Report of the Internal Group on issues relating to 'level playing field', regulatory convergence and regulatory arbitrage in the financial sector

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1. Background for setting up of the Internal Group

There has been increasing interest in setting up NBFCs in general and by banks and foreign institutions in particular. NBFCs offer products/services which included margin funding, leasing and hire-purchase, corporate loans, investment in non-convertible debentures, IPO funding, small ticket loans, venture capital etc. One of the reasons cited for banks preference to establish NBFC is reducing the cost of operations.

The banks and NBFCs are competitors and compete for similar kind of business. However NBFCs are more active in hire purchase, leasing etc and do not provide cash credit, overdrafts etc. NBFCs exist in private sector, public sector and under foreign ownership. There are NBFCs which are associate/sister concerns of banks. There are NBFCs set as subsidiaries of foreign entity as also by foreign banks having branches in India. Subsidiaries of foreign banks having branches in India can undertake transactions which are not permitted to be undertaken by banks or which the banks are permitted to be undertaken with certain restrictions. Since NBFCs -ND are not supervised in a substantial manner ,there could be supervisory gaps in this area and such NBFCs may enjoy regulatory arbitrage vis-a-vis banks. The RBI regulation in respect of non-deposit taking NBFCs (NBFCs-ND) is tenuous thereby creating regulatory arbitrage. In this back drop it is pertinent to note that there are no regulation on the raising of resources other than deposits in the shorter term as CPs or long term funds as debentures or bank borrowings. The bank borrowings are limited by the credit decision and exposure limits set by the banks. The leverage available in gearing the balance sheet by an NBFC -ND is unlimited and without any restriction on the end use of funds it raises systemic issues and needs to be addressed.

The NBFC sector excluding Residuary Non-Banking Companies consists of 436 deposit taking and 12,615 NBFCs -ND as at the end of January 2006. Out of the deposit taking NBFCs (NBFCs-D), 16 companies with asset size above Rs.500 crore account for 48.6 % of the aggregate deposits of Rs. 3,777 crore of the sector. In respect of non-deposit taking companies there were 104 companies (excluding Govt. companies, primary

dealers and holding companies) with asset size of Rs. 100 crore and above. In this segment, Citi group having 5 group companies head the list in terms of aggregate asset followed by GE Capital and its associates. It is interesting to note that out of these 104 companies, about 10 companies hold assets forming 43.3 % of the total assets of this segment. Out of these 10 companies 5 are foreign owned companies. These 5 companies together account for a significant share of the bank borrowings, CPs and the debentures raised by this sector (which exclude Govt. companies, primary dealers and holding companies). Besides, some of the NBFCs have raised large amount of bank funds to fund their capital market operations.

In this backdrop, the issues relating to the level playing field between bank sponsored NBFCs on the one hand and non-bank sponsored NBFCs on the other, needs close examination/analysis. In order to study the issues of regulatory convergence, regulatory arbitrage and level playing field a group was suggested to be constituted to evolve a policy frame work for considering the requests of banks in setting up NBFCs.

Accordingly a Group comprising of CGM-in-C (DBOD), and CGMs, of DBOD, DNBS, and FED was set up to look into the above issues and give its recommendations. The Group held several meetings and deliberated on the entire gamut of the existing regulations and suggested measures to address the above issues.

2. Current Regulatory and Supervisory Framework for NBFCs

The NBFC sector is characterised by its heterogeneity. It is heterogeneous in term of size, business, spread and ownership. There are others which are fairly large. Some of the Indian banks as well as foreign banks have their own non-banking financial companies. RBI presently regulates the NBFCs whether undertaking, exclusively or in combination, the activities of equipment leasing, hire purchase, loaning and investment as their principal business, irrespective of whether they accept public deposits or not.

2. The scheme of regulation of the deposit acceptance activities of the Non-Banking Companies was conceived in the sixties as an adjunct to monetary and credit policy of the country and also to provide an indirect protection to the depositors by insertion in the year 1963, of a new Chapter III B in the Reserve Bank of India Act, 1934. The regulations till 1997 empowered the Reserve Bank of India, only to regulate or prohibit issue of prospectus or advertisement soliciting deposit, collect information as to deposits and to give directions on matters relating to deposits.

3. During the nineties a spurt was observed in the number of non-banking companies and the volume of deposits accepted. Proliferation of institutions both financial and non-financial depending mainly or wholly on deposits from public was viewed with concern by the authorities. Further in the absence of any prudential ceiling, the NBFCs deployed their funds. where they had little experience and expertise as also lent to those sectors with high risks. The resultant high level of NPAs aggravated the liquidity crunch faced by many companies and led to significant failures.

Amendments to RBI Act and New Regulatory Framework

4. Various committees, which went into these aspects, strongly recommended that there should be an appropriate regulatory framework over NBFCs and that more powers should be vested with RBI to regulate NBFCs in a better manner. Chapters III-B, III-C and V of the RBI Act were comprehensively amended in January 1997 for vesting more powers with the RBI and providing, *inter alia*, for minimum entry point norm, compulsory

registration with the Reserve Bank of all existing and newly incorporated NBFCs for carrying on and commencement of financial business. RBI put in place in January 1998 a **new regulatory framework involving prescription of prudential norms for NBFCs, regulation of deposit taking activity to ensure that the NBFCs function on sound and healthy lines and strengthen the financial system of the country.** Regulatory and supervisory attention was focused on NBFCs -D which accept public deposits so as to enable RBI to efficiently discharge its responsibilities to protect the interests of the depositors. The process has helped in ensuring consolidation of NBFC sector as a whole.

5. With the amendment, any company seeking to commence/carry on business of NBFI was required to obtain Certificate of Registration from the Bank under Section 45-IA of the RBI Act, 1934 and also have a minimum Net Owned Fund (NOF) of Rs 25 lakhs. The NOF requirement was increased to Rs 200 lakhs w.e.f. April 21, 1999. While giving registration, an evaluation of the quality of management is undertaken by applying 'fit and proper' norm based on the information furnished by the company in respect of the promoters/directors, bankers' report, report from other regulators like SEBI/IRDA etc. (in case the promoters/directors are involved in activities regulated by these institutions). New Companies are not allowed to raise public deposits for period of two years from the date of registration. For allowing these companies to raise public deposits after a period of two years, detailed appraisal/review is undertaken by the Bank.

Regulations over NBFCs -D

6. Safeguards have been instituted in the regulatory framework for acceptance of public deposits by prescribing detailed regulations covering deposit taking activities of NBFCs. The Bank has prescribed the requirement of minimum investment grade credit rating, limit on the quantum of public deposits, interest rate payable on deposits, brokerage, period of deposits, disclosure norms and requirement to furnish returns on various aspects of the functioning of these companies from time to time. The prudential norms on income recognition, provisioning etc. akin to those applicable to the scheduled

commercial banks have been stipulated which are now mandatory. The Bank has also introduced ALM guidelines for NBFCs for effective risk management.

Residuary Non-Banking Companies (RNBCs)

7. A sub-set of NBFCs which accept deposits from public under the schemes akin to the recurring deposit schemes of the banks and invest them as per direction of the RBI have been classified as RNBCs. For the protection of the depositors' interest, an investment pattern to invest the deposit liabilities in safe and relatively liquid securities in a specified manner has been prescribed for them. With the fine-tuning of regulation and supervision, weak companies have been weeded out and there are only three RNBCs, of which two are prominent RNBCs which are being supervised in a comprehensive manner. In order to impart greater liquidity and safety to the investments of RNBCs and thus enhance protection available to the depositors, RBI has modified and rationalised the directed and discretionary investments to be made by RNBCs. As per the revised guidelines issued on June 22, 2004, RNBCs have to maintain 80% (in addition to 10% liquid assets requirement) of the Aggregate Liabilities of Deposits (ALD) in directed pattern of investment w.e.f April 1, 2005 and 90% (in addition to 10% liquid assets requirement) of ALD as per directed pattern of investments w.e.f April 1, 2006.

Regulations over NBFCs -ND

8. Regulatory attention was focused on the NBFCs accepting/holding public deposits. The companies not accepting public deposits are also regulated albeit in a limited manner. Such companies were earlier not required to furnish any return or information to the Reserve Bank unlike the deposit accepting NBFCs. It is the perception that the lenders in the category of banks, term lending institutions, corporate bodies and others having proper appraisal techniques will be taking adequate precaution for protection of their interests while taking exposure on these entities. As regards the NBFCs -NDs, the exception reports, if any, from the auditors of such companies coupled with adverse market information or sample checking of their operations to determine that these companies have not accepted public deposits and

they continue to be eligible for holding the certificate of registration are the main tools for monitoring the activities of such companies vis-à-vis the RBI Regulations.

Supervisory Model

9. The Bank has instituted a comprehensive supervisory mechanism structured based on four pillars:

(i) On-site inspection
(ii) Off-site returns
(iii) Exception reports submitted by Statutory Auditors
(iv) Market Intelligence

NBFCs-ND

10. Regulation is minimal in respect of, non-deposit taking companies, and they are not required to submit any periodical returns as also balance sheet with certain exception, While prudential norms of asset classification, income recognition and provisioning are applicable, requirement of CRAR and credit/investment concentration norms are not applicable. It is mandatory for the statutory auditors of the NBFCs to report to RBI exceptions if any, in meeting the requirements of provisions and directions issued by RBI.

11. To address the issue of systemic risk, the department had prescribed a monthly return on important financial parameters in respect of NBFCs-ND with asset size of Rs 100 crore and above wherein information in respect of NOF, bank's /FIs exposure towards the NBFC, Capital Market Exposure etc. is obtained from the said NBFCs-ND.

12. ALM system has been put in place for the NBFCs-D having public deposits of Rs. 20 crore and above or those having assets of Rs.100 crore and above, irrespective of deposit size.

3. An analysis of the issues and recommendations

A study of some of the cases received in the departments brought out certain issues relevant to the terms of reference of the group. The various issues analysed in this chapter relate to the following aspects:

(i) Exposure to Capital Markets

(ii) Regulatory arbitrage and NBFC subsidiaries of banks

(iii) Issues relating to level playing field

3.1 Exposure to Capital Markets

Any banking regulator or supervisor would have reasons for concern in case the bank credit is used for speculation in the stock market as it is fraught with risks for the banks. The downward volatility in stock prices can induce defaults by borrowers which can lead to vulnerabilities in one bank and maybe in many others through the contagion effect. One of the routes through which the bank credit can be channelised to the stock market is through NBFCs. The exposure of banks to NBFCs is being regularly monitored by the Department of Banking Supervision. The Department of Non-banking Supervision has also put in place a mechanism for monitoring the Capital Market Exposure of NBFCs as under:

- The NBFCs -ND having assets of Rs 100 crore and above are being monitored on a monthly basis since September 2005.
- The NBFCs -D having public deposits of Rs.50 crore and above are being monitored on a monthly basis.

3.1.1 An analysis of the various issues relating to capital market exposure of NBFCs can be carried out by delineating the various aspects relating to (a) NBFCs-Dand (b) NBFCs-ND, which differ in several respects. Within both the above categories the analysis can be further expanded to include (i) the NBFCs not forming a part of the banking group and (ii) the NBFCs forming a part of the banking group. The details are mentioned below:

(a) NBFCs – D

i) NBFCs not forming a part of the banking group

The CRAR requirements which apply only to the NBFCs -Ds have limiting effect on their leveraging capacity, which in turn restricts the exposure that the NBFCs-D can take in the capital market. The NBFCs-D are also subjected to norms relating to exposure to sensitive sectors such as real estate and unquoted stocks to the extent of 10% of their owned funds. However, they are not subjected to any regulatory ceiling relating to capital market exposure.

ii) NBFCs forming a part of the banking group –

In such NBFCs the exposure to capital market is limited because of the ceiling prescribed for the exposure to capital market of the entire group which can not exceed 2% of the on-balance sheet assets of the group under the system of consolidated supervision.

Internationally, some regulators prescribe a ceiling on the level of transactions that a bank can have with its affiliates. The Federal Reserve has a rule which mentions that[1] " Section 23A (of the Federal Reserve Act) prohibits a bank from initiating a "covered transaction" with an affiliate if, after the transaction, (i) the aggregate amount of the bank's covered transactions with that particular affiliate would exceed 10 percent of the bank's capital stock and surplus, or (ii) the aggregate amount of the bank's covered transactions with all affiliates would exceed 20 percent of the bank's capital stock and surplus. Covered transactions include *loans and other extensions of credit to an affiliate, investments in the securities of an affiliate, purchases of assets from an affiliate, and certain other transactions that expose the bank to the risks of its affiliates*. A bank's capital stock and surplus is defined in section 223.3(d) of Regulation as the sum of the bank's tier 1 and tier 2 capital under the risk-based capital guidelines, plus the balance of the allowance for loan and lease losses not included in tier 2 capital, based on the bank's most recent Call Report. The amount of any investment by the bank in a financial subsidiary that counts as a covered transaction and is required to be deducted from regulatory capital is added back for purposes of calculating capital stock and surplus for purposes of section 23A."

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[1] Extracts taken from "Appendix – Comprehensive Review of Regulation W" attached to SR 03-2 January 9, 2003 issued by Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington, DC.

The Working Group on Monitoring of Financial Conglomerates (Chairperson Smt Shyamala Gopinath, Dy. Governor) had considered prescribing ceilings for intra-group transactions and exposures (ITEs) for bank related financial conglomerates. It suggested, to begin with, monitoring of such transactions above cut-off levels for fund-based and non-fund based transactions.

This issue was also deliberated upon by this Group. The Group is in agreement with the approach of the Working Group on Monitoring of Financial Conglomerates and recommends that the existing arrangement for monitoring of ITEs through quarterly reports for financial conglomerates should be continued. Suitable prudential ceilings on ITEs for bank's exposure on Group entities may be prescribed in tune with the international best practice after sufficient database is built up.

3.1.2 The NBFCs -Ds, part of a banking group or not , need to be regulated and supervised on more or less similar lines as banks to eliminate any regulatory arbitrage. In this connection, 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, " 'Banklike' financial institutions should be supervised like banks."

3.1.3 The regulatory parity between banks and NBFCs -Ds has been established to a large extent after introduction of a comprehensive regulatory regime for such companies since 1997 by way of introduction of requirements relating to SLR, creation of statutory reserve, prudential norms, CRAR etc. As per the available data, the capital market exposures of such companies are rather low, not warranting any supervisory concern.

3.1.4 However, unlike in the case of banks there is no stipulated ceiling for capital market exposure in respect of NBFCs -Ds. Therefore, to have a regulatory parity among the deposit taking financial institutions, there is a need for prescribing regulatory ceiling relating to capital market exposure of the NBFCs -Ds. In this context, it may be added that the norm of ceiling on capital market exposure should not be made applicable to the investment companies whose principal business is investment. However, it would be essential to limit the permissible bank financing for the permitted

activities to ensure that the bank funds do not facilitate their taking very large capital market exposures as it may jeopardize the safety of bank funds.
As regards the stock broking NBFCs, banks are permitted to provide need based credit against shares and debentures held by them as stock in trade. Such bank financing is reckoned towards bank's Capital Market Exposure.
As regards the Investment companies, they are not eligible for bank finance for their Capital Market Activity. In terms of the current instructions, investments of NBFCs both of current and long term nature in any company/entity by way of shares, debentures etc are activities not eligible for bank credit. The exception to this rule is that SPVs which satisfy certain conditions as laid down in circular DBOD.BP.BC.83/21.04.137/2002-2003 dated 21st March 2003 are eligible for bank finance for PSU disinvestments of Government of India. Such SPVs are however not treated as Investment Companies and therefore are not considered as NBFCs. Further, at present SPVs set up as holding companies are not allowed to be financed by banks for the purpose of investing in the equity of other companies.

Keeping in view the above position and the need to limit bank finance to Investment Companies and Stock Broking companies (deposit taking and otherwise) no Capital Market Exposure limits are proposed for them. The Group recommends that all bank finance (advances + investment) to these companies should be reckoned towards bank's Capital Market Exposure except where the bank finance is for financing of SPV's participation in PSU disinvestments of GOI or where SPV is a holding company and bank finance is to fund the holding company's investment in the equity of companies exclusively engaged in infrastructure activities.

As per the existing guidelines banks cannot lend against the security of shares, debentures and PSU bonds to an individual, more than Rs. 10 lakhs (Rs. 20 lakhs if the securities are held in dematerialized form). Such a norm has not been prescribed for the NBFCs -Ds. The Group recommends that the above guidelines for banks regarding ceiling on finance to individuals may be prescribed for NBFCs -Ds.

3.1.5 The following approach can be adopted for the NBFCs -NDs:

(b) Non-deposit taking NBFCs

Unlike in the NBFCs -Ds there are no norms regarding exposure to sensitive sectors such as real estate and unquoted stocks for the NBFCs -NDs. There is no capital market exposure ceiling also prescribed for the NBFCs -NDs. In case the NBFCs -ND is a part of the banking group the leveraging capacity gets restricted because of application of CRAR and other prudential norms on a group wide basis. In case of the NBFCs -NDs not forming a part of the banking group, there is a potential for high leverage as the norms relating to CRAR etc. are also not applicable to them. It is observed that some NBFCs -NDs are mobilizing large funds through issue of commercial papers (CP) thereby leveraging their balance sheet to a considerable extent. In respect of foreign owned non-deposit taking companies NBFCs, the rating agencies attach a lot of weight to the strength of the parent and thus they are able to borrow through CPs at large multiple of owned funds. Moreover although CPs and other bonds issued by NBFCs -NDs are unsecured, they are not subject to any kind of limits either under the Companies Act or under the RBI Act. Additionally, while for FIs there is a overall cap on their borrowings i.e., umbrella limit, there is no such limit on the total borrowings by the NBFCs. Though the borrowings of NBFC is capped to some extent by the limit stipulated by the rating agencies it has not been very effective in containing leverage particularly for foreign owned NBFCs as discussed earlier. Therefore there is a need for looking into the issue of NBFCs availing advantage of raising very large amount of CPs and playing in capital market. The Group felt that the following options could be explored viz. i) treating commercial paper as a public deposit and ii) introduce capital adequacy ratio requirements forNBFCs -NDs to limit the leverage of capital funds and (iii) stipulate a gearing ratio i.e. borrowing as a multiple of capital funds as in the case of DFIs. However, if these are not considered feasible the Group is of the view that the objective could be pursued through a supervisory process both by DBS and DNBS. The banks lending to NBFC through CPs may be monitored by DBS. Similarly, DNBS may put in place an appropriate supervisory watch on the NBFCs and appropriate supervisory review process may be initiated.

In tune with the above recommendation, the DNBS may carry out an analysis of the monthly return being submitted by theNBFCs -NDs. Based upon the analysis done if a high leverage or higher borrowing from the banking system or a higher capital market exposure is observed, appropriate supervisory actions may be triggered by the DBS jointly with DNBS.

3.1.6 In view of the above, the Group recommends that in respect of the flow of bank funds to the capital market through the NBFCs -NDs it may be necessary to take one of the approaches mentioned below-

(i) There is a need for containing the leveraging capacity of the NBFCs -NDs. The NBFCs can be subjected to a norm relating to their capacity to leverage by prescribing an acceptable debt equity ratio . To begin with, these norms may be made applicable to *all NBFCs -Ds* and *systemically important NBFCs -NDs with asset size of Rs.100 crore and above*.

(ii) If detailed regulation for the NBFCs -NDs is not to be prescribed, the systemic concerns that may arise would have to be addressed by making suitable modifications to the regulatory prescription relating to banks' exposure to capital market. This can be done in the following manner:

(a) RBI may consider imposing a limit on the extent of bank finance that can be extended to a NBFCs -ND. This limit could be fixed at a certain percentage of the total capital of the bank. Alternatively banks may not be permitted to take exposure on NBFCs if NBFCs debt equity ratio is larger than an acceptable level.

(b) The entire exposure of a bank to the NBFCs -ND could be treated as a part of the capital market exposure of the bank. This may not sound logical. However, the recommendation is based on the premise that money is fungible. The bank finance availed by the NBFC can be used for business purposes and the "owned funds" of the NBFC can be channelised to the capital market. Thus, although the bank finance is not directly diverted to the capital market, the availability of bank finance enables the NBFC to play in the capital market apparently using its own funds.

(c) RBI may carry out a supervisory review of the banks which have a significant exposure to the highly leveraged NBFCs. The supervisory review should specifically

examine the adequacy of the bank's internal control mechanisms to address the risks undertaken and whether there is a need to mandate additional capital requirements in case the internal controls are found to be inadequate or ineffective.

The observations made in paragraph 3.1.5.(b) may also be seen in connection with the supervisory review process.

3.1.7 It is important to have a clear cut definition of the exposure to capital market for banks and NBFCs.

3.1.8 The Group recommends that the Department of Banking Supervision should continue to obtain information relating to the exposure of banks to non-banking financial companies – both funded and non-funded exposures. In order to ensure that the supervisory resources are not too thinly spread, the monitoring may be restricted to NBFCs which are having an asset size of Rs. 100 crores and above. Such NBFCs can be treated as systemically important and therefore subjected to the monitoring mentioned above. Any spurt in the banks exposure to NBFCs should be carefully analysed so as to ascertain whether the resources are flowing to the capital market through the NBFC route.

3.1.9 The monitoring of exposure taken in the capital market by entities which are regulated by SEBI or IRDA, etc. has to be carried out by obtaining the information in this regard from the respective regulator such as SEBI or IRDA as the case may be. This would require a greater degree of co-ordination and information sharing between RBI and the other regulators such as SEBI or IRDA, etc.

3.1.10 The Group is of the view that it is important to define exposures which can be treated as systemic in nature. For this purpose, systemic exposure is defined as one where the exposure to another regulated entity is more than a prescribed level of the assets of that entity. Special monitoring mechanisms have to be put in place wherever the exposures are treated as being systemic in nature. Monitoring of systemic exposures of banks to NBFCs may not be difficult as the banks as well as a good chunk of NBFCs are regulated and supervised by RBI.

3.1.11 In case of systemic exposure of a particular bank to an entity which is regulated by SEBI or IRDA, details of such exposure can be called for from the bank. However, it is possible that the threshold of 5% as defined above may be due to exposure of several banks on one SEBI or IRDA regulated entity. In such cases, RBI may have to co-ordinate closely with SEBI or IRDA in order to monitor such systemic exposures.

3.2 Regulatory arbitrage and NBFC subsidiaries of banks (domestic or foreign) with branch presence in India

The banks may setup NBFC subsidiaries to benefit from regulatory arbitrage. A bank's NBFC subsidiary which grants retail loans such as consumer loans, vehicle loans, housing loans etc. coupled with a bank ATM can circumvent the branch authorization restrictions imposed on the bank by extending its outreach substantially. The customer can deposit or withdraw cash at the bank ATM, obtain a loan from the NBFC and make repayments into the loan account by using the bank ATM. Thus, the bank together with its NBFC subsidiary can perform more or less all the functions which a bank branch undertakes.

3.2.1 The foreign banks may adopt the NBFC route instead of the bank subsidiary/branch route to take advantage of different regulatory prescriptions for the banks and the NBFCs. This leads to regulatory arbitrage because of the following:

i) The NBFCs -NDs are exempted from CRAR requirement.

ii) The NBFCs-NDs are exempt from credit and investment concentration norms.

iii) The Non-deposit taking NBFCs are not subject to restrictions on investment in land and building and unquoted shares.

iv) The NBFCs-NDs are subject to less supervisory rigour in the sense that normally they are not subjected to any inspection.

v) The banks with a limited branch network may find the NBFC route as convenient for business expansion by circumventing the branch licensing requirements.

vi) The foreign bank sponsored NBFCs generally have a high credit rating such as AAA, etc. which enables it to raise low cost debt resources with ease. This obviates the need for further infusion of funds by the parent for their activities in India.

3.2.2 In order to address some of the above issues, the Group notes that the application of the framework of consolidated supervision to the parent bank and its NBFC subsidiary should be adequate as the prudential requirements on a group level cover the areas of capital adequacy, single and group borrower norms and exposure to capital markets. The Group recommends that the framework of consolidated supervision may be applied even in the case of a NBFC promoted by a foreign bank under the Automatic route and the branch of that foreign bank, even though the parent subsidiary relationship does not exist between the NBFC and the branch.

3.2.3 In order to address the issues relating to branch authorization, the Group recommends that while examining the proposals for branch authorization of banks, one of the factors which may be considered should be the presence of the bank's NBFC subsidiary at various centres.

3.2.4 Regulatory arbitrage : NBFC subsidiaries set up by foreign banks not having any presence in India

Even though the group concept can be applied to the structure relating to an "Indian bank parent and its NBFC subsidiary" or "a foreign bank with branches in India and its NBFC subsidiary" it is not possible to apply group concept in case of a NBFC subsidiary set up by a foreign bank without any branch presence in India. In the above situation, the foreign bank is not subjected to the regulation of RBI. The Group, however, notes that this constraint can be reasonably addressed by the various recommendations relating to deposit taking and NBFCs -NDs.

3.3 **Level playing field between (i) NBFCs set up by Indian banks and foreign banks and (ii) Bank sponsored NBFCs and non-bank sponsored NBFCs**

There is a lack of level playing field between NBFCs set up by foreign banks and those set up by Indian banks. To illustrate, Asset Management Companies floated by foreign banks (without a branch presence in India) can offer discretionary portfolio management services as it is permitted under the SEBI Regulations. The asset management company set up by an Indian bank or by a foreign bank operating in India, is not

permitted to offer Portfolio Management Services on a discretionary basis unless specifically authorised by RBI to do so.

3.3.1 There is a lack of level playing field between the NBFC subsidiary of a bank and a NBFC which is not a bank subsidiary. In terms of the RBI regulations, the Asset Management Companies set up by banks are not permitted to offer Portfolio Management Services on a discretionary basis. The Asset Management Companies which are not sponsored by banks can offer Portfolio Management Services on a discretionary basis as the same is permitted under SEBI Regulations.

3.3.2 Another interesting aspect is that although the Department of Banking Operations & Development prohibits bank subsidiaries from carrying out discretionary PMS, the Internal Debt Management Department permits the Primary Dealers, which are also bank subsidiaries to offer PMS services subject to certain conditions as laid out in the circular no. IDMD. PDRS. 1/03.64.00/2005-2006 dated July 12, 2005.

3.3.3 In view of the irregularities observed in the securities transactions of banks, the general powers given to banks and their subsidiaries to operate PMS and similar schemes were withdrawn and banks were advised to approach RBI for offering the scheme in terms of the circular DBOD.No.BC.73/27.07.001/94-95 dated June 7, 1994. Banks were advised not to restart or introduce any new PMS or similar scheme in future without obtaining specific prior approval of RBI. Due to the concerns on account of 'holding out' risk, the risk of contagion spreading from the subsidiary to the bank, and the moral hazard that may manifest, RBI has not permitted the banks and their subsidiaries to carry out PMS activities.

3.3.4 The Group recommends that in order to ensure a level playing field the bank subsidiaries may also be permitted to undertake activities such as discretionary PMS etc. which are permissible for the other SEBI regulated entities to undertake. This however should be subject to the banks concerned having satisfactory controls in place to be able to contain any adverse effect on them through the activities of their subsidiaries.

3.4 Regulatory arbitrage arising out of diversification of NBFCs -NDs into activities not coming in the permitted list for FDI under Automatic Route.

In respect of foreign NBFCs, FDI is permitted under the Automatic route in 19 specified activities subject to compliance with the Minimum Capitalization norms.

The Group felt that we may need to clarify that once an NBFC is established with the requisite capital under FEMA, subsequent diversification either through the existing company or through downstream NBFCs would be permitted only in the 19 permitted activities under the Automatic route. Diversification into any other activity would be permitted with 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.

4. Summary of Recommendations

The recommendations of the group are given below:

1. The Group is in agreement with the approach of the Working Group on Monitoring of Financial Conglomerates and recommends that the existing arrangement for monitoring of ITEs through quarterly reports for financial conglomerates should be continued. Suitable prudential ceilings on ITEs for bank's exposure on Group entities may be prescribed in tune with the international best practice after sufficient database is built up.
(paragraph 3.1.1 (a) (ii))

2. The Group recommends that all bank finance (advances + investment) to Investment Companies and Stock Broking companies should be reckoned towards bank's Capital Market Exposure except where the bank finance is for financing of SPV's participation in PSU disinvestments of GOI or where SPV is a holding company and bank finance is to fund the holding company's investment in the equity of companies exclusively engaged in infrastructure activities.
(paragraph 3.1.4)

3. As per the existing guidelines banks cannot lend against the security of shares, debentures and PSU bonds to an individual, more than Rs. 10 lakhs (Rs. 20 lakhs if the securities are held in dematerialized form). Such a norm has not been prescribed for the NBFCs -Ds. The Group recommends that the above guidelines for banks regarding ceiling on finance to individuals may be prescribed for NBFCs -Ds. (paragraph 3.1.4)

4. The Group felt that there is a need for looking into the issue of NBFCs availing advantage of raising unlimited amount of CPs and playing in capital market. The Group felt that the following options could be explored viz. i) treating commercial paper as a public deposit. and ii) introduce capital adequacy ratio requirements for NBFCs -NDs to limit the leverage of capital funds and (iii) stipulate a gearing ratio i.e. borrowing as a multiple of capital funds as in the case of DFIs. The Group is of the view that the objective could alternatively be pursued through a supervisory process both by DBS and DNBS. The banks lending to NBFC through CPs may be monitored by DBS.

Similarly, DNBS may put in place an appropriate supervisory watch on the NBFCs and appropriate supervisory review process may be initiated.
(paragraph 3.1.5).

5. The Group recommends that in respect of the flow of bank funds to the capital market through the NBFCs -NDs it may be necessary to take one of the approaches mentioned below-

(i) The NBFCs can be subjected to a norm relating to their capacity to leverage by prescribing a debt equity ratio of an acceptable level.. To begin with, these norms may be made applicable to all N*BFCs -Ds* and *systemically important* NBFCs -NDs *with asset size of Rs.100 crore and above*.

(ii) Capital Adequacy Ratio requirement for NBFCs -NDs may be stipulated to limit the leveraging of capital funds.

(iii) If as has been considered by BFS, detailed regulation for the NBFCs -NDs is not to be prescribed, the systemic concerns that may arise would have to be addressed by making suitable modifications to the regulatory prescription relating to banks' exposure to capital market.

This can be done in the following manner:

(a) RBI may consider imposing a limit on the extent of bank finance that can be extended to a NBFCs -ND. This limit could be fixed at a certain percentage of the total capital of the bank. Alternatively banks may not be permitted to take exposure on NBFCs if NBFCs debt equity ratio is larger than an acceptable level.

(b) The entire exposure of a bank to the NBFCs -ND could be treated as a part of the capital market exposure of the bank. This may not sound logical. However, the recommendation is based on the premise that the money is fungible. The bank finance availed by the NBFC can be used for business purposes and the "owned funds" of the NBFC can be channelised to the capital market. Thus, although the bank finance is not directly diverted to the capital market, the availability of bank finance enables the NBFC to play in the capital market apparently using its own funds.

(c) RBI may carry out a supervisory review of the banks which have a significant exposure to the NBFCs. The supervisory review should specifically examine the

adequacy of the bank's internal control mechanisms to address the risks undertaken and whether there is a need to mandate additional capital requirements in case the internal controls are found to be inadequate or ineffective.

6. It is important to have a clear cut definition of the exposure to capital market for banks and NBFCs.
(paragraph no. 3.1.7.)

7. The Group recommends that the Department of Banking Supervision should continue to obtain information relating to the exposure of banks to non-banking financial companies – both funded and non-funded exposures. In order to ensure that the supervisory resources are not too thinly spread, the monitoring may be restricted to NBFCs which are having an asset size of Rs. 100 crores and above. Such NBFCs can be treated as systemically important and therefore subjected to the monitoring mentioned above. Any spurt in the banks exposure to NBFCs should be carefully analysed so as to ascertain whether the resources are flowing to the capital market through the NBFC route.
(paragraph no. 3.1.8)

8. The monitoring of exposure taken in the capital market by entities which are regulated by SEBI or IRDA, etc. has to be carried out by obtaining the information in this regard from the respective regulator such as SEBI or IRDA as the case may be. This would require a greater degree of co-ordination and information sharing between RBI and the other regulators such as SEBI or IRDA, etc.
(paragraph no. 3.1.9)

9. The Group is of the view that it is important to define exposures which can be treated as systemic in nature. For this purpose, systemic exposure is defined as one where the exposure to another regulated entity is more than prescribed level of the assets of that entity. Special monitoring mechanisms have to be put in place wherever the exposures are treated as being systemic in nature. Monitoring of systemic exposures of banks to

NBFCs may not be difficult as the banks as well as a good chunk of NBFCs are regulated and supervised by RBI.
(paragraph no. 3.1.10)

10. In case of systemic exposures of a particular bank to an entity which is regulated by SEBI or IRDA, details of such exposure can be called for from the bank. However, it is possible that the threshold defined may be due to exposure of several banks on one SEBI or IRDA regulated entity. In such cases, RBI may have to co-ordinate closely with SEBI or IRDA in order to monitor such systemic exposures.
(paragraph 3.1.11)

11. In order to address issues relating to regulatory arbitrage, the Group is of the view that the application of the framework of consolidated supervision to the parent bank and its NBFC subsidiary should be adequate as the prudential requirements on a group level cover the areas of capital adequacy, single and group borrower norms and exposure to capital markets. The Group recommends that the framework of consolidated supervision may be applied even in the case of a NBFC promoted by a foreign bank under the automatic route and the branch of that foreign bank, even though the parent subsidiary relationship does not exist between the NBFC and the branch.
(paragraph 3.2.2)

12. The Group recommends that while examining the proposals for branch/ATM authorization of banks, one of the factors which may be considered should be the presence of the bank's NBFC subsidiary at various centres.
(paragraph 3.2.3)

13. The Group felt that it is not possible to apply group concept in case of a NBFC subsidiary set up by a foreign bank without any branch presence in India. In the above situation, the foreign bank is not subjected to the regulation of RBI. The Group,

however, notes that the constraint can be reasonably addressed by the various recommendations relating to deposit taking and NBFCs -NDs.
(paragraph 3.2.4)

14. The Group recommends that in order to ensure a level playing field the bank subsidiaries may also be permitted to undertake activities such as discretionary PMS etc. which are permissible for the other SEBI regulated entities to undertake. This however should be subject to the banks concerned having satisfactory controls in place to be able to contain any adverse effect on them through the activities of their subsidiaries.
(paragraph 3.3.4)

15. The Group felt that RBI may need to clarify that once an NBFC is established with the requisite capital under FEMA, subsequent diversification either through the existing company or through downstream NBFCs would be permitted only in the 19 permitted activities under the automatic route. Diversification into any other activity would be permitted with 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.
(paragraph 3.4)