

November 30, 2006

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

As mentioned in Para 141 of the Mid Term review of the Annual Policy Statement 2006 – 07, the Reserve Bank of India had constituted an Internal Group 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 was prepared and placed in the public domain to invite further feedback by November 3, 2006. The draft guidelines were open for comments till close of business on November 17, 2006. On the basis of the feedback received, the draft guidelines have been suitably revised and are now issued for further comments by December 7, 2006. The salient features of the revised draft guidelines are:

- a) All systemically important non deposit taking NBFCs shall :
 - i) maintain a minimum capital adequacy ratio of 10%;
 - ii) comply with single and group exposure norms, which are similar to those applicable to deposit taking NBFCs;

- b) Banks may assume exposure on a single NBFC (both deposit taking and non-deposit taking) up to 10% of their capital funds, and to all NBFCs up to 40% of their capital funds. These limits may be exceeded by 5% and 10% of capital funds, respectively, if the additional exposure is on account of funds on-lent by the NBFCs to infrastructure sector.

- c) NBFCs promoted by the parent / group of a foreign bank having presence in India, which is a subsidiary of the foreign bank's parent / group or where the parent / group is having management control would be treated as part of that foreign bank's operations in India and brought under the ambit of consolidated prudential regulations.

- d) NBFCs which are subsidiaries of banks or where banks have a management control will also be allowed to offer discretionary portfolio management scheme to their clients, on a case by case basis.

- e) Banks in India, including foreign banks operating in India, shall not hold more than 10 % of the paid up equity capital of a deposit taking NBFC. This restriction would, however, not apply to investment in housing finance companies.

- f) 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 capitalisation norms and other regulations as applicable.

Taking into account the likelihood that some of the banks/NBFCs may not be in compliance with some of the elements of the revised regulatory framework it has been decided to provide for a transition period up to end March 2007. Accordingly, banks and NBFCs should comply with all elements of the revised framework with effect from April 1, 2007. In case any NBFC – ND – SI or bank needs more time for compliance, they shall apply to the concerned regulatory department of the Reserve Bank of India before the close of business on January 31, 2007 clearly indicating the reasons for which they are not able to ensure compliance within the above period and the time frame within which they would be able to comply with all the relevant elements. This will enable the Reserve Bank to take a view on the requests by end March 2007.

The guidelines contained in this circular will be applicable to the NBFCs as specified in the relevant paragraphs except the categories mentioned below for which the present regulatory framework will continue to apply for the present:

- i) The Residuary Non Banking Companies (RNBCs) and Primary Dealers (PDs).
- ii) Government owned companies, as defined under Section 617 of the Companies Act, which are registered with the Reserve Bank of India as NBFCs.

Alpana Killawala
Chief General Manager