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Bankers' Dilemma

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FOCUS Banks

Bankers' Dilemma

RBI's proposals on intra-group transactions might hurt banks but will make the financial system more robust. By MANU KAUSHIK

In a bid to strengthen the Indian financial system, the Reserve Bank of India (RBI) has issued draft guidelines for banks on intra-group transactions.

The objective is to minimise the risk arising from large financial institutions operating multiple subsidiaries or forming joint ventures. The RBI is concerned about the way financial conglomerates use intra-group transactions to their advantage. The central bank says such deals can help a group take unacceptable risks and escape scrutiny by transferring the losses of a regulated entity to unregulated entities.

There is a need for a better risk management framework, say analysts. Rajesh Mokashi, Deputy Managing Director, CARE Ratings, points out that the chances of unsound intra-group transactions are growing as large banks expand. A bank investing in its insurance unit, for instance, will be at risk if the insurer fails, he says. "Since 90 per cent of banks' funding is made up of depositor money, a lot of public money will be at stake."

The proposed guidelines stipulate that bank boards must approve all intra-group transactions. Also banks would be required to have a comprehensive policy for monitoring such deals. In addition, banks should not buy a low-quality asset from group entities nor can they accept such assets as collateral for a loan.

The RBI has also proposed to limit a bank's exposure to group entities. The total exposure to all group entities should not exceed 20 per cent of a bank's paid-up capital and reserves. The cap would be 10 per cent for non-financial and unregulated financial services companies. The RBI has sought comments on the proposed norms by September 14.

The draft guidelines come in the wake of rising bad loans in the banking system. According to a report by ratings firm ICRA, gross bad loans across all banks had surged to ₹1.29 trillion by end-December 2011, from about ₹78,000 crore at the end of fiscal 2009/10. State Bank of India, the country's largest lender, has reported a 63 per cent jump in net bad loans to ₹20,324 crore for the April-June quarter of this year.

RBI wants to ensure that banks maintain an arm's length relationship with their group entities, say experts. The draft proposals, if implemented, will impact about 10 large banks, including State Bank of India, ICICI Bank and Kotak Mahindra Bank.

"From the risk management point of view, these guidelines are a step in the right direction," says Sangeet Shukla, Senior Advisor, Indian Banks' Association. The timing is not ideal since the banking industry is passing through hard times in a slowing economy, he adds.

Global ratings firm Moody's expects the guidelines to hurt banks, especially those with large international operations. The proposals could affect companies that depend on parent banks for capital and brand support.

CARE Ratings's Mokashi says a cap on exposure in group companies may make banks unattractive for investors. "Banks and financial services companies need a higher degree of leverage to maximise the return on equity and shareholder returns," he says>

RBI'S WISH LIST

- Banks should have a policy on monitoring intra-group deals
- Banks cannot have unlimited exposure to group entities
- Banks should not buy low-quality assets from group entities
- Banks' total exposure to all group entities capped at 20 per cent