fashion subject to appropriate regulations and supervision.

I. UNIVERSAL BANKING : DEFINING THE CONCEPT

Universal banking encompasses providing diverse banking services under one roof. More precisely, the term 'Universal Banking' 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 Bank' refers to those banks that offer a wide range of financial services beyond commercial banking and investment banking such as insurance. However, universal banking does not mean that every institution conducts every type of business with every type of customer. Universal banking is an option; a pronounced business emphasis in terms of products, customer groups and regional activity, in fact, be observed in most cases.

In the spectrum of banking, specialised banking is on one end and the universal banking on the other.

In many developed countries, besides traditional activities like accepting deposits and making advances, the banks are now undertaking such activities as

* financing fixed investments in industrial projects by way of making loans and advances on a longer term.
* trading in financial instruments, foreign exchange and its derivatives.
* creating/financing venture capital funds;
* securitising debt.
* underwriting new debt. and equity issues.

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* providing corporate advisory services including advice on mergers and acquisitions
* making investment management and providing depository services
* selling insurance products.

Undertaking so many activities by commercial banks in various countries has changed the face of banking from "Omni present banking facilities" to "Omni potent banking" having multifarious functions and selling/marketing their new products and many modern banking services. This change is obviously prompted by the perceived necessity of attuning to the current trends in globalisation.

The herald of Universal Banking is eulogised as harmonisation of the role and operations of development financial institution (DFI's) and banks. DFIs were set up initially with a view to meeting the term financing needs of a project for creation of fixed assets. On the other hand, commercial banks were perceived as prime providers of short- term working capital finance, with its limited supplementary role in funding capital cost of projects (Gangopadhyay, 1999). Recently, the role of DFIs and commercial banks has blurred as both of tem are now providing term loan and working capital finance. The reforms in financial sector, e.g., the deregulation of interest rates, emergence of disintermediation pressures arising from a liberalised capital market and increasing participation by DFIs in working capital and finance significantly altered the operating environment of banks. This changed environment of banks. This chan-ged environment has set the path to move towards the universal banking.

There are two models of practising universal banking viz (a) Fully Integrated Universal Banking Model (FIUB) and (b) Financial Conglomerate Model (FC).

Under the FIUB model, big banks serve as super markets and provide a wide range of banking services including commercial banking, securities related services (Investment banking) and insurance business related services etc. under one roof. This model is also known as German type financial model of universal banking as it originated and is being practiced in Germany.

On the other hand, FC model is popularly known as British-American type model of universal banking. Under this model, banks are carrying out comprehensive banking activities and separate subsidiaries are being set up for providing some specific banking services like credit card, insurance etc.

The German type model of universal banking is considered the true model as the Universal Banks in Germany combine the functions of commercial banking and investment banking and provide all types of financial services under one roof and the bank is free to choose the activities it intends to undertake subject to certain regulations. These universal banks - when they come into existence - are expected to be developed and regulated by a single larger regulatory authority. However, in case of FC model, universal banks carry out diverse banking activities through different subsidiaries and the Bank does not have complete control on all the activities (Sabnani, 2000).

In simplified form, Universal Banking takes one of three forms, i.e., in- house, through separately capitalized subsidiary or through a holding company structure. Universal

banking in its fullest or purest form would allow a banking corporation to engage 'in-house' in any activity associated with banking, insurance, securities trading etc. That is, these activities would be undertaken in departments of the organisation rather than through separate subsidiaries (Saunders and Walter, 1994).

II. NEED FOR UNIVERSAL BANKING

In recent times, there is severe strain on interest spread and bottom- line of banks because of various developments visible in the present operating environment of banks and financial institutions Globalization, liberalization and deregulation of financial markets in many developed and developing countries have resulted in increased disintermediation and has made commercial banks vulnerable to interest rate risk. Relating exchange controls, adopting uniform accounting practices in regard to income recognition, asset classification and provisioning norms and prescribing capital adequacy norms has further aggravated the position. Furthermore, the developments in information technology and telecommunications are allowing international pooling of financial sources thereby spreading the risk across more than one market. Consequently, banks have started emphasizing on new sources for non-interest income to arrest the pressure on their bottomlines. The efforts of many foreign banks have yielded good results as their income from non- fund based business to total income has increased manifold. Thus, they managed to overcome the adverse situation by indulging in the diversification of the existing activities (i.e. adopting the universal banking concept).

It has also been recommended that the financial institution should be allowed to move towards universal banking to cope with the ground breaking changes wrought by the new economic policies since the early 1990's. The measure was also deemed absolutely necessary to help the leading financial institutions compete in a world where money flowed across national boundaries with minimum restrictions (Khan, 1998).

With the opening up of the financial sector under the auspices of World Trade Organisation (WTO), India is obliged to gradually open up the financial sector to overseas competition. The only way domestic institutions could prepare themselves to face the increasing competition in the new era is by converting themselves into true universal banks.

The universal banking concept should also be welcomed in India due to various benefits from its adoption. The main argument in favour of universal banking is that it results in greater economic efficiency in the form of lower cost, higher output and better products. Costs would drop because of the large volume of investments for a given level of overheads on investments.

Cost efficiency will result not only due to economics of scale but also due to economics of scope. The underlying logic for this is that the cost of offering various activities by different units is greater than when they are offered together.

Further, the economies of scale and scope are expected to help the entity deal better with business cycles. A shift in business cycle is expected to alter the demand for products. Multi- product firms are, therefore, inherently better placed to handle changes in the type of product demanded.

Table 1 : Activities offered by SBI's subsidiaries

Name of the Subsidiary	Activity Offered
SBI Funds Management Ltd.	AMC for SBI Mutual Fund
SBI Capital Markets Ltd.	Merchant banking leasing and hire purchase
SBI Factors and Commercial Service Ltd.	Factoring
SBI Gilts Ltd.	Primary Dealer
SBI Securities	Broking Business
SBI Cards and Payments Services Ltd.	Credit Card Business

III. UNIVERSAL BANKING IN INDIA

Banks in India have gradually started practising universal banking. They are adopting the FC model of Universal Banking. They have set up subsidiaries for providing the whole range of financial services. For instance, State Bank of India (SBI) has set up various subsidiaries to provide different services as shown in the following table :

Many other banks like, Canara Bank, Bank of Baroda, Bank of India, Punjab National Bank, Indian Bank, Andhra Bank and Central Bank of India have also set up their subsidiaries to move towards the universal banking system. Private sector banks and foreign banks are far ahead, of course, in this race.

With respect to the financial institutions one important proposal has been the allowance of DFIs converting them into banks. This is the first step towards universal banking which simply means a one-stop shop for any type of banking needs or products. Such type of banking has been immensely successful in the European markets and in the Indian case at least for a start - ICICI and IDBI should be gearing themselves for conversion into banks. This would help not only in servicing the corporate clients but also serve the retail businesses. In addition, it would give better leverage in financial and product management of DFIs. The ICICI has taken steps in this direction by adopting financial conglomerate route by setting up a number of subsidiaries offerring a number of diverse financial services as shown in Table 2.

Besides the necessity to introduce universal banking created by changing environment of banks due to financial sector reforms, ICICI has already put on drawing board a "dream project" to convert itself into a true universal bank (based on FIUB model). According to a discussion held between ICICI Ltd and Reserve Bank of India (RBI), the FI would first convert itself into a bank and then go for a merger with its subsidiary, ICICI Bank. The FI also submitted that it would take about seven years time to fully comply with the present reserve requirements applicable for a bank. During the transition period, ICICI proposed that it will maintain CRR and SLR on the incremental liabilities and it is understood that by the end of seven years a bulk of ICICI's deposits would mature and it would

Table 2 : Diversified services of ICICI's subsidiaries

Name of Subsidiary	Financial Service Offered
ICICI Bank Ltd.	Commercial banking
ICICI International Ltd.	Off- shore investment management.
ICICI Securities & Finance Company Ltd.	Investment banking
ICICI Capital services Ltd.	Merchant banking services
ICICI brokerage services Ltd.	Brokerage services
ICICI Invest mgt. Co. Ltd.	Managing MF and VCFs
ICICI experts Ltd.	To own & operate the payment gateway infrastructure to service internet and corporate clients
ICICI KINFRA Ltd.	Infrastructure financing & development assistance in Kerala.

be primarily left with fresh liabilities on which reserve requirements have been adhered to, (Badrinath, 2000).

IDBI has also sought to become a universal bank by launching retail banking sercies. M B. Athreya panel had for the first time recommended that IDBI should become a bank. Keeping in view the recommendations of the panel, IDBI is considering a proposal to merge its subsidiary, IDBI bank, with itself once the regulatory norms for universal banks are in place.

As regards insurance though banks have been allowed to enter the insurance sector, it has come with strings attached. This is justified, for insurance being a business which would initially need a lot of funds and at least five to six years to break even. By now ICICI and HDFC have plunged into the insurance business by entering into joint ventures with prudential life insurance and standard life insurance companies of UK respectively, (Das, 2000).

III. PREREQUISITES FOR SUCCESSFUL ADOPTION OF UNIVERSAL BANKING

The approach to universal banking should be guided by international experience and domestic requirements. The process of enabling the provision of diversified services both by banks and DFIs, either in-house or through the subsidiary route as a conglomerate, should continue albeit in a gradual and orderly fashion, subject to appropriate regulation by the RBI. The number of intermediate steps are needed before the universal banking model becomes a reality.

1. The entire aspect of harmonising the roles of DFIs and banks is being revisited or the premise that the basic functional difference would continue, at least for the present. Therefore, the development of a function- specific regulatory framework that is institution-neutral with regard to the regulatory treatment of identical services rendered

by any participant in the financial system can be considered.

2. The competition between commercial banks and DFIs is not uniform. For example, banks have to bear increased regulatory costs in the form of higher CRR on their deposits, while DFIs do not have any such pre-emptions on their resources. Moreover, commercial bank have been subjected to certain stipulations in the lending areas for which compliance is mandatory. It is understood that similar guidelines should be prescribed for DFIs to create a level playing field. Besides, the regulatory system should also include uniform statutory reserve requirements, capital adequacy, asset classification, income recognition and provisioning norms for banks and DFI turned banks. To implement this scheme, the issue of transformation of a DFI into a bank should ideally be considered after a reasonable period of time has elapsed. If the DFI chooses to become a bank or NBFC, then it should be prepared to fully conform to the entire gamut of prudential, regulatory and supervisory norms aplicable to banks and NBFCs within a specified timeframe.

3. The issue of regulation has to be addressed, as in India; DFIs are regulated by separate acts while banks are regulated by the RBI and the merchant banks are regulated by SEBI etc. Regulation is one single most important reason responsible for practising 'financial conglomerate model' by many banks in India. A common regulatory framework should be considered as the most fundamental prerequisite for introducing universal banking in India.

   The establishment of a 'super-regulator' to supervise and co-ordinate the activities of the multiple regulators is the step required to resolve above-mentioned issue.

4. Another important issue that advocates caution in moving towards universal banking relates to dismantling of clear cut Berlin wall between the commercial banks and the DFIs with the increasing involvement of commercial banks in supplying term finance to the industry and participation of DFIs in providing working capital finance.

This is because DFIs have special skills in project appraisal, an area in which banks are yet to fully specialise. On the other hand, the conversion of DFIs into banks will result in to the clash of interest as DFIs will be eating the slice from the same cake because the need for working capital finance will not increase overnight.

The point to remember to resolve this issue is that the objective of harmonisation is not to impede competition or to create interest clashes but to ensure that appropriate quantum of credit to made available to industry at a reasonable cost. Therefore, until the long term debt market improves in terms of liquidity and depth, there is a special role for DFIs in the financial system. Large and medium sized firms continue to depend on DFIs for long term financing.

5. If the banks have to survive and prosper, they have necessarily to shed some of their less remunerative activities which tax their managerial resources while taking up new business activities envisaged under universal banking. For instance, to enable the banks to build up expertise in handling the new business, perhaps, the rural

banking activities may be segregated. The withdrawal from rural sector may hasten the process of their evolution as universal banks. The rural business of the commercial banks could be amalgamated with the RRBs at state level (Thingalay,1999).

6. As regards insurance, Government will have to take a view on linkages between banks and insurance companies both as the owner of public sector banks, DFIs and insurance companies and a sovereign that has to assign appropriate regulatory jurisdiction whenever the two activities overlap. Indeed, the design of appropriate regulatory framework may be considered as a pre-condition for any notification or permission for banks or DFIs to be involved in any type of insurance activity (Reddy 1999).

IV. RBI'S EFFORTS TO MOVE TOWARDS UNIVERSAL BANKING

In the light of the transformation in the financial system in terms of structure, performance and participants and in view of the need to evolve a vibrant financial system, the Reserve Bank constituted a Working Group in December, 1997 for harmonizing the role and operations of DFIs and banks. The Working Group headed by Mr. S.H. Khan asked for gradual elimination of existing boundaries between commercial banks and DFIs, both on the assets side and liabilities side. The group submitted its report in May 1998 recommending that DFIs should move towards universal banking progressively with a simultaneous development of an enabling regulatory and supervisory framework, the Group has come out with the following suggestions :

1. The development of a function- specific regulatory framework that is institutional-neutral with regard to the regulatory treatment of identical services rendered by any participant in the financial system.
2. A system of consolidated supervision of financial entities.
3. A focus on off-site supervision based on periodic reporting by banks /DFIs.
4. The establishment of a super-regulator to supervise and coordinate the activities of the multiple regulators and
5. Speedy legal reforms in the debt recovery areas of banks and financial institutions.

Keeping in View the recommendations made by the group, the RBI prepared a Discussion Paper (DP) in January 1999 for wide public debate on the issue of universalisation of banking and eliminating the specific functional role of specialisaed financial institutions. The architecture for the financial system in India, as delineated in the DP can be precisely given as follows :

The DP observed that the approach to Universal Banking in India should be guided by the twin considerations of international expeience and domestic requirements and contended that the transformation of DFI should ideally be considered after a reasonable period of time has elapsed; in the interim DFIs could tailor their needs to become either a NBFC or a bank, depending on institution-specific considerations and their comparative advantages. The options to pursue banking activity could be explored and such a process could occur either through a process of mergers and acquisitions thus enabling DFIs to reap the economics of a branch network through a full-fledged subsidiary as part of a conglomerate. The transitory arrangements in the process of evolution could be worked

out, after a detailed examination by the RBI, on a case to case basis, in view of the unique position of each FI as part of its progress towards universal banking practices. In view of special role of banks in the financial sector, any such conglomerate, in which a bank is present, should be subject to a consolidated approach to supervision and regulation while ensuring consistency with monetary policy and prudential standards. (The DP, however, recognized that till such time as the long-term debt market improves in term of depth and liquidity, there would be a definitive role for the DFIs in providing long-term developmental finance (Discussion Paper, RBI, 1999).

In fact, these observations of DP are corroborations of the report of the Committee on Banking sector Reforms. Narasimham Committee has also felt that DFIs should over the period of time, convert themselves into banks, so that in future, there would be only two types of financial intermediaries viz banks and non-banks. If the DFI chooses to become a bank on NBFC, then it should be prepared to fully conform to the entire gamut of prudential regulatory and supervisory norms applicable to banks/NBFCs. With a view to create a level playing field for banks and DFIs, Tarapore Committee on capital account convertibility has also recommended that DFIs be allowed to borrow from overseas market and invest abroad and be accorded the full fledged Authorised Dealer's status.

On the issue of having a super regulator, the DP observed that the question of whether the supervisory responsibility should lie solely with the Board for Financial Supervision (BFS) or with a separate supervisory system to be devised for the purpose, would need to be considered in due course. In this respect, a proposal was floated by Dr. Y.V. Reddy (Deputy Governor of RBI) in recently organised seminar. The features of the proposal are : The BFS can continue to supervise banks and non-banks but with the Deputy Governor as Chairman; the insurance regulatory authority-IRDA, will supervise the insurance companies and securities and Exchange Board of India (SEBI)will continue with its regulatory jurisdiction. An apex financial regulatory authority (Super-regulator) may be constituted, by statute with the Governor of RBI as Chairman and the members could be the Chairmen of the three regulatory agencies. The apex body should also include some outside experts on a part-time basis. Finance secretary could be a permanent special invitee or a regular member without voting rights as in the case of the RBI Board. The apex authority could have by law, jurisdiction to assign regulatory gaps to one of the agencies, arbitrate on regulatory overlaps and ensure regulatory coordination. The apex body could be serviced by a part-time secretariat of the RBI.

The DP also recognises the need for a system of consolidated supervision as suggested in a draft of new capital adequacy framework circulated by Bank for International settlements (BIS) as a consultative paper to replace the existing capital adequacy norms.

The Draft emphasizes the need to continue efforts aimed at aligning capital standards of banking, securities and insurance supervisors in order to assist the assessment of conglomerate wide capital adequacy. The draft also lays emphasis on the need for cooperation among banking, securities and insurance supervisors to ensure that the overall level of capital and its distribution are adequate to meet the

risks within the mixed group and risks arising elsewhere in the group are adequately taken into account.

V. CONCLUSION

The experience the world over shows that major banks everywhere have increasingly diversified the products and services they offer, such as investment banking, life insurance etc., either in-house or through subsidiaries banks have entered a period of rapid structural change with this development. This change in culture is quite unprecedented and requires careful handling.

It is believed by some people that this change of culture will affect the core-banking activities which comprise of accepting deposits from public and providing payment services as an integral part of the payment system in the economy. Consequently there is no longer thing as banks. Some others say that banks will be financial conglomerate or retailers when they will provide one-stop solutions. The most important of all, mixing of financial services and other banking activities with core- banking activities may result in substantial increase in this burden of the Central Bank as it might create expectations among public as well as investors that Central Bank's safety net may be extended to all the activities of a bank in times of need. This could place too much demands on the central bank's resources, besides aggravating the problem of moral hazard.

But this is not the truth. These developments have not. fundamentally altered the special characteristics of banks. Undoubtedly, the universal banks may be radically different from what they were some years ago. But at the heart , they are the bank as they accept deposits and lend money (Munn,1999). On the liability side, although some close substitutes for deposits, such as, money market mutual funds have taken place which have eroded banks market share as repository for liquid asset holdings. Such erosion has generally been very small and bank deposits still constitute a single largest source of liquid asset holding. Even though in recent years some new facilities have been developed for making payments, such as debit cards or credit cards most transaction are still settled through banks. On the asset side also, there is some evidence of gradual erosion of the role of banks in financial intermediation, due mainly to larger corporate borrowers accessing domestic and international capital market directly. Small corporates. on the other hand, continue to remain heavily dependent upon bank finance.

Thus, while there certainty have been important changes affecting banks and the environment in which they work, they have not yet been such as to substantially alter their key functions or the importance of those functions to the economy; nor have they altered fundamentally the distinctive characteristics of either the banks' liabilities or their assets. They continue to remain special in term of the particular characteristics of their balance-sheets, which are necessary to perform those function (George, 1997).

Moreover, the experience of the countries reveals that universal banking is not incompatible with the maintenance of the safety of financial system or with protecting the Central Bank against excessive demands as the lender of last resort. This is because universal banking, in these countries, evolved gradually over a period giving time for appropriate institution, practices, experience and conversions to be developed and a body of formal as well

as non formal guidelines for regulatory purposes to be established.

Besides adopting the evolution process on lines followed by such countries, it should also be seen that financial markets operate in a relatively competitive environment to realise efficiency gains from universal banking.

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