

Address by S.P. Talwar Deputy Governor Reserve Bank of India at Round Table on "The Role and Regulation of NBFCs"

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"The Role and Regulation of NBFCs"

1. The Indian economy is going through a period of rapid 'financialisation'. Today, the 'intermediation' is being conducted by a wide range of financial institutions through plethora of customer friendly financial products. The segment consisting of Non-Banking Financial Companies (NBFCs), such as equipment leasing/hire purchase finance companies, have made great strides in recent years and are meeting the diverse financial needs of the economy. In this process, they have influenced the direction of savings and investment. The resultant capital formation is important for our economic growth and development. Thus, from both the macro economic perspective and the structure of the Indian financial system, the role of NBFCs has become increasingly important. It is interesting to note that as at the end of March 1996 the regulated deposits (deposits which RBI regulates) of 10194 NBFCs amounted to Rs.45,439 crore. The borrowing of these companies stood at Rs.62,995 crore. One of the most important component of these deposits/ borrowings is deposits from public in which RBI is more concerned. Such deposits stood at Rs.17,883 crore (excluding HFCs) which comes out to 4.25 per cent of the total deposits of scheduled commercial banks.
2. The momentum of recent developments in non-banking financial sector has evinced considerable debate. While there is a class in the industry strongly opposing the strengthening of regulatory framework and focusing closer supervisory attention, ostensibly in support of principle of free market, the another urging Reserve Bank to intervene and enhance the image quotient of the industry so that a moderate level of sustainable growth is assured of. To appreciate and understand the present predicament, it is better to look back to the history of the regulation of NBFCs.
3. To briefly recapitulate, the scheme of regulation of NBFCs originated in mid-sixties when sudden upsurge in deposit mobilisation by Non-Banking Companies was noticed. However, the focus of regulation was mainly intended to ensure that it serves as an adjunct to monetary and credit policy and also provides an indirect protection to the depositors. The focus continued to be the same till early 90s. Over a period of time, especially during late 80s and early 90s, NBFCs have penetrated into the main stream of financial sector and have established themselves as complements of banking industry.
4. At the dawn of liberalisation era, the Narasimham Committee (1991) had broadly touched upon the role of NBFCs in the emerging financial sector and made certain valuable recommendations for their healthy growth. The general tone of the committee was that these companies should be encouraged to grow with corresponding reinforcement of regulatory and supervisory framework. As a sequel to Narasimham Committee, Reserve Bank had appointed a Working Group on Financial Companies (Chairman, Dr. A.C. Shah) to make an in-depth study of the role of NBFCs and suggest regulatory and control measures to ensure healthy growth and operation of these companies. The Committee had made several recommendations with far reaching implications. Accepting most of the recommendations of the Committee, Reserve Bank had considered the Report as an Approach Document for furtherance of the NBFCs sector.

Some of the major recommendations of the Group were relating to shift of regulatory approach from the liability to the asset side, introduction of scheme of registration and entry point norm with minimum net owned fund (NOF) of Rs.50 lakhs for existing/new NBFCs, issue of prudential norms for income recognition, provisioning, capital adequacy etc., and amendments to RBI Act, 1934 giving enhanced power to RBI for better regulation of NBFCs. The recommendations of the committee were implemented in a phased manner. While the scheme of registration was introduced in April 1993 for all NBFCs having NOF of Rs.50 lakhs and above, prudential norms/ guidelines were issued in June 1994 for all registered NBFCs. These norms were more in the nature of guide lines which were not mandatory in the absence of necessary statutory powers. Subsequent to this, in April 1995, underscoring the importance of setting out a effective supervisory frame work, an expert group under the Chairmanship of Shri P.R. Khanna, Member of the Advisory Council for the Board for Financial Supervision was appointed to design an effective and comprehensive supervisory framework for NBFC sector. Most of the recommendations of the Committee have been accepted and a supervisory framework comprising on-site inspection for bigger companies and off-site surveillance system for other companies has been designed and the same is being implemented in a phased manner.

5. As mentioned earlier, since mid 60s legislative frame work was structured mainly to regulate the deposit acceptance activities of NBFCs. However, in the changed scenario and in the light of the recommendation of the Shah Working Group so also the observations of the Joint Parliamentary Committee a comprehensive draft legislation was prepared in 1994 which however, required extensive discussion with Ministry of Finance and Law. Finally, an Ordinance was promulgated by the Government in January 1997, effecting comprehensive changes in the provisions of RBI Act. The ordinance has since been replaced by an Act in March 1997. The amended Act, among other things, provide for entry point norm of a minimum NOF of Rs.25 lakhs (eventhough the Ordinance provided for the minimum limit at Rs.50 lakhs) and mandatory registration for new NBFCs for commencing business, maintenance of liquid asset ranging from 5 to 25 per cent of deposit liabilities, creation of reserve fund by transferring not less than 20 per cent of the net profit every year, power to the Bank to issue directions relating to prudential norms, capital adequacy, deployment of funds, etc. power to issue prohibitory order and filing of winding-up petition for non-compliance of Directions/Act. The above legislative changes would enable Reserve Bank to better regulate the NBFCs.
6. While the amendments have been mostly welcomed by the industry and the others concerned, it was alleged by a section of people that the amendments are reflection of RBI's expansionist attitude which would negate the true spirits of the current liberalisation programme. For a more complete understanding, one should keep in mind that economic liberalisation is about bringing market closer to the participants so that they have the freedom to make economic decisions. Obviously, this means better regulatory interference. A well functioning market does not suddenly emerge devoid of deliberate acts of the Regulators. Many economic historians have noted a complex interaction between State regulation and growth of the market as an institution. One of them, Karl Polyani called it a 'double-movement'. To simply state "every time the market widens its scope of operation, new regulations by the State are needed to make the market function well. Such double movement is a complex process of adaptive interaction where both must learn to co-operate." Therefore, the legislative changes should be seen as a conscientious act of regulatory response. In fact, this response emerged with an intention to act as facilitator for the industry which has established itself in the emerging market and surely not as an overkill. Moreover, the changes have the following objectives;
 - i. to ensure healthy growth of NBFC sector;
 - ii. to ensure that they function on prudential lines;
 - iii. to quickly remove bad ones in the industry to avoid contamination effect through regulatory intervention

7. Another dimension to the legislative changes is the presence of heterogeneous and some time questionable accounting practices being followed by NBFCs and the imperative need to bring uniformity in the accounting practices which would enable inter-firm and inter-industry comparison. It is beyond doubt that a well knit accounting practices in conformity with international standards are a pre-requisite to repose faith in the industry. There are several instances where NBFCs have capitalised from the absence or inadequacies of the standard accounting practices. One such example is 'Leasing'. It is commonly noticed that 'Leasing' route has been used mainly as a tool for deferring tax liability. The sale and lease back transaction was rampant supposedly on the items of 100 per cent depreciable category, which has prompted Government to come out with amendments to I.T. Act recently.
8. In the light of the amendments and also in the backdrop of recent developments relating to CRB Capital Market Ltd, several policy changes have been introduced/being contemplated. The major highlights of the changes are as follows :
 - a. In order to enhance financial soundness by ensuring a moderate level of liquidity in the companies' asset portfolio and also as a measure of in-built protection to the depositors, the percentage of liquid assets has been increased in a phased manner to 12.5 per cent and 15 per cent with effect from January 1, and April 1, 1998 for Equipment Leasing & Hire Purchase Finance Companies, Loan & Investment Companies (registered under the earlier scheme). There were also some disquieting practices among NBFCs e.g. creating encumbrance on the SLR securities and thereby defaulting in meeting the liquidity requirement. As this practice jeopardises the interest of depositors/investors, it has been decided that NBFCs should entrust the securities to one of the scheduled commercial banks at the place where the registered office of the company is located. These securities are allowed to be withdrawn only for repayment of deposits or for substitution or in case of reduction in the deposit.
 - b. After the issue of prudential norms in June 1994, it was observed that some of the norms were subjected to various interpretation by different NBFCs leading to non-compliance with the requirements. With a view to removing doubts as also to rationalise the same in the light of recent developments, the prudential norms are being reissued under the appropriate powers vested with Reserve Bank. Pending registration, the norms are being made applicable to all NBFCs with NOF of Rs.25 lakhs and above. Furthermore, having regard to risk profile of NBFCs, the capital adequacy ratio is being proposed to be raised in a phased manner to 10 per cent and 12 per cent to be achieved by end March 1998 and 1999, respectively.
 - c. It was also observed in the recent past that certain NBFCs were not disclosing the provisioning made for non-performing assets and for diminution in the value of investments in the financial statements prepared by the concerned NBFCs. With a view to making NBFCs' financial statements more transparent, it is being proposed that they have to disclose the provisions made in the financial statement under appropriate heads.
 - d. In our perception, non-banking financial sector will be vibrant and shock proof only if its constituents are sound, strong, agile and amenable to market discipline. Accordingly it is only natural that a more liberal leveraging capacity can be sustained only by well performing companies. Of course, a holistic view will be taken on the level of performance of a company which normally would include compliance with prudential norms with emphasis on capital adequacy and exposure norms, other directions relating to deposit acceptance and obtention of specified credit rating etc. Needless to mention that there will be continuous vigil on the companies which enjoy the increased freedom, especially the bigger NBFCs in terms of out-side liabilities, so as to minimise any systemic risk. After all, freedom given should necessarily be utilised for the betterment of the NBFC and the industry. Let it not be frittered away by the industry in their anxiety to make quick profits.

- e. In the backdrop of recent legislative changes, several trade bodies have represented to Reserve Bank to consider giving a separate dispensation for closely-held investment companies. The principal reason adduced is that these companies in essence are not doing any financial intermediation including trading in stocks as such but only functioning as vehicle for holding shares of other group companies for strategic reasons. They have also mentioned that such companies are not accepting deposits from public. There appears to be some merit and the issue is under active consideration of Reserve Bank. However, I urge the industry to bring down the multiplicity of NBFCs belonging to same group through the route of merger and acquisition. This would go a long way in enabling regulators to read the pulse of the industry near to the perfection. Of course, this also helps in arriving at the number of serious players in the market.
 - f. Norms for classification of NBFCs into various categories are also being revised and accordingly only those NBFCs whose assets and income constitute 60 per cent or more of their total assets and income will be recognised as EL/HP finance companies. The existing EL/HP finance companies will be given time to meet this new requirement. I may also mention that there were demands from certain section to do away with the system of classification of NBFCs into various categories. It should be appreciated that the classification is done on the basis of principal business and it is very much necessary to differentiate NBFCs for setting out discriminatory dispensation.
9. In pursuance of the requirements under recent legislative amendments, w.e.f. 9th January, 1997, no NBFC shall commence or carry on financial activity without obtaining/applying for a Certificate of Registration from/to the Reserve Bank. The industry has promptly responded to the legal requirement and around 37,500 applications have been received before the dead line. Out of this, from a preliminary quick scrutiny it is found that only around 8300 NBFCs were having threshold limit of NOF of Rs. 25 lakhs and above. The onerous task of issuing Certificate of Registration is being attended to on war footing. In terms of the provisions of the Act, Reserve Bank among other things is required to satisfy that ;
- . the NBFC is in a position to pay its depositors when claim accrue;
 - i. the general character of the management of the NBFC is not prejudicial to the interest of the depositors/public;
 - ii. it has adequate capital structure and earning prospects;
 - iii. any other condition specified by Reserve Bank.
10. Having regard to the huge number of applications to be processed, it is proposed to utilise the services of Chartered Accountants as a one time exercise for conducting special audit of applicant companies and to help RBI in determining the suitability for issue of Certificate of Registration. I hasten to add that, those existing NBFCs which have failed to submit their application for certificate should stop functioning as NBFCs forthwith or else face the stringent penal provisions of the Act. Once the checks and balances are put in place in pursuance to the amended provisions of the Act, we are sure that companies with poor record of recovery, weak financials, large exposures to the group companies and following unethical practices will find it hard to escape the rigours of regulations.
11. With a view to setting out a foolproof disclosure standards by removing the shortcomings in the existing reporting formats of Balance Sheet and Profit and Loss Account, as prescribed under the Companies Act, 1956, an in-house study group has been constituted with members from the Institute of Chartered Accountants of India. The formats of the financial statements when reviewed, is expected to make the affairs of an NBFC more transparent.
12. Another important point I wish to highlight is the role of Statutory Auditors in certification of financial statements and other documents of NBFCs. Some instances have come to our notice where the assets and investments shown in the Balance Sheet were not truly reflective of the existence of actual assets. Obviously, in such cases, the concerned statutory auditors should have qualified the Balance Sheet. Therefore, there is an urgent

need for the accounting profession to be more responsible. We foresee that in the post amendment period the `financial audit' should converge into a more broad based `management audit'.

13. While Reserve Bank is gearing itself to take on the increased regulatory responsibility, at the same time I urge upon the industry to appreciate the increasing need for promoting Self Regulating Organizations(SROs) especially in the light of divergent nature and heterogeneous practices of NBFCs. Such Organisation can effectively function as channel of communication between the regulators and the industry. Besides, these SROs can also bring in peer pressure on the members so that they adhere to fair business practices.
14. In the recent past, the role of credit rating agencies in assessing the debt servicing capacity of NBFCs has assumed much importance. The agencies which have since come out of their infancy are required to establish themselves with more credible assessment of their clients. This would go a long-way in enabling the investors and the regulators to place more reliance on the credit rating.
15. Finally, I may also call upon the investors/depositors to be more cautious while placing their deposits especially with those companies which offer very high rates of interest. They should note that the dictum of high interest co-exist with high risk is equally true in case of NBFCs also.