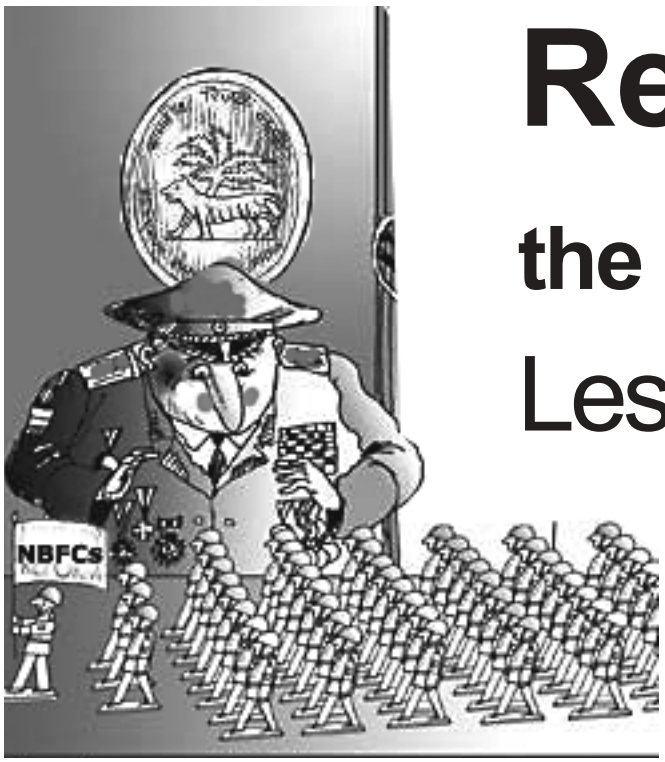

Regulating the NBFCs- Lessons from RBI

NBFC sector encounters a crisis of confidence and credibility because of failure of some NBFCs to service the deposits. However, all NBFCs can't be tarred with the same brush and their contributions to economic development should not be understated.

Shyamala Gopinath

The regulation by RBl covering financial intermediaries is based on two factors -- protecting depositors' interest where public deposits are accepted and the systemic stability considerations. The responsibility and associated regulatory and supervisory powers are conferred upon RBI under the Banking Regulation Act for banks and the RBI Act for non-banking companies. While regulation of banks has been in place for a long time, the regulation of non-banking finance companies started when the RBI Act was amended in 1963 to provide for regulation of the deposit acceptance activities of non-banking institutions (NBIs).

Proliferation of NBFCs in India

Non-Banking Financial Companies (NBFCs) encompass an extremely heterogeneous group of intermediaries. They differ in various attributes, such as size, nature of incorporation and regulation, as well as the basic functionality of financial intermediation. Notwithstanding their diversity, NBFCs are characterised by their ability to provide niche financial services in the Indian economy. Because of their relative organizational flexibility leading to a better response mechanism, they are often able to provide tailor-made services relatively faster than banks and financial institutions. This enables them to build up a clientele that ranges from small borrowers to established corporates and to fund sectors where a credit gap exists. While NBFCs are capable of enhancing the functional efficiency of the financial system, instances of unsustainability, often on account of high rates of interest on their deposits and periodic bankruptcies, underscore the need for reinforcing their financial viability.

Several factors have contributed to the rapid growth of NBFCs in India. The activities of NBFls in India over a period have undergone a qualitative change through functional specialization in diverse lending activities viz. equipment lease finance, hire

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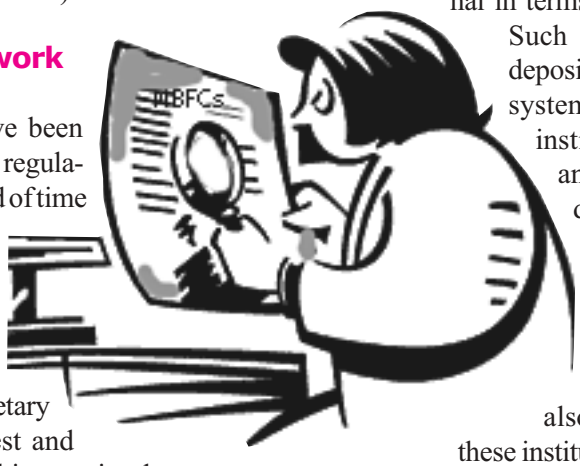
purchase finance, loan, investment, chit fund, housing finance, stock broking, merchant banking, primary dealership, micro finance, etc. Comprehensive regulation of the banking system on the one hand and relatively lower degree of regulation over NBFCs have to a significant extent contributed to their rapid growth.

Jurisdiction of RBI in regulating NBFCS

There are several types of NBFCs. The NBFCs falling under the exclusive jurisdiction of other regulatory authorities like SEBI (stock broking companies, merchant banking companies, etc.), National Housing Bank (housing finance companies), IRDA (insurance companies) and Department of Company Affairs (Nidhis) have been specifically exempted from RBl regulations. Chit Fund companies are under the purview of Registrar of Chits of the States except for regulation of the deposit acceptance activities (under RBI Regulations).

Evolution of Statutory Framework

Historically, companies and firms have been accepting public deposits and the current regulatory framework has evolved over a period of time keeping in view developments in the sector. However, an attempt to regulate them started only in the sixties. Regulation of these institutions was found to be necessary for three reasons viz. ensuring efficacy of credit and monetary policy, safeguarding depositors' interest and ensuring healthy growth of NBFls. This was implemented through insertion in 1963 of a new Chapter IlIB in the Reserve Bank of India Act, 1934. These regulations centered on restricting the deposit raising capacity of NBFCs. Subsequently, based on the recommendations of committee called the Shah Committee, the RBI issued as part of prudential supervision regulations on asset classification etc and capital adequacy requirements. It also formulated a scheme of voluntary registration, which evoked only a limited response. There were practically no entry norms for non-banking financial companies. Companies had only to register under the Companies Act and unincorporated bodies were generally covered by state legislations relating to moneylenders, which have certain provisions relating to registration of moneylenders with designated authorities. The lack of entry norms resulted in haphazard and mushroom growth of such NBFCs and their number increased to well over 40,000 by 1996. During the eighties and nineties therefore, the growth of NBFCs was phenomenal in terms of deposits collected. Such unfettered growth of deposits outside the banking system and proliferation of institutions both financial and non-financial depending mainly or wholly on deposits from public was viewed with great concern by the authorities. There were also failures of some of these institutions which brought to the fore the need for greater regulation of these institutions. Given the need for continued existence and growth of NBFCs the task before the regulators was a daunting one viz. how to afford a degree of protection or comfort to the depositors while at the same fostering the development of a healthy diversified financial sector. Several committees strongly recommended that there should be an appropriate regulatory framework over NBFCs and that more powers should be vested with RBI to better regulate NBFCs. The Narasimham Committee in 1991 recommended that the supervision of these institutions should be brought within the purview of the agency to be set up for the purpose under the aegis of the RBI.



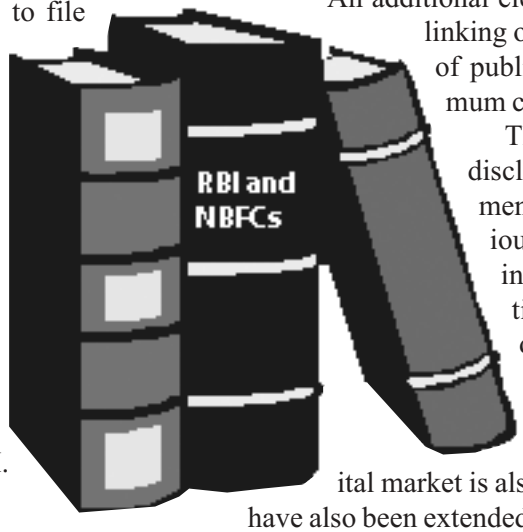
Banks are not allowed to lend to NBFCs for investment in real estate or capital markets or for investment in other companies. However, banks can grant loans to the NBFCs against lease or hire purchase assets.

This led to the amendment of the RBI Act in 1997. The RBI Amendment Act 1997 introduced compulsory registration with the RBI of all existing and newly

The Working Group on DFIs, which also looked into certain aspects of the functioning of NBFCs, has recommended that though non-deposit-taking NBFCs are slated to be excluded from the purview of the regulations, there is a need to focus on all large sized NBFCs from the angle of their systemic significance.

incorporated NBFCs and prescribed certain minimum capital requirements as basic entry norms for a company to be able to operate as an NBFC.

RBI was also given powers to give directions to the NBFCs and their auditors, to file winding up petition against the erring NBFCs and impose penalty directly on the erring NBFCs, etc. NBFCs were also required to maintain liquid assets as a percentage of their deposit liabilities and transfer at least 20 per cent of their net profits to a reserve fund to strengthen their owned funds base. New applicants are prohibited from accepting deposits for a period of 2 years by which time a financial track record becomes available to the RBI. The sector was also brought under the Board of Supervision of the RBI.



Approach to regulation

All NBFCs, both deposit taking and non-deposit taking, have to obtain certificate of registration from RBI. The minimum net owned fund (NOF) for registration, was stipulated at Rs.2.5 million for the then existing NBFCs and Rs.20 million for new NBFCs seeking grant of CoR on or after April 21, 1999. Since there are a large number of NBFCs and to optimize supervisory resources to focus on deposit taking NBFCs, in our regulatory framework, a distinction is made between NBFCs accepting public deposits and those who do not accept public deposits. As per global practices, deposit-taking companies are subject to much higher degree of regulation. Non-deposit taking NBFCs are not required to maintain minimum capital adequacy ratios and are not subject to exposure norms. However, they are subject to other prudential norms relating to asset classification and provisioning.

Regulations over NBFCs accepting public deposits

In the wake of certain developments in the NBFC sector and as a part of the exercise to implement the new statutory framework, the regulatory mechanism was extensively revised in January 1998. Safeguards have been instituted in the regulatory framework for acceptance of public deposits by prescribing detailed regulations covering deposit-taking activities of NBFCs viz., the requirement of minimum investment grade credit rating, quantum of public deposits, interest rate on deposits, brokerage, period of deposits, etc.

An additional element in regulation is the linking of credit rating to quantum of public deposits and the minimum capital adequacy ratio.

The RBI has also prescribed disclosure norms and requirement to furnish returns on various aspects of the functioning of these companies from time to time and has introduced ALM guidelines for NBFCs for effective risk management. Exposure of big NBFCs to the capital market is also monitored. KYC norms have also been extended to NBFCs.

Supervisory Model for NBFCs

In addition, the Reserve Bank has been strengthening the supervisory framework for NBFCs to ensure sound and healthy functioning and to avoid excessive risk-taking. The degree of supervisory oversight is based on the following three criteria, viz., (a) size of the NBFC, (b) the type of activity performed, and (c) the acceptance (or otherwise) of public deposits.

The NBFC supervisory framework rests on a four-pronged strategy encompassing the following, viz. (a) on-site inspection, based on the CAMELS

methodology, (b) off-site monitoring (c) market intelligence, and (d) exception reports of statutory auditors of NBFCs.

Defaulting NBFCs

A system of identification, follow-up and supervision of problem NBFCs has been put in place by the RBI. In order to impress upon such NBFCs to repay public deposit in time and to maintain the faith of the depositors in the financial system, supervisory action as warranted is taken against the erring and recalcitrant companies wherever any serious violation is noticed during such an exercise.

RBI can issue prohibitory orders, from accepting further deposits and alienation of assets except for repayment of the matured deposits, filing winding up petitions and launching criminal proceeding against NBFCs and their management for serious violation of the provisions of RBl Act.

The nature of action depends upon the magnitude of the default and the violations of the statutory provisions. Thus, there has been a fall in the number of operating NBFCs reflecting mergers, closures and cancellation of licenses.

Besides, the number of public deposit-accepting companies also came down because of conversion to non-public deposit-accepting activities.

Deposit taking NBFCs

Notwithstanding the differences between banks and NBFCs, there are areas of operational convergence due to their engagement in similar types of activities in the broad product space of deposit mobilization and lending. A critical issue is the desirable degree of regulatory convergence between banks and NBFCs in view of the complex set of similarities and differences in their functions. Banks and NBFCs essentially perform the function of financial intermediation in the economy. Their regulatory design has serious implications for the efficiency of the financial system, as well as for financial stability. Gaps often create the scope for regulatory arbitrage that has impact on the process of price discovery and efficient allocation of resources, or results in regulatory repression of the various segments of the financial sector.

Banks and public deposit-accepting NBFCs compete for deposits. Besides, banks and NBFCs are also competing for sources of funds in certain sections of the credit markets. These two factors provide the basic case for regulatory convergence in terms of licensing (and entry), capital adequacy, loan-loss provisioning and risk management. At the same time, a large number of NBFCs do not mobilize public deposits and therefore, do not fund their activities through deposit money, as in the case of banks. This implies that the case for regulatory convergence based on depositors' protection between banks and NBFCs does not apply uniformly to the latter.

The differences in regulation of banks and NBFCs reflect their unique characteristics and the fundamental differences in their operations. First, while both bank and non-bank deposits reflect investor choice, bank accounts -- current and/or savings -- are necessary to settle financial transactions since banks exclusively have the power of issuing cheques as constituents of the payments system. Secondly, transactions put through banks and NBFCs carry very different macroeconomic implications. This implies that certain regulatory measures, such as the imposition of cash reserve requirements, apply uniquely to banks.

What's RNBC

A RNBC is a company which receives any deposit under any scheme or arrangement by whatever name called in one lump sum or in installments by way of contributions or subscriptions or in any other manner but is not an equipment leasing company, a HP finance company, a housing finance company, an insurance company, an investment company, a loan company, a mutual benefit financial company, a miscellaneous NBC, and a mutual benefit company.

In India, the major differences in regulatory environment between banks and NBFCs are:

- Low entry capital requirements for NBFCs Rs. 20 million as against Rs 200/300 million for new banks
- Lower SLR ratio for NBFCs 15% as against 25% for banks
- No cash reserve ratio for NBFCs
- Higher capital adequacy ratio for NBFCs rang ing from 12 to 15 per cent depending on the type of business
- Quantum of public deposits that can be accepted is linked to owned funds and credit rating for NBFCs (other than RNBCs)

which is not the case for banks

It will, therefore, be seen that to ensure that regulatory arbitrage is minimized and in view of the relatively higher risk involved in NBFC operations, RBI has prescribed higher capital adequacy ratios for NBFCs (15 percent against 10 percent for banks), they are not allowed to accept demand deposits, the provisioning norms are similar to those of banks, they are also subject to exposure limits and above all NBFC deposits are not covered by official deposit insurance. Furthermore, in order to ensure that there are limits on the total amount of public deposits that they can access, a leverage ratio in the form of public deposits to owned funds has been prescribed except in the case of RNBCs. In the interest of transparency and public awareness, NBFCs were instructed to include a clause in any advertisement/ statement issued by them for inviting public deposits that the deposits placed with them are not insured. NBFCs are also not eligible for any LOLR support.

In India, banks continue to be dominant in financial intermediation and the percentage of deposits of NBFC sector to aggregate deposits of all scheduled commercial banks is just 1.6 per cent. However it is the skewness within the sector that is significant.

Banks exposures to NBFCs

In view of the diverse nature of activities engaged by NBFCs and to ensure that NBFCs do not use bank funds for lending/investment in sectors, which banks cannot directly lend or where their exposures to certain sectors are subject to limits, banks lending or investment in NBFCs is regulated. Banks are not allowed to lend to NBFCs for investment in real estate or capital markets or for investment in other companies. However, banks can grant loans to the NBFCs against lease and hire purchase assets. The bills discounted by NBFCs arising from the sale of commercial vehicles and two/three wheelers are permitted to be rediscounted by banks.

To ensure that regulatory arbitrage is minimized and in view of the relatively higher risk involved in NBFC operations, RBI has prescribed higher capital adequacy ratios for NBFCs (15 per cent against 10 per cent for banks) they are not allowed to accept demand deposits.

Financial Companies Regulation Bill, 2000

The Task Force on NBFCs appointed by the Government has made various recommendations for improvement in the regulatory framework for NBFCs and enhancement in depositor protection. RBI has already implemented the recommendations, which do not require any change in the RBI Act. Some of the recommendations of the Committee require amendment to Chapters IlIB, IlIC and V of the RBl Act, which deal with regulation of NBFCs and unincorporated bodies.

For improving regulations of NBFCs in the light of recommendations of the Task Force, as also on the experience gained by RBI in supervising this significant sector so far, it is considered necessary to have a separate legislation for regulating and supervising NBFC sector. The Government has since promoted a separate Bill for regulating the activities of NBFCs.

Working Group on DFIs

The Working Group on DFIs, which also looked into certain aspects of the functioning of NBFCs, has recommended that though non-deposit taking NBFCs are slated to be excluded from the purview of the regulations, there is a need to focus on all large sized NBFCs from the angle of their systemic significance. The Group has recommended that for this, RBI should put in place as an ini-

tial measure a system of periodical collection of all information relevant to the systemic concerns pertaining to large sized non-public deposit taking companies say with total assets of Rs. 500 crore and above.

In regard to RNBCs, the group has suggested that the regulatory structure should be revisited particularly in the light of the unrestricted growth of deposits. It has suggested that a cap in terms of NOF may be fixed for mobilization by RNBCs of public deposits. This cap may be fixed at a level of 16 times the owned funds and gradually reduced to 4 or 1.5 times depending on the CAR over a period of 5 years. The Group has also suggested some modifications in the regulations on directed investments.

The recommendations are under examination. However, it will be evident from the manner in which the regulatory framework for NBFCs has evolved in India that in respect of NBFCs the underlying rationale is to regulate public deposit-taking activities since these are unsecured. The regulatory framework should therefore provide NBFCs with sound asset base to diversify their liabilities and not rely excessively on unsecured deposits which is not healthy and exposes depositors to large risks, which they may not be aware of. Furthermore, as stated by the Working Group on DFIs from the perspective of systemic impact, there is a need to consider whether, the activities of large NBFCs and those who are financial conglomerates because of inter-sectoral linkages should be subject to a greater degree of regulatory oversight.

The NBFC sector encounters a crisis of confidence and credibility because of failure of some NBFCs to service the deposits. However, all NBFCs cannot be tarred with the same brush and their contributions to the economic development should not be understated. The NBFCs, more particularly, the leasing and hire purchase finance companies, have performed a very important financial intermediation role conducive to the economic well-being of the country, especially in the development of road transport.

The regulatory challenge is, thus, to design a supervisory framework that is able to ensure protection of depositors and financial stability without dampening the innovativeness that sustains the sector, which provides a cost efficient credit delivery system to sectors that do not have access to bank credit. ■