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RESERVE BANK OF INDIA
वेबसाइट : www.rbi.org.in/hindi
Website : www.rbi.org.in
इ-मेल email: helpdoc@rbi.org.in

संचार विभाग, केंद्रीय कार्यालय, एस.बी.एस.मार्ग, मुंबई-400001
DEPARTMENT OF COMMUNICATION, Central Office, S.B.S.Marg, Mumbai-400001
फोन/Phone: 91 22 2266 0502 फैक्स/Fax: 91 22 22660358

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Inter-connectedness of Banks and NBFCs in India: Issues and Policy Implications: RBI Working Paper Series No. 21

The Reserve Bank of India today placed a Working Paper Series No. 21 titled "Inter-connectedness of Banks and NBFCs in India: Issues and Policy Implications" by A.Karunagaran.

The recent global financial crisis (2007-2009) has clearly demonstrated the gravity of high financial interconnectedness within the financial system. In India, the rapid growth of non-banking finance companies (NBFCs), especially in the nineties, has led to a gradual blurring of dividing lines between banks and NBFCs. Over a period both banks and non-bank financial institutions have become key elements of broad-based sound financial system in India. In the context of recent global financial crisis, however, the nexus between the banking system and the NBFIs put the financial system in wider debate focussing the financial interconnectedness of the banking system with the NBFIs as excessive inter-institutional exposure put the entire financial system into vulnerability.

This paper brought out that NBFCs in India are highly reliant on the banking system for their resources. As NBFCs are discouraged from raising public deposits, these companies are increasingly substituting public deposits with borrowings from the banking system. Hence, there seems to be a strong growing systemic financial inter-connectedness between banks and NBFCs. This has even more systemic concerns than NBFCs directly raising resources by way of public deposits. NBFCs' high dependency on banks for their funding results in funding of medium to long term assets from the short term sources.

The study has suggested that a correct policy mix should include promoting an appropriate degree of diversity in channels of financing the needs of the economy along with a balanced set of incentives for complementary development of banking and NBFCs. Given a regulated approach rather than restrictive policy approach, NBFCs will be able to play a more positive role in promoting economic activities that are not served by the banking system. NBFCs, for instance, could raise resources from corporate debt market and that needs a strong policy support, the paper suggests. There also seems to be scope for fixing separate ceiling for NBFCs-ND companies to borrow from the banking system. The policy can encourage more consolidation among the smaller NBFCs so that the entire NBFC sector can be brought under uniform regulatory framework on par with the banking system. Going forward, there is a requirement for redefinition of 'systemically important NBFCs-ND'. Higher liquidity requirements against excessive reliance on wholesale short term funding and higher capital requirements for inter-financial sector and intra-financial sector exposures are some of the key prudential requirements that need consideration.

Alpana Killawala
Chief General Manager

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