

*Speech***REGULATORY FRAMEWORK FOR
NON-BANKING FINANCIAL COMPANIES*****S.P. Talwar**

I extend a hearty welcome to you all to this Seminar which is taking place at a time when the Non-Banking Financial Companies (NBFC) sector is passing through a critical time and the process of its consolidation has just set in. With a view to effectively disseminating and appreciating the rationale of the revised regulatory framework, the need for effective supervision of the NBFC sector and to share the major supervisory concerns, we have thought it useful to conduct today's Seminar where representatives from a cross section of NBFCs, Credit Rating Agencies and audit professionals have been brought on a common platform.

Role of the NBFCs

2. The NBFCs, more particularly the leasing and hire purchase finance companies, perform a very important financial intermediation role contributing to the economic development of the country. They supplement the role of banking sector to cater to the increasing financial need of a developing economy and have diversified their activities and expanded intermediation both in the areas of credit and in channelising

the savings of the society. They act as agents between the savers and users of funds and offer tailor made services to both the borrowers as also the savers.

RBI Regulations

3. The provisions of Chapter III B of the Reserve Bank of India Act, 1934 (before the recent amendments) were in existence for more than three decades. The said provisions however, vested very limited powers in RBI in as much as the Bank was only empowered to regulate or prohibit issue of prospectus or advertisement soliciting deposit, collect information as to deposits and to give directions on matters relating to receipt of deposit. For violation of Directions, the RBI could issue orders prohibiting erring companies from accepting further deposits. So long as the directions relating to deposit acceptance were complied, no stringent action could be initiated on other adverse features found out, if any, during inspection. The legislative intent and the focus were thus mainly to moderate the resource mobilisation exercise by way of deposits by NBFCs and thereby providing indirect protection to the

* Key note address by Shri S.P. Talwar, Deputy Governor, Reserve Bank of India, at the seminar on "Regulatory Framework for Non-Banking Financial Companies" in Mumbai, on March 17, 1998.

depositors by linking the quantum of deposit to their Net Owned Fund (NOF). Several expert/working groups which looked into the functioning of NBFCs were unanimous about the inadequacy of the legislative framework and recommended introduction of suitable legislation for ensuring sound and healthy functioning of NBFCs. The Joint Parliamentary Committee which went into irregularities in securities transactions in 1992 had also observed in paragraph 6.61 of the report that Government should examine whether the provisions in Chapter III B of the RBI Act are sufficiently wide to cover the necessary regulation. If not, the question of reinforcing the existing legislation or to enact a separate legislation for the NBFCs be examined so as to ensure proper functioning of NBFCs and also to protect the interest of the depositors.

Mushrooming of the NBFCs

4. The NBFCs have been able to mobilise deposits on a substantial scale in recent years subject, however, to regulations concerning the ceiling on deposits in relation to their NOF. As on March 31, 1996 only 10,194 NBFCs furnished their returns to the Reserve Bank and their regulated deposits accounted for Rs.45,440 crore - about 11 per cent of the aggregate deposits of Scheduled Commercial Banks (excluding Regional Rural Banks) - as against Rs.30,035 crore as at end - March 1995. The mushrooming of NBFCs has been facilitated by the fact that regulations on them were nowhere close to those applicable to Scheduled Commercial Banks - in as much as many of the NBFCs did not even report about their operations to the RBI. Although NBFCs registered with the RBI under 1993 scheme, which was not mandatory, were required to adhere to the prudential norms from March 1995, many of the registered companies failed not only to comply with the

norms but also to submit the related half-yearly returns thus defeating the very purpose of registration. In fact, till recently, there was no compulsion of registration with the central bank (compulsory registration by all NBFCs has been mandated in the amended RBI Act only in January 1997). Furthermore, they do not have to maintain cash reserve that banks are required to maintain. The investment in liquid assets to be maintained by NBFCs is at a much lower level than the Statutory Liquidity Ratio (SLR) applicable to Scheduled Commercial Banks.

Working Group on the NBFCs

5. The Working Group on Financial Companies constituted in April 1992 (Shah Committee) set out the agenda for reforms in the NBFC sector. The Group made wide ranging recommendations covering, inter-alia entry point norms, compulsory registration of large sized NBFCs, prescription of prudential norms for NBFCs on the lines of banks, stipulation of credit rating for acceptance of public deposits and more Statutory powers to the RBI for better regulation of the NBFCs. The Reserve Bank also constituted in April 1995 an Expert Group for designing a supervisory framework for the NBFCs (Khanna Committee) to suggest the Off-site Surveillance and the On-site Examination System for the NBFCs depending upon their asset size and the nature of business carried on by them. Many of the recommendations of both the Groups had been accepted by the RBI and the steps have been initiated to put in place a comprehensive supervisory mechanism on the basis of these recommendations.

Amendments to the RBI Act

6. The RBI Act was amended in January 1997 by effecting comprehensive changes in

Chapter III B and V of the Act vesting more powers with the RBI. The amended Act provides for:

- (i) entry point norm of Rs. 25 lakh as minimum capital funds;
- (ii) minimum level of liquid assets as a percentage of the deposits outstanding to be maintained in unencumbered approved securities (Government securities/guaranteed bonds);
- (iii) creation of Reserve Fund and transfer of at least 20 per cent of the profits to the said Reserve Fund;
- (iv) authorising Company Law Board to direct a defaulting NBFC to repay deposits;
- (v) vesting with the RBI the powers to
 - (a) give Directions to the NBFCs regarding prudential norms;
 - (b) give Directions to the NBFCs and their Auditors on matters relating to Balance Sheet and cause Special Audit as also to impose Penalty on erring Auditors;
 - (c) prohibit NBFCs from accepting deposits for violation of the provisions of the RBI Act and direct NBFCs not to alienate their assets;
 - (d) file winding up petition against the erring NBFCs;
 - (e) impose Penalty directly on the erring NBFCs, etc.

The New NBFC Policy

7. In the context of the amendment to the

RBI Act and in the light of certain disquieting developments in the NBFC sector in the recent past, the entire gamut of regulation and supervision over the activities of NBFCs has undergone a qualitative change both in terms of thrust and forces. We have adopted a very pragmatic approach to stratify the NBFCs into three main categories for the purpose of regulating their activities:

- (a) those accepting public deposits;
- (b) those which do not accept public deposits and are engaged in the financial business; and
- (c) core investment companies which hold at least 90 per cent of their assets as investments in the securities of their group/holding/subsidiary companies.

Focus of the New NBFC Policy

8. The regulatory attention would now be focussed on NBFCs accepting public deposit. The RBI has favoured a policy to restrict the short term and the unsecured borrowings of the NBFCs on the strength of their credit rating, the size of NOF and the activities of the companies. While the overall borrowing capacity of NBFCs would be restricted by the capital adequacy requirement, maximum ceiling on public deposits which an NBFC can accept is related to its rating and level of NOF. All of you would agree with me that the saving community is the fountainhead of public deposits and their confidence should be maintained persistently. In terms of the new regulatory approach, the NBFCs not accepting public deposits would be regulated in a limited manner. Such companies have been exempted from all the key provisions of the RBI Directions on Acceptance of Public Deposits and capital

adequacy requirement as also the credit/investment concentration ceilings of the Prudential Norms. The core investment companies holding investments in their group/subsidiary/holding companies are exempt from all the provisions of the RBI Directions. However, the provisions of the RBI Act remain applicable to them to the extent they are not exempted.

Relaxations in the New NBFC Policy

9. The new regulations provide for a number of relaxations for the companies, some of which are listed below:

- (i) There are no restrictions on the borrowings by way of ICDs, issue of secured debenture, deposits from foreign citizens subject to Exchange Control permission, deposits from shareholders by a private limited company.
- (ii) Brokerage norms have been relaxed and interest rate ceiling has been raised from 15 to 16 per cent per annum.
- (iii) The prudential norms are applicable in entirety to the deposit taking companies only. The companies not accepting/holding public deposits have been exempted from the capital adequacy and credit/investment concentration norms.
- (iv) Income recognition norms on lease and hire purchase assets have been relaxed from 6 months to 12 months.
- (v) Block valuation method has been permitted for valuation of different categories of quoted investment.
- (vi) The maintenance of liquid assets has been linked to public deposits only.

Hence the amount of investment in approved securities w.e.f. April 1, 1998 will be much less than hitherto.

- (vii) All the exempted companies need not submit any of the statutory returns viz. half-yearly return on prudential norms and the annual return on deposits as also a copy of their balance sheet.

Rationale of the New NBFC Policy

10. May I briefly share with you the rationale in the formulation of the policy guidelines ?

- (i) It has been argued that the requirement of credit rating for acceptance of public deposits has been imposed on the NBFCs without giving any time or opportunity to them to fall in line with the regulations. It may be pointed out that the Working Group on Financial Companies recommended that credit rating for fixed deposits should be prescribed for the NBFCs. In pursuance to the implementation of the recommendations of this Working Group, Reserve Bank had, in April 1993, announced to all NBFCs that the recommendation of the Group for credit rating for fixed deposits had been accepted. Further, in June 1994, credit rating was made obligatory for all registered NBFCs (registered under the 1993 scheme). The NBFCs having NOF of Rs.2 crore and above were allowed time upto March 1995 to obtain credit rating and those having NOF below Rs.2 crore were given the option to obtain credit rating upto March 1996. The mandatory credit rating for the NBFCs which propose to access public deposit has thus come after the NBFCs have been given sufficient time to put their

house in order and get ready for credit rating. Credit rating for public deposits has been made compulsory because it serves as an opinion to assess the financial health of the rated institution and permits the investor to take an informed decision about the risk attached to his/her investment. It is natural that the confidence of the savers can be sustained only by good performance which is reflected in the compliance of the prudential norms and the level of credit rating. With a view to minimising any systemic risk and channelising the savings for economic development of the country, it is necessary that the NBFCs which are given the facility to access deposits from public should be kept under continuous vigil. This will serve the interests of the NBFC sector.

- (ii) Another suggestion was that there should be no ceiling on the amount of public deposits once a company complies with the regulatory requirements because the capital adequacy ratio in itself regulates not only the deposits taking limit but also total borrowings of an NBFC. It was observed that some of the NBFCs offered high interest rates for mobilising excessive public deposits and they were unable to service such high-cost funds thus jeopardising the faith of the savers. Liability management and ensuring quality of assets are the two main attributes of any good financial institution. Heavy reliance on public deposits is not a healthy trend. A prudent company should raise resources from a judicious mix of avenues. Besides, it may be noted that Capital to Risk-weighted Assets Ratio (CRAR) is not a barometer of the quality of assets of the

company. A conscious decision has, therefore, been taken to prescribe different ceilings on public deposits for the NBFCs on the basis of the level of their rating.

- (iii) Some of the Associations of the NBFCs have suggested that the RBI should have its own rating system. At present, there are approximately 3000 NBFCs which are accepting public deposits. As a central banking authority, it is not advisable to take up the micro level examination of the management system of the companies. We shall have our own supervisory rating only to modulate our inspection frequency and type of supervision to be carried out over the NBFCs.
- (iv) Many finance companies have requested for an upward revision in the limits on public deposits. You may be aware that there is hardly any 'AAA' rated company which has accepted public deposits beyond 4 times. The companies which are rated 'AA' and 'A' should moderate their deposits from the public as compared to 'AAA' rated companies because of the inherent risk factors. Nevertheless, with the time frame of three years to repay excess deposits, the difficulties envisaged by the companies may not be material. It is expected that the companies would be able to readjust their functioning in tune with the new regulatory framework. During this three-year period, the companies should increase their NOF, obtain/improve their credit rating and/or substitute public deposits by other forms of debt.
- (v) There has been an opinion that Reserve Bank has reversed the liberalisation process by regulating the

interest rate once again. Although RBI deregulated the interest rates for those NBFCs qualified for such a dispensation, majority of the NBFCs, which were still governed by the ceiling on interest rates, often offered higher returns by way of additional compensation (unauthorisedly) in a wide variety of ways (e.g. gifts, cash incentives, etc.), so that the effective rates of return were much higher and beyond the pale of surveillance. However, good NBFCs are not affected by the present ceiling on the interest rates because many of them are offering interest on their deposits within a range of 13.0 to 14.5 per cent per annum.

- (vi) The brokerage norms were eased and the slab system was abolished to make it uniform because we had information that despite the brokerage norm, some companies were paying/refunding to the brokers more than the permitted amount of brokerage. The brokerage at 2 per cent of the deposits is the ceiling and an NBFC can pay lower brokerage, if it so desires.
- (vii) Some NBFCs have time and again raised the demand that a part of the liquid assets should be allowed to be maintained in the form of bank deposits. They have expressed some difficulties in making investment in Government securities/guaranteed bonds stating that these are not easily and quickly available. Now that the NBFCs have been given three clear months to determine their actual obligation to invest in Government securities and the easy availability of these securities at State Bank of India and other nationalised bank branches at the district

head quarters should not pose any problem to them to comply with this statutory requirement. Moreover, the requirement prescribed under the provisions of Section 45-IB of the RBI Act envisages holding of such investments in the form of Government securities and guaranteed bonds alone. There is no provision in the RBI Act for reckoning deposits with banks as part of the liquid assets. I may remind that the liquid asset requirements have now been linked to the amount of public deposits alone.

- (viii) Some of the companies have contended that in the provisioning norms against lease and hire purchase assets, the value of assets financed has not been given any place. In our opinion, these transactions have the basic assumption that in case a lessee or a hirer is unable to pay the instalments, the NBFC being the owner of the asset, should quickly move to cover its dues and take all effective steps including repossession of the asset. A period of initial 12 months for not recognising an asset as non-performing is a sufficiently long period allowing the NBFC to assess the chances of recoverability of its dues from the defaulting customers and take appropriate action. The companies should not carry for a long period unrealisable assets on their balance sheets and there is a recognised need for accelerated provisions against such assets.

Supervisory Mechanism

11. The Reserve Bank has taken a number of steps to put in place an effective supervisory mechanism over the NBFCs. The Bank has brought out a comprehensive Inspection Manual and has devised Special

formats for Off-site Reporting/Monitoring. Companies with asset size of Rs.100 crore and above have been asked to furnish an Annual Return giving the comparative position of their operational data for 3 years in regard to various items of their balance sheet, Profit and Loss Account and certain key ratios. It is the intention that the On-site Inspection should be more by exception, than a routine activity. Accordingly, On-site Inspection of the NBFCs will be carried out on a random basis taking into account the record of their compliance with the Directions and prudential norms, incidence of complaints, problem companies and will cover the NBFCs having large amounts of public deposits. The remaining companies will be mainly subjected to Off-site Surveillance and scrutiny of Statutory Returns, Balance Sheets, Profit & Loss Account, Auditor's Reports, etc. The Bank proposes to network Central Office with all the Regional Offices to build up profile of the companies and reduce response time in follow up of the irregularities with the erring NBFCs. All the returns are to be computer compatible and their processing has to be computerised so as to facilitate their scrutiny without any delay. These returns are to serve the objective of Off-site Surveillance. We have opened 16 Regional Offices of the Department to serve the NBFC sector at a place nearer to the place of their registered offices. The companies are advised to approach these offices for any clarification on the regulatory framework.

Role of Auditors

12. The RBI has assigned a greater role for the auditors of the companies in imposing discipline on them. In order to expedite the process of registration, the Bank enlisted the support of Chartered Accountants to conduct special audit of the NBFCs with asset size of Rs.5 crore and above. Further, the statutory

auditors of the NBFCs have been given added responsibilities to report by exception on the NBFCs' non-compliance with the RBI regulations. The annual return on deposits, the half yearly prudential norm return and the information on certain other aspects of the functioning of the NBFCs are required to be certified by the auditors. As you are aware, the NBFCs not accepting public deposits are not required to file with RBI copy of their balance-sheet or the return on deposits. The Bank has to largely depend upon the auditors' report for the purpose of even Off-site Surveillance on such companies. The efficiency of the auditors and their objective reporting will be critical for monitoring the activities of such NBFCs.

Depositors Education

13. The depositors have already been cautioned by the Reserve Bank of India to understand the financial status of the NBFC while filling up the application form for deposits before making deposits because no amount of regulations can provide a fail-safe system. The Bank does not guarantee the repayment of deposits and the NBFC deposits are unsecured and uninsured for the present. However, the Bank has a plan for educating general public through media. The purpose is to explain to the masses at large that they may look into certain aspects of functioning of the concerned NBFC and certain other features in its deposit schemes while making deposits with it. This is the task which in fact the NBFCs themselves or the Self Regulatory Organisation should undertake. We would like that NBFC Association should take steps in this direction.

Deposit Insurance

14. After the debacle of one of the large NBFCs, there has been a strong opinion about

the deposit insurance scheme for their deposits. Even the Hon'ble Supreme Court had directed the Government to examine the feasibility of extending such a protection to the depositors of the NBFCs. A high level Working Group had examined the strengths and weaknesses of the NBFC sector, the extent of regulations, the methods of their operations, the quality of assets created by them, the level of comfort which the insurance agency might enjoy with the weak units, the maturity of the players and overall financial health of the individual units. The Group recommended that:

“Once all the regulatory measures introduced recently including prudential and capital adequacy norms are implemented, a comprehensive supervisory framework which is being installed is operationalised and several built-in and operational safeguards provided in the enactment are enforced, a deposit insurance scheme, for only registered and rated NBFCs complying with all the regulatory and supervisory norms, may be introduced after a period of six years. The status of the insurance agency and detailed modalities of the insurance scheme may be decided at the relevant time.”

The Reserve Bank of India has taken up the matter with General Insurance Corporation of India to consider formulating a scheme for deposit insurance for the NBFCs.

A Word of Caution

15. As you are aware that the currency crisis faced by some of the South East Asian countries had triggered the crisis in financial markets also. Perhaps we may have to draw a lesson from the experience of these Asian tigers. One of the important factors of their difficulties is the asset-liability mismatch and investment in unproductive assets. In India

also, there are reports that some of the NBFCs borrowed heavily and the excess liquidity was misallocated in the corporate finance with imprudence and lack of proper credit appraisal and real estate business for an overkill. Because of certain economic reasons, such companies are suffering liquidity crisis at present thus accentuating risk to the depositors' interest. While NBFCs provided to their customers the advantages of quicker decision-making and of servicing of their specific needs, they assumed greater risks and high exposures, notwithstanding the specification of prudential norms for registered NBFCs as early as 1994-95. The quality of assets created by the NBFCs has a direct bearing on the financial viability and depositors' confidence.

Registration of the NBFCs

16. All of the NBFCs existing on January 9, 1997 were required to submit upto July 8, 1997 their application for statutory registration under the RBI Act. The Bank received 37,478 applications from existing companies of which 9074 companies were found to have NOF of Rs. 25 lakh and above and 2371 companies were accepting public deposits. All these applications are being dealt with due care and speed in the light of the Statutory obligations cast on the RBI. The Bank has already approved 2540 NBFCs for registration and the application of 15 NBFCs have been rejected. It is intended to complete the process of registration by end-June 1998. In the meanwhile, the companies are advised to ensure compliance with the directions and co-operate with the auditors to expedite the process of registration. It has come to the notice of the RBI that many of the companies existing as on January 9, 1997 had not applied to the RBI for a certificate of registration but they continue to do their business of a financial institution despite wide publicity

given in the press and the communications sent to the companies in many cases which is in violation of the provisions contained in the RBI Act. The NBFCs incorporated after the relevant date of January 9, 1997 are required to obtain a certificate of registration from the Bank before they can commence their business of a financial institution. The statutory auditors of these companies are now enjoined upon to directly report to the RBI the cases where such applications have not been made to the Bank for certificate of registration. Any failure to do so on the part of both the NBFCs and their auditors will attract severe penalties as provided for under the RBI Act.

Conclusion

17. In the end, I may say that the objective of the regulation and supervision as also the mission of the RBI is to ensure that —

- (i) the financial companies function on healthy lines;
- (ii) these companies function as a part of the financial system within the policy

framework, in such a manner that their existence and functioning do not lead to systemic aberrations;

- (iii) the quality of surveillance and supervision exercised by the Bank over the NBFCs is sustained by keeping pace with the developments that take place in this sector of the financial system; and that
- (iv) the depositors' interest is safeguarded.

It is expected that 3 to 5 years down the line, an efficient, viable and vibrant NBFC sector would emerge. I may assure you that the Bank has an open mind for any suggestion within the framework of policy and basic postulate that the depositors' interest should be safeguarded. As you are aware, after we have announced the new regulatory dispensation in January 1998, there were certain concerns expressed in the industry in regard to some of the Directions. All these concerns were examined objectively and revised guidelines have been issued which would go a long way in the best interests of strengthening the NBFC sector.