



Module-D Unit- 16

JAIIB PAPER-1

**Indian Economy and Indian
Financial System (IE & IFS)**



JAIIB Paper 1 IE & IFS Module D Unit 16: Para Banking and Financial Services Provided By Banks

Introduction

- Banks are permitted to conduct a number of other activities, which are called para banking and Financial Services activities.

Types Of Para Banking And Financial Services Activities

- These services were earlier named as Para Banking Services (RBI Master Circular dated 1st July 2015).
- Subsequently, RBI has come out with Master Direction, 2016, wherein, Prudential Regulations for Investment by a bank in a subsidiary or in a financial services company (not being a subsidiary) or a non-financial services company have been provided. RBI, in its **Master Direction (2016) has further expanded the scope of these services by adding the following financial activities:**
 - Investment advisory services
 - Agency Business by Banks
 - Broking services for commodity trading segment

Activities of banks which come under para banking and Financial Services, as per the RBI Master Circular dated 1st July 2015 and the Master Directions (2016) on “Financial Services provided by Banks” dated 26th May 2016 (updated 10th August 2021) are as follows:

- Sponsoring of an Infrastructure Debt Fund
- Equipment Leasing and Hire Purchase Business
- Factoring Services
- Primary Dealership Business
- Underwriting Activities
- Mutual Fund Business
- Insurance Business
- Pension Fund Management by Banks
- Investment Advisory Services
- Portfolio Management Services
- Agency Business by Banks
- Referral Services
- Retailing of Government Securities
- Membership of SEBI approved Stock Exchanges
- Broking services for Commodity Derivatives Segment
- Banks’ investment in Venture Capital funds
- Cheque writing facility for investors of money market mutual funds
- Safety net Services

Organisation Of Para Banking and Financial Services Activities By A Bank

- Banks can undertake certain eligible financial services or para-banking activities, either departmentally or by setting up subsidiaries for the purpose.
- Banks may form a subsidiary company, for undertaking the types of businesses, which a banking company is otherwise permitted to undertake, with prior approval of Reserve Bank of India.

General Guidelines

- ✓ Bank desirous of undertaking the businesses permitted **under Section 6(1) of the Banking Regulation Act, 1949** may do so, either departmentally or through a separate subsidiary set up for the purpose, under the provisions of **Section 19(1) of the Banking Regulation Act, 1949**.
- ✓ An activity undertaken departmentally shall follow RBI guidelines on KYC compliance and Charter of Customer Rights issued. In addition, all the instructions/regulations of respective regulators such as SEBI, IRDA and PFRDA, as applicable, shall also be complied with. Master Directions on '**Prudential Norms for Banks Exposures**' wherever applicable, shall also be complied with.
- ✓ Banks are also allowed to hold equity in both financial services companies as well as companies not engaged in financial services activities, within the limits specified **under the provisions of Section 19(2) of the Banking Regulation Act, 1949**, and subject to the prudential limits, as enumerated in this chapter.

- **Factoring:** Means factoring as defined in the Factoring Regulation Act, 2011.
- **Financial Services Company:** Means a company engaged in the 'business of financial services'
- **Hire Purchase:** Means hire purchase as defined in the Hire Purchase Act, 1972.
- **Infrastructure Debt Fund:** means an infrastructure debt fund as defined in the Notification no. DNBS.233/CGM (US)-2011 dated November 21, 2011, as amended from time to time.
- **Investment Advisory Service:** Means the service offered by an investment advisor, as defined in the SEBI (Investment Advisors) Regulations, 2013.
- **Mutual Fund:** means a fund as defined in SEBI (Mutual Funds) Regulations, 1996.
- **Non-Financial Services Company:** Means a company not engaged in any of the business mentioned in Section 3(vi) of these Directions.
- **Pension Fund Management:** Means management of a pension fund, as defined in the Pension Fund Regulatory Development Authority (Exit and Withdrawals under National Pension System) Regulations, 2014.
- **Portfolio Management Services:** Means the service offered by a portfolio manager, as defined in the SEBI (Portfolio Managers) Regulations, 1993.

- **Referral Services:** Means the arrangement between a bank and a third-party financial product provider, for referring the customers of the bank to the third-party financial product provider.

Prudential Regulation for Banks' Investments in a subsidiary or in a financial services company

Limits on investments:

- Equity investment in a subsidiary company, or a financial services company, not being a subsidiary, individually, shall not exceed: 10% of the bank's paid-up share capital and reserves, as per the last audited balance sheet or a subsequent balance sheet, whichever is lower.
- The aggregate of equity investment in factoring subsidiaries and factoring companies shall not exceed 10% of the bank's paid-up capital and reserves
- Bank shall not contribute more than 49% of the equity of Infrastructure Debt Fund, set up as a Non-Banking Finance Company (IDF-NBFC)
- A bank contributing less than 30% of the equity of IDF-NBFC shall not be a sponsor.
- **Restrictions on Exposure:**
 - ✓ Banks are not allowed to hold more than 10% in the equity of a deposit taking NBFC (other than a housing finance company).
 - ✓ Further, Banks should not invest more than 10% of the unit capital of a Real Estate Investment Trust/Infrastructure Investment Trust, subject to overall ceiling of 20% of its net worth permitted for direct investments in shares, convertible bonds/debentures, units of equity oriented mutual funds and exposures to Alternative Investment Funds Besides, Banks should not hold more than 10% of the paid-up capital of a company, not being its subsidiary engaged in non-financial services or 10% of the bank's paid-up capital and reserve, whichever is lower.
 - ✓ However, investments in excess of 10% but not exceeding 30% of the paid-up share capital of such investee company shall be permissible, if the investee company is engaged in nonfinancial activities permitted for banks in terms of Section 6(1) of the Banking Regulation Act, 1949; or the additional acquisition is through restructuring of debt or to protect the banks' interest on loans/investments made to a company.
 - ✓ Banks should not hold along with their subsidiaries, associates or joint ventures or entities directly or indirectly controlled by the bank; and mutual funds managed by Asset Management Companies (AMCs) controlled by the bank, more than 20% of the investee
 - ✓ company's paid-up share capital engaged in non-financial services. However, this cap doesn't apply to the investee company engaged in non-financial activities permitted for banks or in case the additional acquisition is through restructuring of debt or to protect the banks' interest on loans/investments made to a company.

- ✓ Any investment by a bank's subsidiary in a Category III Alternative Investment Fund (AIF) shall be governed by the SEBI Regulations. Hence, Banks are not allowed to invest in AIF (category –III)

Banks' aggregate equity investments made in all subsidiaries and other entities engaged in financial services and non-financial services, including overseas investments shall **not exceed 20% of the bank's paid-up share capital and reserves (not applicable for investments held under 'Held for Trading' category [90-day defeasance period])** and investments in excess of 10% in non-financial companies acquired through restructuring of debt or to protect the banks' interest on loans/investments.

Banks are required to take prior approval of RBI

Before making investment in a subsidiary and a financial services company that is not a subsidiary. However, in following cases, such prior approval shall not be necessary:

- ✓ The investment is in a company engaged in financial services; and
- ✓ The bank has the minimum prescribed capital (including Capital Conservation Buffer) and has also made a net profit in the immediately preceding financial year; and
- ✓ The shareholding of the bank including the proposed investment is less than 10% of the investee company's paid-up capital; and
- ✓ The aggregate shareholding of the bank along with shareholdings, if any, by its subsidiaries or joint ventures or other entities directly or indirectly controlled by the bank, is less than 20% of the investee company's paid-up capital.
- ✓ It may be explained that prior approval of RBI shall not be required, if the investments in the financial services companies are held **under the 'Held for Trading' category and are not held beyond 90 days.**
- ✓ As directed by the RBI, prior permission of the RBI is required for making investment in a nonfinancial services company in **excess of 10% of such investee company's paid-up share capital**, where the investee company is engaged in non-financial activities permitted for banks in terms of **Section 6(1) of the Banking Regulation Act, 1949.**

Besides, prior permission of the RBI is also needed before making investment of **more than 10% of the paid-up capital/ unit capital in a Category I/ Category II Alternative Investment Fund (AIF).**

Para-Banking and Financial Services Undertaken By A Bank

Sponsoring of an Infrastructure Debt Fund

- Infrastructure Debt Funds (IDFs) can be set up either as a Mutual Fund (IDF-MF) or a Non-Banking Finance Company (IDF-NBFC), subject to Board approval and after making proper disclosure in the prospectus/offer document that the sponsoring bank's liability is limited to the extent of its contribution to the paid-up capital.

Equipment Leasing and Hire Purchase Business

- Banks can form subsidiary companies for undertaking equipment leasing and hire purchase, with prior approval of RBI.

The following guidelines should govern the conduct of such business by the banking companies:

- ✓ The subsidiaries/joint ventures formed should primarily be engaged in any of the above-mentioned activities and such other activities as are incidental to equipment leasing, hire purchase business and factoring services.
- ✓ While banks may invest in other equipment leasing/hire purchase/factoring companies, within the limits specified in **Section 19(2) of Banking Regulation Act, 1949**, with the Reserve Bank's prior approval, they shall not act as promoters of such companies.
- ✓ They should be undertaken only by certain select branches of banks having such facilities/arrangements.
- ✓ The facilities extended by way of equipment leasing, hire purchase finance and factoring services would be covered within the extant exposure ceilings. Banks should maintain a balanced portfolio of equipment leasing, hire purchase and factoring services vis-à-vis the aggregate credit.
- ✓ Banks are required to frame an appropriate policy on leasing business with the approval of their Boards and evolve safeguards to avoid possible asset liability mismatch.
- ✓ Any changes brought about in respect of guidelines in asset classification, income recognition and provisioning for loans/advances and other credit facilities would also be applicable to leased assets of banks, undertaking leasing activity departmentally.
- ✓ Equipment Leasing and Hire Purchase business through a subsidiary shall be subject to compliance with all Prudential Regulations for Banks' Investments.

Factoring Services

The following aspects to be kept in view by banks in relation to the factoring of receivables by factors vis-a-vis borrowings of the clients from banks:

- ✓ Banks and factors should share information about common borrowers.
- ✓ Banks are required to issue letters of disclaimer to the factor/s on book debts factored, to facilitate assignment of debt and factors in turn, should route the proceeds of repayment and final adjustment through the borrowers' bank.
- ✓ Borrowers should declare separately the extent of book debts proposed to be factored and those against which, bank finance is to be obtained in their projection for assessment of bank credit. Banks may also take into account, the finance availed under factoring, while sanctioning loans to the borrower.

The borrower's bank may also obtain from the borrower, periodical certificates regarding factored receivables, to avoid double financing.

i) Factor may intimate the limits sanctioned to the borrower to the concerned bank/s and details of debts factored to avoid double financing. This could be cross checked with the certificate obtained by banks from borrowers.

ii) All Prudential Regulation for Banks' Investments have to be complied with, while undertaking business through a subsidiary.

- ✓ Factoring services shall be subject to extant prudential norms on loans and advances.
- ✓ Credit information of any default on dues by the person on whom exposure was booked shall be furnished to the Credit Information Companies authorised by RBI, subject to the guidelines under **Credit Information Companies (Regulation) Act, 2005**.

Primary Dealership (PD) Business

- For undertaking the PD business through a subsidiary, a bank should be registered as an NBFC with RBI (DNBR)
- For undertaking the PD business departmentally the bank is required to be registered with RBI (IDMD) for the same.
- A primary dealer (PD) is an RBI registered entity that is authorised in buying and selling government securities.
- There are two types of primary dealers in India



Standalone primary dealers: Either subsidiaries of scheduled commercial banks, Indian subsidiaries of entities incorporated abroad or

companies incorporated under Companies Act and are registered as Non-Banking Financial Companies (NBFCs).

Banks fulfilling the following minimum eligibility criteria may apply to RBI for approval, for undertaking primary dealership business, provided they fulfil the following criteria:

- ✓ Minimum Net Owned Fund of Rs 1,000 crores
- ✓ Minimum CRAR of 9 %
- ✓ Net NPAs of less than 3% and a profit-making record for the last 3 years

Underwriting Activities

- Underwriting of issues of shares, debentures and bonds may be undertaken, either departmentally or through a merchant banking subsidiary.
- Underwriting business undertaken departmentally and through subsidiary, shall be subjected to Prudential Regulation for Banks' Investments Banks are permitted to extend underwriting activities for corporate shares and debentures and PSU bonds, as part of para banking activities.
- While underwriting issues, as a part of their merchant banking activities, banks should ensure the prudential exposure norms, prescribed by RBI from time to time, as well as the statutory limits contained in **Sections 19(2) & (3) of the Banking Regulation Act, 1949** are strictly adhered to. Further, while undertaking such activities, banks as well as their merchant banking subsidiaries would also be required to comply with relevant SEBI regulations.

Mutual Fund Business

Banks desirous of undertaking mutual fund business should obtain prior approval of RBI, for setting up such funds, subject to the following:

- Bank-sponsored mutual funds should comply with the guidelines issued by SEBI, from time to time.
- Where a bank's name has been associated with the mutual Fund, a suitable disclaimer clause should be inserted, while publicising new schemes that the bank is not liable or responsible for any loss or shortfall resulting from the operations of the scheme.

Insurance Business

No bank shall undertake insurance business with risk participation except through a subsidiary/joint venture set up for the purpose, ***subject to fulfilment of the eligibility criteria (as on March 31 of the previous year) as under:***

- It has a **net worth of `1000 crore and its minimum net worth** shall not be less than **`500 crore after investing in the equity of such company;**
- It has the minimum prescribed capital (including Capital Conservation Buffer) after investment
- Its level of net non-performing **assets is not more than 3 per cent;**
- It has made a net profit in the preceding three financial years; and
- The track record of the performance of its subsidiaries, if any, is satisfactory.

Undertaking of insurance broking/corporate agency by a subsidiary/joint venture:

No bank shall set up a subsidiary/joint venture company for undertaking insurance broking and corporate agency, until it fulfils the eligibility criteria (as on March 31 of the previous year) as under:

- Its net worth shall not be less than `500 crore after investing in the equity of such company;
- It complies with conditions stated at 7(a) ii, iii, iv and v.

Pension Fund Management by Banks

Banks may undertake the business of pension fund management only through a subsidiary set up for the purpose, *subject to the fulfilment of the eligibility criteria (as on March 31 of the previous year) listed below:*

- Banks shall not undertake the business of pension fund management departmentally.
- Its net worth shall not be less than `500 crore after investing in the equity of such company;
- It has the minimum prescribed capital (including Capital Conservation Buffer) after investment;
- Its level of net non-performing assets is not more than 3 per cent;
- It has made a net profit in the preceding three financial years; and
- The track record of the performance of its subsidiaries, if any, is satisfactory.

Investment Advisory Services (IAS)

- Banks may undertake the business of investment advisory services (IAS), through a separate subsidiary, set up for the purpose or one of its existing subsidiaries and after taking specific prior approval.
- IAS shall be provided only for products and services in which banks are permitted to deal in as per the **Banking Regulation Act, 1949**.

Agency Business by Banks

- Agency business shall be undertaken only for the products and services, in which, a bank is permitted to deal in, as per **Banking Regulation Act, 1949**.
- The service shall be provided on fee basis, without any risk participation.
- Agency business of mutual fund companies undertaken departmentally shall be subject to the **following additional conditions:**
 - ✓ The investors' applications for purchase/sale of mutual fund units shall be forwarded to the mutual funds/registrar's/transfer agents.
 - ✓ The purchase of units shall be at the customers' risk without the bank guaranteeing any assured return.
 - ✓ No mutual fund units shall be acquired from the secondary market or bought back from a customer for selling it to other customers.
 - ✓ Extension of credit facility to individuals against the security of mutual fund units shall be in accordance with the Master Directions on Credit Management issued by the RBI.
 - ✓ A bank holding custody of mutual fund units on behalf of its customers shall keep the investments of the customers distinct from its own investments.

Referral Services

- Banks offering referral services shall do so only for financial products other than insurance, on a nonrisk participation basis.
- Referral Services means the arrangement between a bank and a third-party financial product provider, for referring the customers of the bank to the third-party financial product provider. Banks are permitted to offer referral services to their customers for financial products, **subject to the following conditions:**
 - ✓ The bank/third-party issuers of the financial products should strictly adhere to the Know Your Customer (KYC)/Anti-Money Laundering (AML) guidelines in respect of the customers, who are being referred to the third-party issuers of the products.
 - ✓ The bank should ensure that the selection of third-party issuers of the financial products is done in such a manner so as to take care of the reputational risks to which the bank may be exposed to, in dealing with the third-party issuers of the products.
 - ✓ The bank should make it explicitly clear upfront to the customer that it is providing purely a referral service strictly on a non-risk participation basis.
 - ✓ The third-party issuers should adhere to the relevant regulatory guidelines applicable to them, and while offering referral services, the bank should strictly adhere to the relevant RBI guidelines.

Retailing of Government Securities

As part of para banking and financial activities, banks are permitted to undertake the business of retailing of Government Securities with non-bank clients, in terms of the guidelines issued by RBI from time to time, as applicable. ***They also need to adhere to the following conditions:***

- Banks are free to buy and sell Government Securities, on an outright basis, at prevailing market prices, without any restriction on the period between sale and purchase.
- Banks shall not undertake ready forward transactions in Government Securities, with non-bank clients.
- The retailing of Government Securities should be on the basis of ongoing market rates/yields.
- No sale of Government Securities should be effected by banks, unless they hold the securities in their portfolio either in the form of physical scrips or in their SGL Account maintained with RBI.
- Immediately upon sale, the corresponding amount should be deducted by the bank from its investment account and also from its SLR assets.
- Banks should put in place adequate internal control checks/mechanism in this regard.
- These transactions should be subjected to concurrent audit, as per RBI's extant instructions and should also be looked into by the auditors, at the time of bank's statutory audit.

Membership of SEBI approved Stock Exchanges

The AD Category- I scheduled commercial bank shall not become a trading/clearing member of the currency derivatives segment of the **SEBI recognised stock exchanges unless** –

- It has a minimum net worth of `500 crore;
- It has the minimum prescribed capital (including Capital Conservation Buffer);
- Its net NPA does not exceed 3 per cent and
- It has made a net profit in the preceding three financial years.

Broking services for Commodity Derivatives Segment

No bank shall offer broking services for the commodity derivatives segment of SEBI recognised stock exchanges except through a separate subsidiary set up for the purpose or one of its existing subsidiaries and shall do so subject to the following conditions:

- The subsidiary shall, with the approval of its Board, put in place effective risk control measures including prudential norms on risk exposure in respect of each of its clients, taking into account their net worth, business turnover, etc.
- The subsidiary shall not undertake proprietary positions in the commodity derivatives segments.
- The subsidiary shall ensure strict compliance with various margin requirements as may be prescribed by SEBI, its own board or the “**Commodity Exchanges.**”

Investment in Venture Capital Funds

- Various aspects of venture capital funds have been dealt with in a separate chapter covered earlier in this Module. In view of the significance of venture capital activities and the need for banks' involvement in financing of Venture Capital Funds (VCFs), it is important to address the relatively higher risks inherent in such exposures.
- As such, banks should obtain prior approval of RBI, for making strategic investment in VCFs, i.e., investments **equivalent to more than 10 per cent of the equity/unit**. All exposures to VCFs (both registered and unregistered) will be deemed to be on par with equity and hence will be reckoned for compliance with the capital market exposure ceilings (ceiling for direct investment in equity and equity linked instruments as well as ceiling for overall capital market exposure).

Money Market Mutual Funds (MMMFs)

- Money Market Mutual Funds (MMMFs) come under **the purview of SEBI regulations**.
- However, banks desirous of setting up MMMFs would have to, initially, seek necessary clearance from RBI for undertaking this additional activity before approaching SEBI for registration.

Cheque Writing Facility for Investors of Mutual Funds/Money Market Mutual Funds

Banks are permitted to tie-up with MMMFs as also with MFs, in respect of Gilt Funds and Liquid Income Schemes, which predominantly invest in money market instruments (not less than 80% of the corpus) to offer cheque writing facilities to investors, **subject to the following safeguards:**

- In the case of a MMMF set up by a bank, the tie-up arrangement should be with the sponsor bank. In other cases, the tie-up should be with a designated bank. The name of the bank should be clearly indicated in the Offer Document of the Scheme.
- The Offer Document should clearly indicate that the tie-up to offer cheque writing facility is purely a commercial arrangement between the MMMF/MF and the designated bank
- The facility to any single investor in the MMMF/MF can be permitted at the investor's option, in only one of the branches of the designated bank.
- This should be in the nature of a drawing account, distinct from any other account, with clear limits or drawals, the number of cheques that can be drawn, etc., as prescribed by the MMMF/MF. No deposits can be made in the account. Each drawal made by the investor under the facility should be consistent with the terms prescribed by the MMMF/MF and treated as redemption of the holdings in the MMMF/MF to that extent.
- The facility can be availed of by investors only after the **minimum lock-in period of 15 days for investments in MMMFs** (not applicable in the case of eligible Gilt Funds and Liquid Income Schemes of mutual funds and any prescription of lock-in-period in such cases will be governed by SEBI Regulations).
- The bank should ensure pre-funding of the drawing account by the MMMF/MF at all times and review the funds position on a daily basis.

Safety Net Schemes

- Safety Net is a scheme where the company's promoters assure that they will buy back shares from the retail applicants at the IPO price, if its stock falls sharply during the first six months after listing.
- **It was proposed by the market regulator SEBI in 2012.**
- **SEBI had formulated draft norms for safety net after its study showed that 62% of 117 companies listed between 2008 and 2011 fell below IPO price within the first six months of listing.**
- SEBI, however, could not make it mandatory after the proposal
- RBI had observed that some banks/their subsidiaries were providing buy back facilities under Safety Net Schemes in respect of certain public issues as part of their merchant banking activities.
- Under such schemes, large exposures are assumed by way of commitments to buy the relative securities from the original investors at any time during a

stipulated period at a price determined at the time of issue, irrespective of the prevailing market price.

- Apparently, there was no undertaking in such cases from the issuers to buy the securities. There is also no income commensurate with the risk of loss built into these schemes.

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