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Khanna Committee on NBFC supervision recommends rating system for registered NBFCs

The expert group for designing a supervisory framework for Non-Banking Financial Companies (NBFCs) (Khanna Committee) has recommended introduction of a supervisory rating system for the registered NBFCs. The Group has also recommended that such a rating system should be designed on the basis of different levels of regulatory/supervisory compliance, capital adequacy and ratings assigned by the credit rating agencies. The Group has recommended that the rating process might assign weightage points for each parameter and arrive at the supervisory rating. Based on the rating, the NBFCs could then be placed in three different supervisory 'watch-lists' of low, medium and high risks. The ratings assigned to NBFCs would primarily be the tool for triggering on-site inspections at various intervals.

It may be recalled that the Reserve Bank had, in April 1995, set up an expert group under the chairmanship of Shri P.R. Khanna, Member of the Advisory Council of the Board for Financial Supervision of the Reserve Bank. The Group was set up with the objective of designing a comprehensive and effective supervisory framework for the non-banking companies segment of the financial system.

Stating that the Reserve Bank should perceive the NBFCs segment as an integral part of the financial system, the Group has emphasized the need for ensuring that the NBFCs carried on their business in conformity with the overall framework of the monetary and credit policy and functioned on sound, solvent and healthy lines.

In order to achieve the regulatory and supervisory objectives, the Group has recommended introduction of a comprehensive supervisory framework with all the bodies incorporated as NBFCs engaged, inter alia, in accepting deposits/borrowings from the public, corporates, banks, etc., brought under the supervisory net of the Reserve Bank regardless of their capital base. Recongnising that the number of reporting companies is large, it has, however, suggested that the supervisory attention and focus should be directed in a comprehensive manner only to those NBFCs having net owned funds of Rs.100 lakh and above. The Group has suggested that supervision over unregistered NBFCs might largely be exercised through the off-site surveillance mechanism and their on-site inspection might be conducted selectively as deemed necessary depending on circumstances.

As a long term strategy, the Group has suggested that all NBFCs should be supervised mainly through off-site surveillance system regardless of whether the entities were registered with the Reserve Bank or not. The Group has felt that the off-site surveillance system would structurally be an in-house review and analytical system based on various statutory returns and other statements. The Group has recommended better transparency of the financial position of NBFCs in larger public interest.

As for on-site inspection, the Group has desired that while the objectives of on-site inspection should consist of ensuring regulatory compliance, evaluation of financial soundness/solvency, appraisal of management and identification of areas requiring corrective action, the process should include a review of compliance with regulatory and supervisory guidelines, appraisal of asset quality, analysis of key financial indicators and assessment of policies, systems and procedures. According to the Group, the entire process of capturing data from the returns for the purpose of annual survey and the detailed scrutiny should be completed within a maximum period of three and six months, respectively, from the due date prescribed for submission of the annual return.

For better and effective supervision over the NBFCs, the Group has recommended that an elaborate supervisory model akin to that which was applied to the banking sector should be developed in-house for overseeing NBFCs with asset size exceeding Rs.500 crore each and has recommended introduction of an on-line corporate memory/profile building process based on the observations generated from the off-site surveillance system, market intelligence, complaints, supervisory rating, record of compliance with the directions and inspection findings.

The Group has felt that there was a need to devise a suitable system for co-ordinating the on-site inspection of the NBFCs by the Reserve Bank in tandem with other regulatory authorities so that they were subjected to one-shot examination by different regulatory authorities.

Some of the non-banking non-financial companies (viz. industrial/manufacturing units) were also undertaking more and more financial activities including acceptance of deposits, investment operations, leasing, etc., to a sizeable extent. The Group wanted that the adequacy or otherwise of the existing regulatory control might be examined with a view to guarding against the possibility of misuse of the financial system by such companies. The Group has also stressed the need for identifying an appropriate authority to regulate the activities of these companies, plantation and animal husbandry companies not falling under the regulatory control of either Department of Company Affairs or the Reserve Bank, insofar as their mobilisation of public deposit was concerned.

The Group has recommended introduction of a system whereby the names of the NBFCs which had not complied with the regulatory framework/directions of the Bank or had failed to submit the prescribed returns consecutively for two years could be published in regional newspapers.

Most of the recommendations of the Group have been accepted by the Reserve Bank after an indepth analysis and the revised framework for effective supervision of the NBFCs including off-site monitoring of NBFCs is being put in place.

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