*Regulation of Shadow Banking – Issues and Challenges**

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Mr. Hiranandani, President, Indian Merchants' Chamber (IMC), Mr. Thakkar, Co-Chairman, Finance and Banking Committee, IMC, Mr. T T Srinivasaraghavan, Managing Director, Sundaram Finance Ltd., Mr. K V Srinivasan, CEO, Reliance Commercial Finance, Ms. Usha Thorat, my erstwhile colleague in the Reserve Bank, currently the Director, CAFRAL and the Chairperson of the Working Group that examined the issues and concerns in the Non Banking Financial Companies (NBFC) sector, and all other distinguished guests – it is a pleasure to be here among you in this seminar on NBFCs to discuss the recent guidelines issued by us based on the recommendations of the Working Group on NBFCs chaired by Ms. Usha Thorat.

2. The recommendations of the Working Group have generated a lot of debate in the industry, and as I observed from the presentations of other speakers, the issues continue to elicit considerable interest, if not apprehension. My aim during this talk would be to put the issues in perspective. As a backdrop to my comments on Indian NBFC sector, I would briefly touch upon the global shadow banking sector along with the recent international initiatives in the regulation of the sector. Then I would trace the genesis and development of the NBFC sector in India as well as the evolution of its regulatory framework, and finally the thought process which led to the setting up of the Working Group. I would like to focus on the big picture and elaborate the rationale behind the recent guidelines which is the agenda of this seminar.

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3. All of you must be closely observing the global developments in the context of financial crisis which shook the entire world, and the consequent overhaul of the regulatory framework. Both the regular banking system and the shadow banking system have come under greater regulatory focus on account of gaps in the respective regulatory frameworks and also, most importantly, on account of inter-linkages between both the systems. The shadow banking system that had burgeoned in the run up to the global financial crisis was one of the major causes of the global turmoil and quite understandably, the regulators are revamping its regulation to ensure financial stability. Before I dwell further on the regulatory developments, let me touch upon some underpinnings to the conceptual framework.

What is shadow banking?

4. The term '*shadow banking system*' was first used in 2007, and gained popularity during and after the recent financial crisis, as it highlighted the bank-like functions performed by entities outside the regular banking system. The more comprehensive definition, as adopted by the Financial Stability Board (FSB), *i.e.*, '*credit intermediation involving entities and activities (fully or partially) outside the regular banking system*' has been globally accepted. This definition has two important components: First, non bank financial entities or entities outside the banking system that engage in the '*bank like*' activities of maturity transformation, undertaking credit risk transfer and using direct or indirect financial leverage. Second, activities such as securitisation, securities lending and repo transactions that act as important sources of funding for non-bank entities. Thus, shadow banks comprise entities which conduct financial intermediation directly, such as finance companies or NBFCs, and entities which provide finance to such entities, such as mutual funds. Globally, shadow banking entities could be covered under the broad heads of (i) Money Market Funds, (ii) Credit investment Funds, Hedge Funds, *etc*,

(iii) Finance Companies accepting deposits or deposit like funding, (iv) Securities brokers dependent on wholesale funding, (v) Credit insurers, financial guarantee providers and (vi) Securitisation vehicles.

5. Such non-bank intermediation, when appropriately conducted, provides a valuable alternative to bank funding and supports real economic activity. But experience from the crisis demonstrates the capacity of some non-bank entities and transactions to operate on a significantly large scale, in ways that create bank-like risks to financial stability (longer-term credit extension based on short-term funding and leverage). Such risk creation may take place at an entity level but it can also form part of a complex chain of transactions, in which leverage and maturity transformation occur in stages, creating multiple forms of feedback into the regulated banking system.

6. Like banks, a leveraged and maturity-transforming shadow banking system can also be vulnerable to 'runs' and generate contagion, thereby amplifying systemic risk. Shadow banking can also heighten procyclicality by accelerating credit supply and asset price increases during upswings and exacerbating fall in asset prices during downswings. These effects were powerfully revealed during the global financial crisis in the form of dislocation of asset-backed commercial paper (ABCP) markets, the failure of an originate-to-distribute model employing structured investment vehicles (SIVs) and conduits, 'runs' on MMFs and a sudden reappraisal of the terms on which securities lending and repos were conducted.

7. Traditionally, regulation of banks has assumed greater importance than that of their non-banking counterparts. One reason, of course, is that protection of depositors has been traditionally an important mandate of banking supervisors. Banks are at the centre of payment and settlement systems and monetary policy transmission takes place through them. Banks play a critical role in credit intermediation through maturity transformation, *i.e.,* acceptance of short-term liabilities and converting them into long-term assets *viz.,* loans and advances. Along with economic value, this function also creates potential liquidity risk. Moreover, banks also operate on a significantly higher leverage compared to non-financial entities which could amplify their vulnerability. For all these reasons, banks are subject to a detailed and a rigorous regulatory framework. However, when non-bank financial entities, which are subject to no regulation or light touch regulation, undertake bank-like functions, large risks are created which could potentially be destabilising for the entire system. The global financial crisis demonstrated many ways in which shadow banking can have an impact on the global financial system, both directly and through its interconnectedness with the regular banking system, prompting the move to overhaul the regulation of shadow banking system.

The importance and benefits of shadow banking

8. Shadows do not necessarily mean dark and sinister. In fact, shadow banking activities constitute a very useful part of the financial system. The main advantages of shadow banks lie in their ability to lower transaction costs of their operations, their quick decision-making ability, customer orientation and prompt provision of services. In India, we have always maintained that Non-Banking Finance Companies (NBFC[1]s), a significant segment of shadow banking system, play a crucial role in broadening access to financial services, and enhancing competition and diversification of the financial sector. While NBFCs are, sometimes, seen as akin to banks in terms of the products and services offered, this comparison is strictly not accurate, as more often NBFCs play a range of roles that complement banks. They have carved out niche areas of businesses, such as auto financing, which enables them to address specific needs of the

[1] In India, NBFCs constitute a major segment of shadow banking system alongside other entities such as Insurance companies and Mutual Funds, both of which are regulated by other regulators. In the address, NBFCs are referred to be largely representing the shadow banking sector.

people more efficiently. In addition to complementing banks, NBFCs add to economic strength to the extent they enhance the resilience of the financial system to economic shocks. They can act as backup financial institutions should the primary form of intermediation come under stress, thereby constituting an important avenue for risk diversification away from the banking system. Other non banking finance entities such as mutual funds, insurance companies, *etc*, provide alternatives to bank deposits and constitute alternative funding for the real economy, which is particularly useful when traditional banking or market channels become temporarily impaired.

Risks of shadow banks[2]

9. Notwithstanding the complementary role played by shadow banks to the banking system, their activities, on the flip side, create risks which can assume a systemic dimension, due to their complexity, cross-jurisdictional nature, as well as their interconnectedness with the banking system. The risks emanating from shadow banking could be primarily of four types *viz.*, (i) liquidity risk, (ii) leverage risk, (iii) regulatory arbitrage and (iv) contagion risk

- ***Liquidity risk*** – This is one of the most common risks faced by shadow banks, as these entities undertake maturity transformation *i.e.*, funding long-term assets with short-term liabilities. The risk of ALM mismatch leading to liquidity problems is quite high. In India, we had a situation during the height of global crisis in 2008 when some NBFCs ran into severe liquidity problems as they were using short-term liabilities such as CPs (commercial paper) and NCDs (Non-Convertible Debentures) to fund their long-term lending or investment. I will be discussing this issue in detail a little later.
- ***Leverage risk*** – As shadow banks do not usually have prudential limits on borrowings, they can become highly leveraged. High leverage exacerbates the stress in the financial system and the real economy during the downturn adversely affecting financial stability.
- ***Regulatory arbitrage*** – Credit intermediation is, traditionally, a banking activity. Regulations applied to banks in this regard can be circumvented by transferring components of the credit intermediation function to shadow banks which are subject to less stringent regulation. Transfer of risks outside the purview of banking supervision played an important role in the build-up to the global financial crisis.
- ***Contagion risk -*** Shadow banking entities have close interlinkages with the banking sector both from the asset as well as the liabilities side, and also with other segments of the financial system, which can lead to contagion risk in times of loss of confidence and uncertainty.

Global approach to regulation of shadow banking

10. The developments during the global crisis reflected the gravitas of the risks I have highlighted above. The light touch regulation enabled the shadow banking system to have high leverage. The liquidity risks faced by the shadow banking system quickly got transferred to the banking system due to its interconnectedness and interlinkages with the regular banking system, largely through committed liquidity facilities and reputational concerns. The contagion that followed, prompted the policy makers to review the regulation of the shadow banking sector to ensure and preserve financial stability. As such, at the November 2010 Seoul Summit, the G20 Leaders highlighted the fact that, after formulation of the new capital standards for banks *i.e.*, Basel III, '*strengthening regulation and supervision of shadow banking*' was one of the remaining issues of financial sector regulation that warranted attention. As you are aware, the FSB has the mandate to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of

[2] Green Paper Shadow Banking European Commission March 2012

financial stability. Therefore, the G20 requested the FSB to develop recommendations to strengthen the oversight and regulation of the shadow banking system by mid-2011 in collaboration with other international standard setting bodies. The FSB formed a task force to develop initial recommendations for discussion that would:

- clarify what is meant by the 'shadow banking system';
- set out potential approaches for monitoring the shadow banking system; and
- explore possible regulatory measures to address the systemic risk and regulatory arbitrage concerns posed by the shadow banking system.

11. The FSB felt that the objective of regulation is to ensure that shadow banking is subject to appropriate oversight and regulation, to address bank-like risks to financial stability emerging outside the regular banking system, while not inhibiting sustainable non-bank financing models that do not pose such risks. Their approach was activity specific rather than entity specific, as they focused on identification of those activities that can affect systemic stability, particularly those that caused or exacerbated the crisis. The approach also included monitoring the shadow banking system so that any rapidly growing new activities that pose bank-like risks can be identified early and, where needed, those risks are addressed.

12. The activities identified by FSB can be divided into 5 broad categories

- management of client cash pools with features that make them susceptible to runs (*e.g.* credit investment funds with stable NAV features, leveraged credit hedge funds);
- loan provision that is dependent on short-term funding (*e.g.* finance companies with short-term funding structure or that accept deposits);
- intermediation of market activities that is dependent on short-term funding or on secured funding of client assets (*e.g.* securities brokers whose funding is heavily dependent on wholesale funding);
- facilitation of credit creation (*e.g.* credit insurers, financial guarantee insurers); and
- securitisation and funding of financial entities (*e.g.* securitisation vehicles).

13. The FSB advised that monitoring and responses be guided by a two-stage approach.

- Firstly, authorities should cast the net wide, looking at all non-bank credit intermediation to ensure that data gathering and surveillance cover all the activities within which shadow banking-related risks might arise.
- Authorities should then narrow the focus, concentrating on the subset of non-bank credit intermediation where maturity/liquidity transformation and/or flawed credit risk transfer and/or leverage create important risks.

14. The FSB, working with the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO), has, therefore, examined and developed recommendations in five areas where financial stability risks from shadow banking have arisen. Work streams were created for analysing the issues in greater detail and developing effective policy recommendations in these areas, *viz,*:

- to mitigate the spill-over effect between the regular banking system and the shadow banking system – (BCBS);
- to reduce the susceptibility of money market funds (MMFs) to 'runs' – (IOSCO);
- to assess and mitigate systemic risks posed by other shadow banking entities – (FSB sub group);
- to assess and align the incentives associated with securitisation – (IOSCO and BCBS); and
- To dampen risks and pro-cyclical incentives associated with secured financing contracts such

as repos, and securities lending that may exacerbate funding strains in times of 'runs' – (FSB sub group).

15. The policy recommendations have been guided by the following five general principles for regulatory measures:

- *Focus:* Regulatory measures should be carefully designed to target the externalities and risks the shadow banking system creates;
- *Proportionality:* Regulatory measures should be proportionate to the risks shadow banking poses to the financial system;
- *Forward-looking and adaptable:* Regulatory measures should be forward-looking and adaptable to emerging risks;
- *Effectiveness:* Regulatory measures should be designed and implemented in an effective manner, balancing the need for international consistency to address common risks and to avoid creating cross-border arbitrage opportunities against the need to take due account of differences between financial structures and systems across jurisdictions; and
- *Assessment and review:* Regulators should regularly assess the effectiveness of their regulatory measures after implementation and make adjustments to improve them as necessary in the light of experience.

Size of the Shadow Banking Sector

16. Efficient oversight of any sector requires monitoring which involves data collection and analysis. Given its growing significance, monitoring of the global shadow banking system is being very vigorously pursued. The FSB committed to conducting annual monitoring exercises to assess global trends and risks in the shadow banking system through its Standing Committee on Assessment of Vulnerabilities (SCAV) and its technical working group, the Analytical Group on Vulnerabilities (AGV), using quantitative and qualitative information. The FSB's second annual monitoring exercise, which was recently concluded, covered 25 jurisdictions and the euro area as a whole, thereby bringing the coverage of the monitoring exercise to 86 per cent of global GDP and 90 per cent of global financial system assets. The primary focus of the exercise was on a 'macro-mapping' based on national Flow of Funds and Sector Balance Sheet data, that looks at all non-bank financial intermediation to ensure that data gathering and surveillance cover the areas where shadow banking-related risks to the financial system might potentially arise.

17. The main findings from the 2012 exercise are as follows:

- According to the 'macro-mapping' measure, the global shadow banking system, as conservatively proxied by 'Other Financial Intermediaries' grew rapidly before the crisis, rising from US$ 26 trillion in 2002 to US$ 62 trillion in 2007. The size of the total system declined slightly in 2008 but increased subsequently to reach US$ 67 trillion in 2011 (equivalent to 111 per cent of the aggregated GDP of all jurisdictions). The global estimate for the size of the shadow banking system has increased by some US$ 5 to 6 trillion since last year.
- The shadow banking system's share of total financial intermediation (which includes banks, insurance and pension funds, public financial institutions and central banks) has decreased since the onset of the crisis and has remained at around 25 per cent in 2009-2011, after having peaked at 27 per cent in 2007. In broad terms, the aggregate size of the shadow banking system is around half the size of banking system assets.
- There is also a considerable diversity in the relative size, composition and growth of the non bank financial intermediaries across jurisdictions. For example, the size of the shadow banking system in US and a number of other jurisdictions

continues to be large relative to the regular banking system. The US has the largest shadow banking system, with assets of US$ 23 trillion in 2011, followed by the euro area (US$ 22 trillion) and the UK (US$ 9 trillion).

- There is also considerable divergence among jurisdictions in terms of: (i) the share of non-bank financial intermediaries (NBFIs) in the overall financial system; (ii) relative size of the shadow banking system to GDP; (iii) the activities undertaken by the NBFIs; and (iv) recent growth trends.
- Even during the period immediately following the global financial crisis (2008-11), the shadow banking system continued to grow, although at a slower pace, in seventeen jurisdictions (half of them being emerging market and developing economies undergoing financial deepening) and contracted in the remaining eight jurisdictions.
- Among the jurisdictions where data is available, interconnectedness risk tends to be higher for shadow banking entities than for banks. Shadow banking entities seem to be more dependent on bank funding and are more heavily invested in bank assets, than *vice versa*.

Shadow Banking in India

18. Notwithstanding the data constraints in actual evaluation of its size, the shadow banking sector in India is still small in size compared to its counterparts in advanced economies. In 2011, assets of Other Financial Institutions (OFIs) in India were US$ 375 billion *vis-a-vis* bank assets of US$ 1518 billion and GDP of US$ 1766 billion. The assets of the shadow banking system accounted for 21 per cent of GDP as compared to bank assets which were 86 per cent of GDP.[3] Apart from the fact that the sector is not significant in terms of size, the activities carried out by these entities are also limited.

19. In India, the shadow banks have been brought under progressively tighter regulations and many of the activities which contributed to the global crisis are either not allowed, or, if allowed, are allowed in a regulated environment with appropriate limits. Illustratively, the concern expressed by the FSB regarding Money Market Funds and Credit Investment Funds including ETFs *etc.* was in the context of the practice in some countries, including the US, regarding maintenance of constant NAVs, which led to runs on these funds. On the contrary, in India, Money Market Funds, investment funds and ETFs form part of Mutual Funds and are regulated by the Securities and Exchange Board of India (SEBI) under its Mutual Fund Regulations. SEBI has been gradually mandating a shift from NAVs valued on amortisation basis to mark to market. (In February 2012, SEBI reviewed the valuation norms to ensure fair treatment to all investors based on the principles of fair valuation *i.e.* valuation shall be reflective of the realisable value of the securities/assets). The entire Assets under Management (AUM) of Mutual Funds stood at ₹5872.17 billion as on March 31, 2012 which was 6.6 per cent of GDP. Of this FIIs had a holding of 0.9 per cent and NRIs 6 per cent. Thus, cross border linkages and the consequential impact are also not seen as very high on such funds.[4]

20. Hedge Funds are not significant players in India. Moreover, comprehensive guidelines (Alternative Investment Fund Guidelines) have been put in place by SEBI to regulate all funds established in India, which are private pooled investment vehicles raising funds from Indian or foreign investors.

21. Transferring of risk off balance sheet by banks by using SIVs/conduits is not a model adopted in India. Apart from this, complex and synthetic derivative products which were at the core of the global crisis are also not presently permitted in India. Further, explicit regulations have been put in place to ring fence NBFCs

[3] Source: RBI data

[4] Source SEBI Annual Report 2011-12

from the adverse impact of cross border linkages and minimising the financial contagion. (For example, NBFCs can take equity and fund based exposure while investing overseas within a limit liked to NOF). They are not permitted to provide implicit support such as guarantees or letters of comfort.

NBFC sector in India – Evolution of regulation

22. Non-Banking Financial Companies (NBFCs) in India are defined as companies carrying out a range of financial activities such as making loans and advances; investing in shares/bonds/debentures/and other securities; asset financing including leasing, and hire-purchase finance. The recent additions to this sector have been (i) Infrastructure Finance Companies (IFC), (ii) Infrastructure Debt Funds (IDF), (iii) Micro Finance Institutions (NBFC- MFI) and (iv) Factors. In India, NBFCs quintessentially epitomise the shadow banking system as they perform bank like credit intermediation outside the purview of banking regulation. Apart from this, where the entire OFI assets account for approximately 24 per cent of bank assets as on March 31, 2012, assets of the NBFC sector alone account for 12 per cent, denoting the significance of NBFCs in the Indian shadow banking system.

23. As a background to the setting up of the Working Group on NBFCs chaired by Ms. Usha Thorat, let me briefly touch upon the evolution of regulation of NBFC sector in India. Steps for regulation of NBFCs were initiated as early as in the sixties. Regulation of NBFCs was found to be necessary for three reasons *viz.*, ensuring efficacy of credit and monetary policy, safeguarding depositors' interest and ensuring healthy growth of Non-Banking Financial Intermediaries (NBFIs). Thus, the Banking Laws (Miscellaneous Provisions) Act, 1963 was introduced to incorporate a new chapter (*i.e.*, Chapter III B) in the Reserve Bank of India Act, 1934 to regulate the NBFIs. Subsequently, to enable the regulatory authorities to frame suitable policy measures, several committees were appointed from time to time, to conduct in-depth study of these institutions and make suitable recommendations for their healthy growth. These include the Bhabatosh Datta Study Group (1971), the James Raj Study Group (1974), and the Chakravarty Committee, 1985. Thereafter, the Narasimham Committee (1991) outlined a framework for streamlining the functioning of the NBFCs, which would include, in addition to the existing requirements of gearing and liquidity ratios, norms relating to capital adequacy, debt-equity ratio, credit-concentration ratio, adherence to sound accounting practices, uniform disclosure requirements and assets valuation. The Joint Parliamentary Committee (JPC), appointed in connection with the irregularities in the Securities Transactions, had also recommended that legislative framework should be strengthened to vest in RBI more powers to effectively regulate NBFCs. The extant regulatory and supervisory framework as it stands today is based on the recommendations of the Shah and Khanna Committees (1992 and 1995).

24. The growing significance of NBFCs was also recognised by the second Narasimham Committee (1998) as well as by the Reserve Bank in its Discussion Paper on Harmonisation of the Role and Operations of DFIs and Banks. Recognising the increasing significance of the sector, the Working Group on Money Supply (Chairman: Dr. Y.V. Reddy) in 1998 proposed a new measure of liquidity aggregate incorporating NBFCs with public deposits of ₹0.20 billion and above.

25. There was a significant increase in the nature of NBFC activities in the nineties. NBFCs grew sizably both in terms of their numbers as well as the volume of business transactions. The number of NBFCs grew more than seven-fold from 7,063 in 1981 to 51,929 in 1996. Accordingly, based on the recommendations of the Shah Committee, the RBI Act was amended in January 1997 to provide a comprehensive legislative framework for regulation of NBFCs by effecting changes in the provisions contained in Chapter III-B and Chapter V of the Act and vested more powers with the Reserve Bank. The regulatory framework was

based on the three pillars *viz.*, onsite supervision, offsite monitoring and exception reporting by auditors. Though the amended Act provided for registration of all NBFCs, the focus continued to be the protection of depositors' interest thus covering the deposit taking NBFCs, while keeping the non-deposit taking NBFCs subject to minimal regulation. These measures resulted in consolidation of the sector, reduction in the number of deposit taking NBFCs, reduction in the quantum of public deposits and increase in the number of non-deposit taking NBFCs. The number of deposit taking NBFCs, including Residuary Non-Banking Finance Companies (RNBCs), decreased from 1,429 in March 1998, to 273 in March 2012. The deposits held by these companies (including RNBCs) decreased from ₹238 billion to ₹101 billion during the same period.[5]

26. With the consolidation of the sector and stabilising of deposit taking NBFCs, the focus in 2006 widened to include non-deposit taking NBFCs which were growing in number as well as in size. Considering the issue of systemic importance of large NBFCs in view of their size, their enhanced risk taking capabilities, growing complexity of their activities, and the financial market interlinkages, a comprehensive regulatory framework was introduced for these NBFCs. To begin with, non deposit taking companies having asset size of ₹1 billion (100 crore) and above were classified as systemically important non deposit taking NBFCs (NBFCs-ND-SI) and subjected to capital adequacy and credit concentration norms. Subsequently, liquidity and disclosure norms were made applicable to them. Presently, as on March 31, 2012, there are 375 NBFCs-ND- SI with a total asset size of ₹9,213 billion.

27. The NBFC sector has been the fastest growing segment in the Indian financial sector today with year on year growth higher than that of banking sector as seen from the figures below (Table 1) :

5 RBI data

Table 1: Growth in Total Assets of Banks *vis-à-vis* NBFCs

Item	As at end					
	2007	2008	2009	2010	2011	2012
Banks	3459961	4326486	5241330	6025141	7183522	8299400
Growth (Y-o-Y)		*25*	*21.1*	*15*	*19.2*	*15.5*
NBFCs	366452	478997	560035	657185	866713.7	1038189
Growth (Y-o-Y)		*30.7*	*16.9*	*17.3*	*31.9*	*19.8*

Note: NBFCs include all deposit taking NBFCs and NBFCs-ND-SI
Source: Report on Trend and Progress of Banking in India, RBI, various issues

NBFC sector during the 2008 crisis

28. The NBFC sector came under pressure during the 2008 crisis due to the funding interlinkages among NBFCs, mutual funds and commercial banks. NBFCs-ND-SI relied significantly on short-term funding sources such as debentures (largely non convertible short-term debentures), and CPs, which constituted around 56.8 per cent of the total borrowings of NBFCs-ND-SI as on September 30, 2008. These funds were used to finance assets which were reportedly largely a mix of long-term assets, including hire purchase and lease assets, long-term investments, investment in real estate by few companies, and loans and advances. These mismatches were created mainly as a business strategy for gaining from the higher spreads. However, there were no fall back alternatives in cases of potential liquidity constraints. The ripple effect of the turmoil in American and European markets led to liquidity issues and heavy redemption pressure on the mutual funds in India, as several investors, especially institutional investors, started pulling out their investments in liquid and money market funds. Mutual funds being the major subscribers to CPs and debentures issued by NBFCs, the redemption pressure on MFs translated into funding issues for NBFCs, as they found raising fresh liabilities or rolling over of the maturing liabilities very difficult. Drying up of these sources of funds along with the fact that banks were increasingly becoming risk averse, heightened their funding problems, exacerbating the liquidity tightness.

Measures taken by RBI to enhance availability of liquidity to NBFCs

29. The Reserve Bank undertook many measures, both conventional as well as unconventional, to enhance availability of liquidity to NBFCs such as allowing augmentation of capital funds of NBFCs-ND-SI through issue of Perpetual Debt Instruments (PDIs), enabling, as a temporary measure, access to short-term foreign currency borrowings under the approval route, providing liquidity support under Liquidity Adjustment Facility (LAF) to commercial banks to meet the funding requirements of NBFCs, Housing Finance Companies (HFCs) and Mutual Funds, and relaxing of restrictions on lending and buy-back in respect of the certificates of deposit (CDs) held by mutual funds.

31. In addition to these measures, a Stressed Asset Stabilisation Fund *viz.*, IDBI SASF, was set up to provide liquidity to NBFCs through purchase of securities of NBFCs which would in turn be refinanced by RBI through purchase of Govt. guaranteed securities issued by the SASF.

31. Notwithstanding the market reports, the actual condition of NBFCs was not so alarming inasmuch as only one NBFC availed refinance from the SASF and no NBFCs went under. However, this dichotomy between perception and reality serves to show how susceptible the sector could be to reputational risk. Thus, the significance of the above measures lies also in their ability to create confidence in the sector.

32. The crisis did, however, highlight some regulatory issues concerning the non-banking financial sector, particularly risks arising from regulatory gaps, arbitrage and systemic inter-connectedness. A need was, therefore, felt to reflect on the broad principles that underpin the regulatory architecture for NBFCs keeping in view the economic role and heterogeneity of this sector and the recent international experience. It was felt necessary to examine in depth, the risks in the NBFC sector in the changed scenario and recommend appropriate regulatory and supervisory measures to address these risks with the aim of creating a strong and resilient financial sector which is vital for all round economic growth of the country. Accordingly a Working Group (Chairperson: Ms. Usha Thorat) was constituted to suggest reforms in various important areas relating to NBFC sector. The Working Group comprised representatives from the industry and co- regulators like SEBI.

Recommendations of the Working Group

33. The Working Group in its report submitted in August 2011 made various recommendations both to ensure the resilience of the NBFC sector and also to contain risks emanating from the sector in the context of overall financial stability. The recommendations of the Working Group can broadly be divided into four categories, comprising issues relating to (i) Entry Point norms, Principal Business Criteria, Multiple and Captive NBFCs; (ii) Corporate Governance including Disclosures, (iii) Liquidity management and (iv) Prudential regulation including capital adequacy, asset provisioning, risk weights for certain sensitive exposures, and restrictions on deposit acceptance.

34. Based on the recommendations of the Working Group and the subsequent extensive deliberations with all the stakeholders, *viz.*, industry participants as well as the Government of India, draft guidelines have been formulated and put in the public domain for comments in December 2012.

35. As I have stated before, going by press reports as well as the responses observed today, some apprehension has been expressed regarding the proposed guidelines. However, let me emphasise that our intention is not to restrict the activities or constrain the innovativeness of the sector but rather ensure that possible risks to financial stability are addressed, thereby creating, or should I say, ensuring continuation of a resilient system of non-bank credit intermediation. To go back to my earlier remarks on shadow banking and global regulatory initiatives, I

would stress that the setting up of the Working Group and implementation of its recommendations was undertaken in line with the international agenda for shadow banks.

36. Some apprehensions have been expressed that the regulation of shadow banking is becoming as rigorous as banking regulation, which is not warranted given the differences in the profiles of these two segments. I agree with the concerns. While one can argue that identical functions should be regulated in an identical manner irrespective of the nature of the legal entity in which these functions are housed, we have gone for differential regulations between banks and NBFCs due to differences in business models, their significance in the financial system and varying risk profiles. Regulations for banks are much more stringent than that for NBFCs and the proposed new regulatory framework for banks under Basel III proposes even more stringent requirements to address the risks of banks.

37. However, the distinction between banks and non-banks is more fuzzy now and as the global crisis has adequately evidenced, non-banks are increasingly taking up bank-like activities. In such a scenario, where both banks and non-banks undertake similar activities, if only bank regulation is tightened, there is a very distinct possibility of risks migrating from the more tightly regulated sector to a more lightly regulated sector, the way water flows from high pressure points to low pressure points. Therefore, to contain risks in the overall financial system, there is a case for reviewing the regulations of the non-banking sector along with that for banks, holistically. In India, we have been alive to these issues as I have already mentioned earlier. Setting up of the Working Group on the Issues and Concerns of the NBFC Sector in September 2010 is another instance of taking a pro-active stance in dealing with regulatory issues and concerns.

38. The overarching principles to the new regulatory framework revolve around some guiding principles:

- appreciating the contribution of the NBFC sector to the financial system and the economy and rationalising regulations to preserve the innovativeness of the sector;
- recognising the need to address systemic risk arising out of concentration and exposure of NBFCs to sensitive sectors;
- Recognising that the NBFCs have the ability to leverage on the RBI registration and therefore, rationalising the scope of regulation to address risks appropriately;
- conserving regulatory resources and directing them where required;
- dealing with regulatory arbitrage while not recommending completely bank-like policies and regulation for NBFCs and
- giving adequate transition period to the industry so as to cause minimum dislocation to the sector.

39. Let me briefly touch upon some of the significant features of the draft guidelines.

Principal Business Criteria

40. Under the present dispensation, a company is treated as an NBFC if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets) and income from these financial assets is more than 50 per cent of its gross income. Both these tests are required to be satisfied. There is a problem with this definition. As a financial regulator, Reserve Bank primarily regulates the financial activities of NBFCs, while they can also engage in non financial activities of comparable magnitude. It is, therefore, important to insulate the sector from the spillover of possible risks from non-financial activities. The most preferred solution, therefore, from a regulatory perspective, would be the one in which the NBFCs do not undertake any activity other than financial activities on the same lines as banks are permitted to undertake only those activities which are enumerated in Section 6(1) of the Banking Regulation Act, 1949. However, that is not

possible for the NBFC sector given the structure of the sector. As ensuring 100 per cent financial activity is not feasible, the next best alternative would be to raise the threshold for principal business. Accordingly, the threshold has been raised from 50 per cent to 75 per cent of total assets/income, to ensure that the regulation focuses on predominantly financial entities. However, raising the threshold could result in keeping out of purview of regulations, certain non banking financial entities having financial activities of significant scale which could adversely impact financial stability. This could happen in the following two situations:

- The financial activities of these entities are a significant proportion of the total activities and of significant magnitude; and
- The financial activities of these entities are not a significant proportion of total activities but are of large magnitude.

41. To cover (a) above, the definition of principal business has been expanded to cover those non-bank financial entities whose financial assets or income from financial assets are 50 per cent or more of total assets or gross income respectively and total assets are ₹10 billion or more. However, entities covered by (b) cannot be possibly subjected to entity specific regulation as the scale of non financial activities would be much larger than that of financial activities. Regulatory approach in such a situation will have to evolve over time. One approach could be to subject their financial activities to prudential regulations for those activities. The other alternative would be, as envisaged in FSB's approach, to build up a data base, identify vulnerabilities, and take suitable regulatory action where vulnerabilities could acquire systemic proportions.

Exemption from requirement of registration:

42. In formulating the threshold for registration of NBFCs, we were guided by considerations of conserving limited regulatory resources and issues of materiality of the risk profile of NBFCs. Accordingly, we have proposed to exempt two categories of NBFCs from registration – one, all non-deposit taking NBFCs with asset size below ₹0.25 billion and two, NBFCs with asset size below ₹5 billion and not accessing public funds. These NBFCs would also be exempt from regulation. Small NBFCs having asset size of less than ₹0.25 billion or NBFCs with asset size below ₹0.5 billion and not accessing public funds are not likely to create systemic risk in view of their small size and absence of leverage respectively. This is consistent with the recommendations of the Geneva Report[6] which suggested that such small companies, which it termed 'Tinies', should have minimal conduct of business regulations especially if they are unlevered. It is possible that some of these companies may pose insignificant risks as individual entities but their correlated behaviour may create risks when they move together as part of a larger group or 'herd' and these may not be adequately captured. To address this risk, we have propounded the group concept, in which all NBFCs in a group will be individually treated as Systemically Important (NBFCs-ND-SI) if their aggregate assets total ₹1 billion and above. This is not to deny that there may be valid reasons for creation of multiple NBFCs, but the possible risks from their activities need to be addressed.

43. A lot of apprehension has been expressed in some quarters that NBFCs (*i.e.*, non banking financial entities meeting the Principal Business criteria) having assets below the threshold will be forced out of business. I would like to clarify that this is not the intention of the proposed regulations. All we are saying is that from a materiality perspective such entities need not be the focus of RBI's regulatory oversight and, therefore, should be exempted from registration and regulation. We also do not feel that this will have an adverse impact on their activities because after all, there must be many entities doing

6 The Fundamental Principles of Financial Regulation – Geneva Reports on the World Economy 11.

business even under the current regime, which have significant financial activities but below the 50/50 threshold and, therefore are not NBFCs and not registered with RBI.

Captive NBFCs

44. There are some regulatory concerns regarding the business model of captive finance companies. As captives provide finance for purchase of products of the parent, their business is inextricably linked to the parent's fortunes. It is likely that credit underwriting standards in such companies may be weaker. Hence, while setting up of captive NBFCs is a commercial decision, the risks arising out of the business model of such captives need to be adequately addressed and hence the review of guidelines, requiring a higher Tier I Capital.

Prudential Norms

45. Apprehensions have also been expressed that tightening of prudential norms as proposed in the draft regulations may affect the profits of the NBFCs and increase their lending cost. You would observe that changes have been proposed only in areas where there is a heightened risk perception. While the intention is not to mimic bank regulation completely, I am sure, you all would agree that we should take some of the relevant best practices of the bank regulation which are well developed and tested and adapt them to other sectors where the benefits of such approach outweigh the costs. The proposed increase in the capital requirements for NBFCs is to ensure that the risks in the financial system which surfaced during the crisis are addressed and the regulatory gap between banks and NBFCs does not widen, especially when the capital requirements for banks have increased significantly under Basel III. The proposed measures address regulatory arbitrage between banks and NBFCs in areas such as capital marketor realestate exposure through the calibrated use of prudential measures such as higher capital requirements, and risk weights for sensitive sectors, wherever greater risks are perceived. Accordingly, we have proposed to raise the minimum Tier l capital requirement, for captive NBFCs, NBFCs with major exposure to sensitive sectors such as capital market, commodities and real estate, and NBFCs predominantly engaged in lending against gold jewellery. For NBFCs that are part of a banking group, risk weights for capital market exposure (CME) and Commercial Real Estate (CRE) would be the same as that for banks; for others these would be revised upwards.

46. Convergence in regulation between banks and NBFCs is thought to be required in the areas of asset classification and provisioning norms. This is because both banks and NBFCs are financing similar assets and there is no logical reason for prudential norms to be different. In fact, initially when the 180 day norm was introduced for NBFCs, for assets other than lease and hire purchase transactions, for whom the norms were even more relaxed, the norms were similar to those of banks at that time. However, while banks migrated to 90 day norm, NBFCs continue to be on 180 days norm. As regards the proposed 90 day norm for classification of assets, it has been argued that the clientele of NBFCs is very different from that of banks and hence a longer collection period is needed. I would like to emphasise that once an amount becomes due there is no reason why it should not be paid within 90 days irrespective of the nature of business and clientele. As regards fixing the payment schedules, there are no regulatory prescriptions or constraints. As lenders, NBFCs have the option of fixing the repayment schedule suiting the credit cycle of the borrowers. However, to ensure minimal dislocation, this convergence of time norms will be brought about in a phased manner, and a one-time adjustment of the repayment schedule which shall not amount to restructuring, is proposed to be permitted. Similarly, in the case of provisioning for standard assets, convergence with the banking sector is envisaged and sufficient transition time will be given for compliance.

Deposit acceptance

47. Since 2004-2005, we have maintained that, as a policy, only banks should be allowed to accept public deposits. Deposit acceptance in the NBFC sector is a legacy of the past but no new NBFC has been given a license for acceptance of deposits. Initially, the concept of rating had been introduced for NBFCs accepting public deposits, but, as an exception, unrated AFCs were allowed to accept deposits upto ₹0.10 billion. You would all agree that depositor protection is not a function of the amount of deposit. It is, therefore, proposed to make it compulsory for all existing deposit accepting NBFCs to obtain credit ratings from credit rating agencies. In future, unrated NBFCs will not be permitted to accept deposits and existing unrated deposit taking NBFCs will be given a period of one year to get themselves rated if they wish to continue to accept deposits. Further, to bring parity in the sector, the limit for acceptance of deposits for rated AFCs is proposed to be reduced in line with other deposit taking NBFCs.

Liquidity Management

48. I have spoken in detail about the liquidity risk due to maturity transformation during the credit intermediation process and how this affected NBFCs in 2008. As seen during the crisis, liquidity risks can rapidly translate into solvency risks. Taking lessons from the global crisis, the Basel Committee on Banking Supervision has stipulated that a banking institution should maintain adequate levels of high quality liquid assets which can be converted into cash at very short notice and at small discount to enable it to survive a stress situation over a 30 day time horizon. The Committee has also looked at a longer time horizon by expecting institutions to fund their activities with more stable sources of financing on an on-going basis. These are prudential practices and need to be adopted by all financial entities. Consequently, it is proposed that all registered NBFCs would be required to maintain high quality liquid assets in cash, bank deposits available within 30 days, money market instruments maturing within 30 days, actively traded debt securities (valued at 90 per cent of the quoted price and carrying a rating not lower than AA or equivalent), equal to the gap between total cash inflows and outflows over the 1 to 30 day time bucket as a liquidity coverage requirement. For deposit taking NBFCs, the extant requirement of maintenance of liquid assets will continue. I would like to clarify that the proposed requirement is much less onerous than that for banks in as much as the holding of liquid assets is not calibrated to a stress scenario and holding of financial sector liabilities as liquid assets is permitted which is not the case for banks.

Corporate Governance

49. The global financial crisis exposed major weaknesses in corporate governance systems, particularly in risk management policies and procedures. Internationally, the emphasis on good governance is increasing and it is firmly believed that improving corporate and risk governance could prevent, or at least mitigate, systemic crises. In 2007, the OECD lauded Asian countries for substantially revamping their corporate governance frameworks, but warned that enforcement remained the most significant challenge and an '*unfinished agenda*'. CLSA and the Asian Corporate Governance Association echo the same conclusion in their *2010 Corporate Governance Watch* Report for Asia. A key observation is that '*regulators make it too easy for companies to get away with box-ticking*,' which keeps even the best Asian markets far from international best practices. As per BCBS principles (October 2010) for enhancing corporate governance, effective corporate governance practices are essential to achieve and maintain public trust and confidence in the banking system, which are critical to the proper functioning of the banking sector and economy as a whole.

50. The above arguments apply to the NBFC sector also, especially, in view of their growing size, multiplicity of stakeholders and the increasing complexity of operations. For the purposes of

corporate governance, we have felt it necessary to increase the focus on companies with asset size of more than ₹10 billion, *i.e.*, the really large companies. Again, the proposed prescriptions in this regard centre around materiality, whether in ensuring fit and proper shareholders and management or the quality of disclosures. The proposed prescriptions are aimed at enhancing governance standards in NBFCs by, *inter alia*, stipulating that all registered NBFCs will require prior approval whenever these is a change in control, or a significant increase in share holding; requiring RBI's approval for appointing CEOs of large NBFCs. Other measures are: restricting the number of directorships a director can accept; putting in place a system of due diligence to ensure fit and proper criteria; and requiring enhanced disclosure requirements, including those mandated under Clause 49 of the SEBI listing agreement, *etc.*

Conclusion

51. In conclusion, let me reiterate a few points. The NBFC sector is a very important segment of the financial system warranting encouragement for further development, but at the same time, would also require to be watched and regulated more closely given its growth, increasing complexity and impact on the financial system due to increased interconnectedness. Said differently, the very factors which would require the NBFC sector to be actively promoted would also require the sector to be actively regulated. In India, we have always been cognizant of the fact that NBFCs play a significant role in the financial system and in the economic growth. The regulatory framework has been designed and is reviewed from time to time keeping in mind the requirement of the sector as well as the changing dynamics in the financial system due to increased interconnectedness. It may be said that while the shadow banking sector in India did come under stress during the global financial crisis, the stress levels were comparatively modest which did not threaten their solvency. The sector has been largely sound, mainly due to the kind of regulation that has been put in place. Nevertheless, continuing fine tuning of regulation is required to monitor the growth of this sector as it can take unexpected and unforeseen turns and mutations. That is ultimately the objective of the proposed Guidelines. In my remarks today, I have elaborated on the rationale behind the proposed guidelines so that there is a better understanding of the revised regulations. I am sanguine that the new regulatory framework would address risks and help build a more resilient and robust NBFC sector.

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