DBOD.No.FSD. /556 / 24.01.02/ 2006-07 November 3, 2006

All Scheduled Commercial Banks (Excluding RRBs)
and NBFCs (deposit taking and non deposit taking)

Dear Sir,

Mid-Term Review of Annual Policy Statement for the Year 2006-07- Financial Regulation of Systemically Important NBFCs and Banks' Relationship with them

Please refer to paragraph 141 of the Mid-Term Review of Annual Policy Statement for the year 2006-07 enclosed to Governor's letter No.MPD.BC.286/07.01.279/2006-07 dated October 31, 2006. (copy of the paragraph enclosed as Annex 1).

2. An Internal Group was constituted by the Reserve Bank to study the issues relating to regulatory convergence, regulatory arbitrage and to recommend a policy framework for level playing field in the financial sector. Based on the recommendations of the Internal Group and taking into consideration the feedback received thereon, it has been decided to put in place a revised framework to address the issues pertaining to the relationship between banks and NBFCs and the systemically important NBFCs. A draft of the proposed guidelines have been prepared and furnished as Annex 2. The revised framework will not be applicable to the Residuary Non Banking Companies (RNBCs), which are governed by a separate set of regulations.

3. Banks and NBFCs are requested to forward their comments and feedback on the draft guidelines to the undersigned by close of business on Friday, November 17, 2006.

Yours faithfully,

(Prashant Saran)
Chief General Manager-In-Charge

Paragraph 141 of the Mid-Term Review of
Annual Policy Statement for the year 2006-07

(f) Banks' Exposures to Systemically Important NBFCs

141. An Internal Group was constituted by the Reserve Bank to study the issues of regulatory convergence, regulatory arbitrage and to recommend a policy framework for level playing field in the financial sector. The report of the Group was placed on the Reserve Bank's web-site for wider dissemination and comments. In the light of the recommendations of the Group and the feedback received, and in view of the importance of this segment of the financial sector, a draft circular will be put in the public domain to invite further feedback by November 2, 2006. After providing two weeks for comments, the final circular will be issued before November 30, 2006.

ANNEX 2

DRAFT CIRCULAR - FOR COMMENTS

November 03, 2006

DBOD. No. FSD. BC. /   /2006-2007

All Scheduled Commercial Banks (excluding RRBs)
and NBFCs (deposit taking and non-deposit taking)

Dear Sir,

Financial Regulation of Systemically Important NBFCs and Banks' Relationship with them

Non Banking Financial Companies (NBFCs) play a crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector. They are increasingly being recognised as complementary to the banking system, capable of absorbing shocks and spreading risks at times of financial distress. The application of different levels of regulations to the activities of banks and NBFCs, and even among different categories of NBFCs, has given rise to some issues arising out of this uneven coverage of regulations. The Reserve Bank of India had, therefore, set up an Internal Group to examine the issues relating to level playing field, regulatory convergence and regulatory arbitrage in the financial sector. Based on the recommendations of the Internal Group and taking into consideration the feedback received thereon, it has been decided to put in place a revised framework to address the issues pertaining to the overall regulation of systemically important NBFCs and the relationship between banks and NBFCs. The revised framework will not be applicable to the Residuary Non Banking Companies (RNBCs), which are governed by a separate set of regulations.

Current Status: Prudential Norms

2. The Reserve Bank put in place in January 1998 a new regulatory framework involving prescription of prudential norms for NBFCs which are deposit taking to ensure that these NBFCs function on sound and healthy lines. Regulatory and supervisory attention was focused on the 'deposit taking NBFCs' (NBFCs – D) so as to enable the Reserve Bank to discharge its responsibilities to

protect the interests of the depositors. NBFCs - D are subjected to certain bank – like prudential regulations on various aspects such as income recognition, asset classification and provisioning; capital adequacy; prudential exposure limits and accounting / disclosure requirements. However, the 'non-deposit taking NBFCs' (NBFCs – ND) are subject to minimal regulation.

3. The application of the prudential guidelines / limits, is thus not uniform across the banking and NBFC sectors and within the NBFC sector. There are distinct differences in the application of the prudential guidelines / norms as discussed below:

i) Banks are subject to income recognition, asset classification and provisioning norms; capital adequacy norms; single and group borrower limits; prudential limits on capital market exposures; classification and valuation norms for the investment portfolio; CRR / SLR requirements; accounting and disclosure norms and supervisory reporting requirements.

ii) NBFCs – D are subject to similar norms as banks except CRR / SLR requirements and prudential limits on capital market exposures. However, even where applicable, the norms apply at a rigour lesser than those applicable to banks. Certain restrictions apply to the investments by NBFCs – D in land and buildings and unquoted shares.

iii) Capital adequacy norms; CRR / SLR requirements; single and group borrower limits; prudential limits on capital market exposures; and the restrictions on investments in land and building and unquoted shares are not applicable to NBFCs – ND.

iv) The extent to which all companies can resort to unsecured borrowings is restricted under the Companies Act. Though NBFCs come under the purview of the Companies Act they are exempted from the requirement under this Act since they are under RBI regulation. While in the case of NBFCs – D, their borrowing capacity is limited to a certain extent by the CRAR norm, there are no restrictions on the extent to which NBFCs – ND may leverage, even though they are in the financial services sector.

Current Status: Financial Linkages Between Banks and NBFC

4. Banks and NBFCs compete for some similar kinds of business on the asset side. NBFCs offer products/services which include leasing and hire-purchase, corporate loans, investment in non-convertible debentures, IPO funding, margin funding, small ticket loans, venture capital, etc. However NBFCs do not provide operating account facilities like savings and current deposits, cash credits, overdrafts etc.

5. NBFCs avail of bank finance for their operations as advances or by way of banks' subscription to debentures and commercial paper issued by them.

6. Since both the banks and NBFCs are seen to be competing for increasingly similar types of some business, especially on the assets side, and since their regulatory and cost-incentive structures are not identical it is necessary to establish certain checks and balances to ensure that the banks' depositors are not indirectly exposed to the risks of a different cost-incentive structure. Hence, following restrictions have been placed on the activities of NBFCs which banks may finance:

(i) Bills discounted / rediscounted by NBFCs, except for rediscounting of bills discounted by NBFCs arising from the sale of –
   (a) commercial vehicles (including light commercial vehicles); and
   (b) two-wheeler and three-wheeler vehicles, subject to certain conditions;

(ii) Investments of NBFCs both of current and long term nature, in any company/entity by way of shares, debentures, etc. with certain exemptions;

(iii) Unsecured loans/inter-corporate deposits by NBFCs to/in any company.

(iv) All types of loans/advances by NBFCs to their subsidiaries, group companies/entities.

(v) Finance to NBFCs for further lending to individuals for subscribing to Initial Public Offerings (IPOs).

(vi) Bridge loans of any nature, or interim finance against capital/debenture issues and/or in the form of loans of a bridging nature pending raising of long-term funds from the market by way of capital, deposits, etc. to all categories of Non-Banking Financial Companies, i.e. equipment leasing and hire-purchase finance companies, loan and investment companies, Residuary Non-Banking Companies (RNBCs) and Venture Capital Funds (VCFs).

(vii) Should not enter into lease agreements departmentally with equipment leasing companies as well as other Non-Banking Financial Companies engaged in equipment leasing.

(viii) Lend against lease rental receivables arising out of sub-lease of an asset by a Non-Banking Non Financial Company (undertaking nominal leasing activity) or by a Non-Banking Financial Company as these should be excluded for the purpose of computation of permissible bank finance for such company. This is because banks can only support lease rental receivables arising out of lease of equipment/machinery owned by the borrowers.

Current Status: Structural Linkages Between Banks and NBFCs

7. Banks and NBFCs operating in the country are owned and established by entities in the private sector (both domestic and foreign), and the public sector. Some of the NBFCs are subsidiaries/ associates/ joint ventures of banks – including foreign banks, which may or may not have a physical operational presence in the country. There has been increasing interest in the recent past in setting up NBFCs in general and by banks, in particular.

8. Investment by a bank in a financial services company should not exceed 10 per cent of the bank's paid-up share capital and reserves and the investments in all such companies, financial institutions, stock and other exchanges put together should not exceed 20 per cent of the bank's paid-up share capital and reserves. Banks in India are required to obtain the prior

approval of the concerned regulatory department of the Reserve Bank before being granted Certificate of Registration for establishing an NBFC and for making a strategic investment in an NBFC in India. However, foreign entities, including the head offices of foreign banks having branches in India may, under the automatic route for FDI, commence the business of NBFI after obtaining a Certificate of Registration from the Reserve Bank.

Regulatory Issues

9. NBFCs can undertake activities that are not permitted to be undertaken by banks or which the banks are permitted to undertake in a restricted manner: for example, financing of acquisitions and mergers, capital market activities etc. The differences in the level of regulation of the banks and NBFcs, which are undertaking some similar activities, give rise to considerable scope for regulatory arbitrage. Hence, routing of transactions through NBFCs would tantamount to undermining banking regulation. This is partially addressed in the case of NBFCs that are a part of banking group on account of prudential norms applicable for banking groups.

10. NBFCs - D may access public funds, either directly or indirectly through deposits, CPs, debentures and bank finance and NBFCs – ND may access public funds through all of the above modes except through public deposits. The application of marginal regulation to NBFCs – ND that are large and systemically important and also have access to public funds can be a potential source of systemic risk through contagion even though these entities are not members of the payment and settlement systems.

11. At present, there are no prudential norms or guidelines on the intra-group transactions and exposures (ITEs) between the NBFCs and their parent entities. From the perspective of consolidated supervision of a banking group/ financial conglomerate, it is necessary to have some norms / limits on the ITEs to ensure that the activities of the banking group / financial conglomerate are undertaken in a prudent manner so that they would not be a threat to financial stability. Internationally, some regulators prescribe a ceiling on the level of

transactions that a bank can have with its affiliates. These limits may operate either at a single entity level and / or at an aggregate level.

12. In terms of the provisions of the Banking Regulation Act, a bank is not allowed to set up a banking subsidiary. This ensures that more than one entity in a banking group would not be undertaking similar activities for example, accepting deposits. This also eliminates the scope for more than one entity within a group competing for public deposits. However, this aspect is not well addressed under the existing framework where a bank operating in India may set up an NBFC – D as a subsidiary or where they have / acquire substantial holding in such an entity i.e., say more than 10 per cent.

13. Foreign direct investment in NBFCs is permitted under the automatic route in 19 specified activities subject to compliance with the minimum capitalization norms. Once an NBFC is established with the requisite capital under FEMA, subsequent diversification either through the existing company or through downstream NBFCs is undertaken without any further authorisation. This could give scope for undertaking those activities which do not qualify for FDI through the automatic route.

Underlying Principles for a Revised Framework

14. Thus the regulatory gaps in the area of bank and NBFC operations contribute to creating the possibility of regulatory arbitrage and hence giving rise to an uneven playing field and potential systemic risk. In this backdrop, the related issues have been examined and as recommended by the Group, a review of the existing framework of prudential regulations for bank and NBFC operations was undertaken. The broad principles underlying the review are as under.

i) Entities offering financial services should normally be within the ambit of financial regulations. However, all NBFCs – ND were largely excluded from the scope of financial regulation in view of the state of development of the financial sector at that time and as a matter of prioritisation of regulatory focus. In the light of the recent developments in the financial sector and its growth, as a first step, all systemically relevant entities offering financial services ought to be brought under a suitable regulatory framework to contain systemic risk. The definition of what is considered systemically relevant will be as determined from time to time.

ii) The IMF publication, "Financial Sector Assessment - A Handbook" mentions that, "Similar risks and functions should be supervised similarly to minimize scope for regulatory arbitrage" and that, "Bank-like financial institutions should be supervised like banks." Similarly, the 'Report of the Committee on Fuller Capital Account Convertibility' has also identified that "modifications to regulation to discourage or eliminate scope for regulatory arbitrage, focusing on activity-centric regulation rather that institution-centric regulation will be needed" to enhance the strengthening of the banking system. Hence, the focus will be to reduce or eliminate the scope for regulatory arbitrage by ensuring that regulations are activity specific – irrespective of the medium through which the activity is undertaken.

iii) The ownership of NBFCs, which are subjected to a relatively less stringent regulatory and prudential framework, should be subjected to certain norms which will encourage improved governance so that regulatory arbitrage or circumvention of bank regulations are not resorted to. Further, the ownership pattern should be such that more than one entity in a Group does not compete for public deposits. Additionally, the principle of 'holding out' will operate in a situation where an NBFC is within a bank group. Hence, the eventual fall out of the holding out principle will have to be factored-in while banks decide on the extent to which they would like to be involved in an NBFC.

iv) Consequent upon certain adverse events in the banking sector in the early 1990s, banks are not permitted to offer discretionary portfolio management scheme (PMS). As a corollary, the NBFCs sponsored by banks are also not permitted to offer discretionary PMS. Whereas, other NBFCs are allowed to offer this product. Hence, ownership structure of the NBFC should not be determining factor to decide on the products that NBFCs may offer.

v) Foreign entities can undertake certain permitted activities in India under the automatic route for FDI. However, it might not be appropriate to allow a foreign entity to set up a presence through the automatic route and later expand into activities which are not permitted under the automatic route, without going through a further authorisation process.

vi) The over arching principle is that banks should not use an NBFC as a delivery vehicle for seeking regulatory arbitrage opportunities or to circumvent bank regulation(s) and that the activities of NBFCs do not undermine banking regulations. In case it is observed that any bank has not complied with the spirit of these guidelines, such non compliance should be viewed very strictly by the Reserve Bank.

Modifications to the Regulatory Framework

15. In the light of the concerns that arise out of the divergent regulatory requirements for various aspects of functioning of banks and NBFCs and keeping in view the broad principles for the proposed revision in the regulatory framework, the following modifications are being made with immediate effect.

A. Regulatory Framework for Systemically Important NBFCs

(i) Leverage Ratio

All NBFCs – ND with an asset size of Rs. 100 crore and more will be considered as a systemically important NBFC **– ND (SI – NBFC – ND)** and shall be governed by a leverage ratio whereby they shall be able to raise borrowings only up to 10 times of their net owned funds. The net owned funds for this purpose shall be as per the last audited and published balance sheet.

(ii) Capital Adequacy Ratio for SI – NBFCs – ND

All SI – NBFCs – ND will be required to maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) of 10%. Those SI – NBFCs – ND which presently do not have a CRAR of 10% would have to approach the Reserve Bank (Department of Non-Banking Supervision, Central Office) with a clear indication of the time-frame within which they would be able to comply with the required CRAR. The present minimum CRAR stipulation at 12 % or 15%, as the case may be, for NBFCs – D shall continue to be applicable.

(iii) Single / Group Exposure norms for SI – NBFCs – ND

No SI – NBFCs – ND, as defined above, shall

a) lend to
   - i) any single borrower exceeding fifteen per cent of its owned funds; and
   - ii) any single group of borrowers exceeding twenty five per cent of its owned funds;

b) invest in
   - i) the shares of another company exceeding fifteen per cent of its owned funds; and
   - ii) the shares of a single group of companies exceeding twenty five per cent of its owned funds;

c) lend and invest (loans/investments taken together) exceeding
   - i) twenty five per cent of its owned funds to a single party; and
   - ii) forty per cent of its owned funds to a single group of parties.

The above ceiling on the investment in shares of another company shall not be applicable to an NBFC in respect of investment in the equity capital of an insurance company up to the extent specifically permitted, in writing, by the Reserve Bank. Further, the SI – NBFCs – ND are advised to have a policy in respect of exposures to a single entity / group. The SI – NBFCs – ND which are holding companies, which do not access public funds, both directly and indirectly, and which invest only in the group entities may apply to the Reserve Bank for exemption from the above requirement.

B. Regulatory Framework for Bank Exposures to NBFCs

(iv) Bank Exposures to NBFCs

The exposure (both lending and investment, including off balance sheet exposures) of a bank to a single NBFC should not exceed 5% of the bank's net worth as per its last published balance sheet. Further, the aggregate exposure of a bank to all NBFCs should not exceed 40% of the bank's net worth, as computed above. This is in partial modification of the current single/group borrower exposure ceilings prescribed for banks in terms of our Master Circular DBOD. No. Dir. BC. 33 / 13.03.00/ 2006 -07 dated October 10, 2006, on exposure norms.

C. Regulatory Framework for NBFCs Forming Part of a Banking Group

(v) In terms of our circular DBOD. No. BP. BC. 72/ 21.04.018/ 2001-02 dated February 25, 2003 on consolidated accounting, among other things, capital adequacy, single and group exposure, and capital market exposure norms have been laid down for a consolidated bank. These norms cover NBFCs which are part of a consolidated Indian bank. Henceforth, initially, wholly owned and majority owned NBFCs promoted by the parent / group of a foreign bank having presence in India, would be treated as part of that foreign bank's operations in India and brought under the ambit of consolidated supervision. Consequently, the concerned foreign banks should submit the consolidated prudential returns (CPR) prescribed by the above guidelines to the Department of Banking Supervision and also comply with the prudential regulations / norms prescribed therein to the consolidated operations of that bank in India.

(vi) NBFCs which do not belong to any banking group are currently permitted to offer discretionary portfolio management as a product, as permitted by their respective regulators. However, due to historical reasons, as banks are aware, banks are not allowed to offer discretionary portfolio management as a product; thus bank sponsored NBFCs are also not allowed to offer discretionary portfolio management as a product. Henceforth, bank sponsored NBFCs will also be allowed to offer discretionary PMS to their clients, on a case to case basis. Applications in this regard should be submitted to DBOD, World Trade Centre, Mumbai.

D. Ownership and Governance

(vii) Banks in India, including foreign banks operating in India, shall not hold more than 10 % of the paid up equity capital of an NBFC – D. This restriction would, however, not apply to investment in housing finance companies. Banks which at present exceed the above limits should approach the Reserve Bank, within a period of two months from the date of this circular, supported by a plan for complying with the proposed regulatory requirement within a specified time frame.

E. Expansion of activities of NBFCs through automatic route

(viii) NBFCs set up under the automatic route will be permitted to undertake only those 19 activities which are permitted under the automatic route. Diversification into any other activity would require the prior approval of FIPB. Similarly a company which has entered into an area permitted under the FDI policy (such as software) and seeks to diversify into NBFC sector subsequently would also have to ensure compliance with the minimum capitalization norms and other regulations as applicable.

Yours faithfully,

Chief General Manager