

Dealing with Regulatory Arbitrage in the Financial Sector – Lessons from RBI Experience in Regulation of NBFCs in India

The regulation by RBI 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)¹ 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 organisational 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

¹ A NBFC is a company which receives any deposit under any scheme or arrangement by whatever name called in one lumpsum or in instalments by way of contributions or subscriptions or in any other manner but is not a equipment leasing co, a hp finance company, a housing finance co, an insurance co, an investment co, a loan co, a mutual benefit financial co, a miscellaneous nbc, and a mutual benefit co

through insertion in 1963 of a new Chapter IIIB in the Reserve Bank of India Act, 1934. These regulations centred around 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 money lenders which have certain provisions relating to registration of money lenders with designated authorities. The lack of entry norms resulted in haphazard and mushroom growth of such NBFCs and their number increased to well over 40000 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.

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. The exposure of large NBFCs to the capital market are 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.

Action against delinquent and defaulting NBFCs

A system of identification, follow-up and supervision of problem

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 mobilise 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.

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 ranging from 12 to 15 percent 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

arising from the sale of commercial vehicles and two/three wheelers are permitted to be rediscounted by banks. Further, considering their role in delivery of credit in rural and semi-urban areas, the bank credit to NBFCs for their on-lending against commercial vehicles and to small scale industries has been accorded by RBI the status of priority sector.

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 IIIB, IIIC and V of the RBI 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 initial 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.

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.