Report of the Working Group on Extension of Insurance Cover to the Deposits of Non-Banking Financial Companies

Reserve Bank of India

Department of Non-Banking Supervision
Central Office
Mumbai

May 2003

CR 613

कार्यपालक निदेशक
EXECUTIVE DIRECTOR

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RESERVE BANK OF INDIA
CENTRAL OFFICE,
DEPT. OF NON-BANKING SUPERVISION,
CUFFE PARADE, COLABA, MUMBAI - 400 005.

Ref. DNBS.CO.No. 842 / 02.71 / 2002-03

May 21, 2003

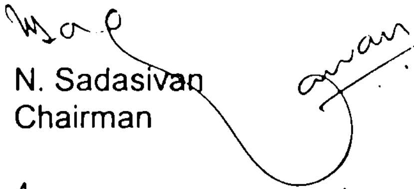
Shri G.P. Muniappan,
Deputy Governor,
Reserve Bank of India,
Central Office,
Mumbai.

Dear Sir,

Extension of insurance cover to deposits of NBFCs - Report of the Working Group

We are pleased to forward herewith the report of the Working Group on Extension of Insurance Cover to the deposits of Non-Banking Financial Companies (NBFCs). We wish to express our sincere thanks to the Bank for having given us an opportunity to be associated with the Working Group.

Yours faithfully,



N. Sadasivan
Chairman

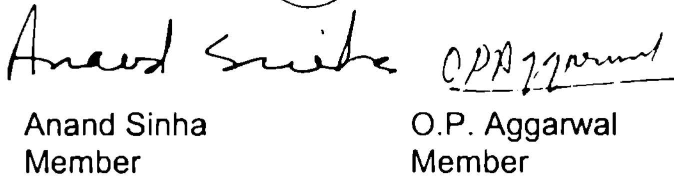


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Table of Contents

Chapter No.	Contents
1.	**Introduction**
	Constitution of the Working Group
	Terms of Reference
	Methodology
2.	**Views of the previous Working Groups / Committees**
	Shere Committee (1997)
	Committee on Banking Sector Reforms (1998)
	Task Force on NBFCs (Vasudev Committee – 1998)
	Committee on Reforms in Deposit Insurance in India (Jagdish Capoor Committee – 1999)
	Summary
3.	**Business and risk profile of the NBFC sector**
	Business profile
	Distribution of Deposits
	Macro Prudential Indicators of NBFCs
	Aggregated Capital Ratios
	Capital Ratio ranges
	Non-Performing Advances Ratios
	Summary
4.	**Need for and viability of insurance cover for deposits of NBFCs**
	Historial Background
	The Regulatory and Supervisory Framework for NBFCs
	Compulsory Registration of NBFCs
	Implementation of Prudential Norms
	Shortcomings / Weaknesses observed in the NBFC sector
	Differences in NBFC Regulation vis-à-vis Regulations for Banks
	Should there be complete harmony in regulation of NBFCs & Banks
	Risk Profile of NBFCs
	The Role of Deposit Insurance

	Moral Hazard Issues	22
	NBFCs and Deposit Insurance	26
	International best practices on providing deposit insurance to NBFIs	28
	Summary & Conclusion	29

Abbreviations used

AMFI	Association of Mutual Funds of India
B.R. Act	Banking Regulations Act
CEO	Chief Executive Officer
CLB	Company Law Board
CRAR	Capital to Risk Weighted Assets Ratio
DICGC	Deposit Insurance and Credit Guarantee Corporation
DNBS	Department of Non-Banking Supervision
FEDAI	Foreign Exchange Dealers' Association of India Ltd.
FIMMDA	Fixed Income Money Market and Derivatives Association of India
JPC	Joint Parliamentary Committee
MI Cell	Market Intelligence Cell
NBFCs	Non-Banking Financial Companies
NBFI	Non-Banking Financial Institution
NOF	Net Owned Fund
NPA	Non Performing Advances
RNBCs	Residuary Non-Banking Companies
SLR	Statutory Liquidity Ratio
SROs	Self Regulatory Organisation
TBTF	Too Big to Fail

CHAPTER-1

Introduction

1.1 Deposit insurance is an integral component of an effective financial safety net. The principal objective of deposit insurance system is to contribute to the stability of the country's financial system and protect less-financially-sophisticated depositors from the loss of their deposits. The first formal system of deposit insurance was established in the U.S. in 1934 with the purpose of preventing the extensive bank runs that contributed to the Great Depression. Other countries, even those where bank distress had accompanied the depression, did not follow this lead, and it was not until the Post-War period that deposit insurance began to spread outside the U.S. The 1980's saw acceleration in the diffusion of deposit insurance, with most OECD countries and an increasing number of developing countries adopting some form of explicit depositor protection. In 1994, deposit insurance became the standard for the newly created single banking market of the European Union.

1.2 In India, successive bank failures in the 50's and more particularly the liquidation of the Palai Central Bank Ltd. and the Lakshmi Bank Ltd. in 1960 led to the erosion of public confidence in the banking system. The Reserve Bank of India, entrusted with the responsibility of sound banking system, was seriously concerned over the developments and the prime need of the hour was restoration of public confidence. As a result, an Act of Parliament established the Deposit Insurance Corporation on January 1, 1962 for the purpose of providing insurance cover to the depositors, particularly small depositors, against the risk of loss arising out of bank failures. At the time of introduction, Deposit Insurance was available only to the deposits with commercial banks. However, pursuant to an amendment to the Deposit Insurance and Credit Guarantee Corporation (DICGC) Act[1] in 1968, insurance cover was also extended in respect of deposits with an "eligible cooperative bank", a co-operative bank in respect of which an order for the winding up, compromise or arrangement or of amalgamation or reconstruction, may be made only with the previous sanction of the Reserve Bank and the respective state legislation also provides enabling powers to Reserve Bank for supersession of the committee of management or other managing body and appointment of an administrator by the Bank, in the public and depositors' interest.

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[1] *Name changed to Deposit Insurance and Credit Guarantee Corporation in January 1971 after introduction of a scheme of credit guarantee for priority sector advances.*

1.3 At the time of introduction, the insurance cover i.e., the total amount payable by the corporation to any one depositor in respect of his deposit in that bank, in the same capacity and in the same right, was not to exceed one thousand and five hundred rupees. However the DICGC Act also provided that the Corporation may, from time to time, having regard to its financial position and to the interest of the banking system of the country as a whole, raise the aforesaid limit of one thousand and five hundred rupees. Accordingly, the insurance limit was enhanced from time to time and the last enhancement was from Rs. 30,000 to the present limit of Rs 1 lakh with effect from May 1, 1993. Every insured bank is liable to pay a premium to the Corporation on its deposits at such rate or rates (not to exceed fifteen paise per rupees hundred of Assessable Deposits) as notified by the Corporation, from time to time. Presently, the Corporation charges a premium of five paise per rupees hundred of Assessable Deposits (i.e., total deposits less deposits not eligible for insurance)

1.4 Since the late 90's there have been deliberations about providing some kind of insurance cover to the deposits of Non-Banking Financial Companies (NBFCs) and several Committees / Working Groups have examined the matter. The recommendations of these Committees are discussed in brief in Chapter 2 of this report. The Shere Committee (1997), and the Vasudev Committee (1998) which went into this aspect, advised against extending deposit insurance to the non-banks on the ground of moral hazards, among others. In fact, the Committee on Banking Sector Reforms, 1998 under the chairmanship of Shri M. Narsimham also endorsed this view. The issue was also examined by the Capoor Committee on Reforming the Deposit Insurance System (1999), which inter alia, opined that it was premature then to extend insurance to deposits of NBFCs and the matter may be reviewed later after 2 years. Accordingly, in January 2002, DICGC had reviewed the matter and did not consider it feasible to provide any insurance coverage to NBFC deposits. Recently, the Joint Parliamentary Committee (JPC) for stock market scam, while reviewing the protection to depositors of NBFCs in the wake of demand from the small investors and Investors' Associations, have made the following recommendation about providing insurance coverage to NBFC deposits :

The Committee notes that at present insurance coverage from the Deposit Insurance and Credit Guarantee Corporation (DICGC) is available to depositors in Co-operative Banks. The Committee suggests that the feasibility of extending a similar scheme to depositors in NBFCs may be examined. The amount of insurance coverage, which stands at Rs 1 lakh at present, also needs to be raised at least to the level of Rs 2 lakh. (Excerpt from para 14.64)

1.5 Against the above backdrop, the Bank set up on February 7, 2003 an internal Working Group to look into the aspects relating to the need and feasibility of extending insurance cover to the depositors of NBFCs.

Constitution of the Working Group

1.6 The members of the Working Group are as under :

	S/Shri	
1.	N. Sadasivan, ED, Chairman	Chairman
2.	Anand Sinha, CGM, DICGC, Head Office	Member
3.	O.P. Aggarwal, CGM, DNBS, CO	Member
4.	C.C. Mitra, GM, DNBS, CO	Member Secretary

Terms of Reference

1.7 The terms of reference of the Working Group are as under :

1. Examine the need and feasibility of extending insurance cover to the depositors of NBFCs;
2. If found feasible, suggest the
   - (i) types of NBFCs to be covered;
   - (ii) types of deposits and depositors to be covered for insurance;
   - (iii) amount of deposits up to which insurance cover can be extended;
   - (iv) different structures of risk based premium and the parameters relevant for assessment of risk as also to suggest whether the insurance premium should be borne by the NBFC or the depositor;
   - (v) the regulatory systems to be put in place as a prerequisite for extension of the Deposit Insurance;
   - (vi) the institutions which will offer the deposit insurance;
3. Any other related issues.

Methodology

1.8 The Group held several meetings to deliberate on the terms of reference to crystalise its views and examine various connected issues. The risk profile of NBFCs sector and the inherent weaknesses were analysed in detail. The Group also assessed the extant supervisory and regulatory initiatives taken by the Bank after comprehensive amendment to RBI Act in 1997 giving incremental powers to the Bank. The need of regulatory parity vis-à-vis banks and the extent thereof were examined keeping in view the role of NBFCs in the financial sector. The systemic importance of the NBFC sector was weighed to assess the need of providing a deposit insurance cover to NBFCs for ensuring stability of the financial sector. The issues of moral hazard and market discipline were analysed and the viability considerations were also examined. The international best practices in this regard were studied. The Group also studied in depth the recommendations made by the various Groups / Committees on the issue. The Group also considered the various representations made to Reserve Bank and the Government of India by the Industry Associations and various Depositors' Fora on the subject. As their submissions on the subject were well known, the Group did not consider it necessary to have any fresh interface sessions with them.

Thus, on the whole, while analysing the issue, the Group adopted a multi-dimensional holistic approach instead of just being guided by uni-dimensional approach of providing a protection measure to the depositors of NBFCs by way of deposit insurance.

CHAPTER-2

Views of the previous Working Group / Committees

2.1 As brought out in introductory chapter of the report, the issue relating to the need and feasibility of providing insurance cover to the depositors of NBFCs have been examined by several Committees / Working Groups since 1996. Their recommendations are briefly discussed hereunder.

(i) Shere Committee (1997)

2.2 A Working Group constituted with Smt. K. S. Shere, the then Principal Legal Advisor as the Chair-person, looked into the aspects of creation of separate instrumentality for regulation and supervision of Residuary and other NBFCs and extension of deposit protection scheme for the deposits of such companies. The Group was constituted against the backdrop of the landmark judgement of the Hon'ble Supreme Court (AIR 1996 S. C. 646) dated January 4, 1996, wherein the Hon'ble Supreme Court had, inter alia, exhorted the Union Government to consider whether it would be advisable to create a separate instrumentality for regulating and supervising the RNBCs. The Hon'ble Supreme Court in its judgement while underscoring the need for adequate protection for the depositors of RNBCs / NBFCs also suggested for examination as to whether a Depositor Protection Scheme on the lines of the U K Act could be introduced in India. The concern obviously stemmed from the fact that these companies and other NBFCs had acquired large resources including public deposits for their operations. The Group submitted the report in August 1997.

2.3 The Group had opined that insurance for bank deposits could be introduced in India in 1961 under the Deposit Insurance Corporation Act after 12 years from the enactment of B.R. Act, 1949 which encompassed all aspects of functioning of banking institutions and similar protection to the depositors of NBFCs would be feasible only after a comprehensive legislative framework on the lines of B.R. Act, and an effective supervisory system are put in place to ensure functioning of NBFCs on sound and healthy lines. Earlier expert groups also observed on the same lines.

2.4 The Group while recognising the need for insurance cover also shared the views of the earlier expert groups and considered that the process of consolidation of the NBFCs had just started. Once all the regulatory measures introduced recently including prudential and capital adequacy norms are implemented, a comprehensive supervisory framework which was being installed, is operationalised and several built-in and operational safeguards provided in the enactment are enforced, a deposit insurance scheme, for only registered and rated NBFCs complying with all the regulatory and supervisory norms, may be introduced after a period of six years. The Group suggested that the status of the insurance agency and detailed modalities of the insurance scheme might be decided at the relevant time.

2.5 The Group was further of the view that the deposits in the form of only the term deposits and recurring deposits received by NBFCs from members of public should be eligible for insurance cover and the main concern should be the protection of deposits of individual depositors especially the small depositors who are exposed to risk due to the ignorance and vulnerability arising out of asymmetry of information and lack of market discipline. The institutional or corporate depositors / lenders / investors need not come under the insurance cover. Deposits from shareholders, directors and their associate concerns should also be outside the purview of the deposit insurance scheme.

2.6 Before introduction of an insurance scheme, the Group recommended fulfilment of certain pre-requisites such as strict enforcement of registration and prudential norms, clear definition of public deposit, enforcement of regulatory framework in letter and spirit, compulsory rating of deposit taking companies, strict enforcement of regulations relating to payment of brokerage / out-of-pocket expenses, enlargement of disclosure requirements, wide publicity for depositors' education and setting up of SROs, etc.

(ii) Committee on Banking Sector Reforms (1998)

2.7 The Government of India appointed a committee on Banking Sector Reforms under the Chairmanship of Shri M. Narasimham which submitted its report on April 22, 1998. The Committee amongst others also deliberated on regulatory and supervisory mechanisms for NBFCs. The Committee observed that deposit insurance for NBFCs could blur the distinction between banks, which are much more closely regulated, and the non banks as far as safety of deposit is concerned, and consequently could lead to a serious moral hazard problem and adverse portfolio

selection. Therefore the Committee concluded against any insurance of deposits with NBFCs.

(iii) Task Force on NBFCs (Vasudev Committee-1998)

2.8 The Government of India appointed a Task Force on NBFCs under the Chairmanship of Shri C. M. Vasudev, the then Special Secretary (Banking), Ministry of Finance to examine the inadequacies in law and to suggest the changes in statutory and regulatory framework so as to suggest the changes in law and to enhance the protection available to depositors as also to deal with the delinquent NBFCs. On matter relating to deposit insurance the Committee had reported that it would not be judicious to introduce a deposit insurance scheme for the depositors in NBFCs because of the moral hazard issues, likelihood of asset stripping and the likely negative impact on the growth of a healthy NBFC sector. The Task Force also found the global experience in this regard not instructive. The report added that since it had suggested that the depositors would have a first pro rata charge on the SLR deposits of the NBFCs, an element of comfort would become available for such depositors. It also reiterated the Shere Working Group's prescription that the ultimate insurance must necessarily be a transparent system, better disclosures, better prudential norms, effective regulation and supervision and decision making by informed investors who are in position to balance risk and returns.

(iv) Committee on Reforms in Deposit Insurance in India (Jagdish Capoor Committee-1999)

2.9 The Governor constituted an Advisory Group and a Working Group to review the system of deposit insurance and to suggest changes therein in the context of financial sector reforms undertaken since 1991. The Advisory Group headed by Shri Jagdish Capoor, the then Deputy Governor, in its report submitted on October 28, 1999 had inter alia, dealt on the issues relating to desirability of providing deposit insurance cover to the depositors of NBFCs and the comments are briefly reproduced as under :

> *"The argument for inclusion of the NBFCs into deposit insurance fold has to be examined in terms of whether their liabilities fall under monetary aggregates, its potency to create shocks in the system and whether they are adequately regulated and supervised. Although deposits of NBFCs do not strictly come under any of the monetary aggregates, they come under the liquidity aggregates. The Working Group on Money Supply (Chairman: Dr. Y. V. Reddy) had recommended that deposit of NBFCs should be included in*

liquidity aggregates. Secondly, although deposits of NBFCs in relation to deposit of the scheduled commercial banks are not considerable, the systemic impact of failure of the NBFCs on the banking system would be considerable. Thirdly, only in January 1998. the NBFCs have been brought under a more comprehensive regulatory and supervisory ambit of the Reserve Bank. The process of registration is still on, and the regulatory and supervisory system is yet to stabilise. A new enactment is also being contemplated. We believe that deposit insurance is not a substitute for supervision. It is premature to extend deposit insurance cover to NBFCs. But denying their access to deposit insurance cover indefinitely may not be prudent. Once these entities are adequately regulated and supervised, and there is some degree of regulatory parity vis-a-vis banks extension of deposit insurance could be considered. For this purpose, a review may be made after two years."

2.10 As may be observed, the Committee had stressed on proper regulation of supervision of NBFCs and some regulatory parity with banks, before considering providing deposit insurance coverage to the depositors of NBFCs. The committee had recommended to review the position after a period of two years and deposit insurance be thought of only for those NBFCs which meet the registration and supervisory norms. The review was undertaken by the DICGC and it did not consider in favour of introducing insurance coverage to the depositors of NBFCs. A Committee of the Deputy Governors also endorsed the above review.

Summary

2.11 The Narsimham Committee and the Vasudev Committee had completely ruled out any scheme of deposit insurance for the NBFC sector on the grounds of maintaining the distinction between banks and non-banks, and pronounced moral hazard problem. The Committees had primarily stressed on the desirability consideration as distinct from the systemic point of view. The Capoor committee had also opined that it was premature to extend deposit insurance cover to NBFCs. It had stressed that deposit insurance is not a substitute for supervision and had suggested only for a review of the question after two years after the NBFCs are adequately regulated and supervised, and after some regulatory parity vis-à-vis banks has developed. Subsequently, after undertaking a review, DICGC did not consider in favour of extending any insurance cover to NBFC deposits. In sum, none of the committees which had examined the subject have found any clear case for the introduction of insurance for the depositors of NBFCs.

CHAPTER-3

Business and risk profile of the NBFC sector

Business Profile

3.1 The NBFCs are a heterogeneous lot, in terms of business extent, size and spread. A broad business profile of the NBFC sector as at the end of March 2000, 2001 and 2002 based on the periodic returns submitted by deposit accepting / holding companies is presented in Table below.

(Rs in crore)

	As at end-March					
	2000		2001		2002	
	NBFCs	Of which : RNBCs	NBFCs	Of which : RNBCs	NBFCs	Of which : RNBCs
No.of reporting companies	1,005	9	981	7	736	5
Total Assets	51,324	11,317	53,878	16,244	55107	17041
Public Deposits	19,342	11,004 (56.9)	18,085	11,625 (64.3)	18394	12889 (70.07%)
Net Owned Fund	6,223	-443	4,943	-179	4821	111

Note : 1. Figures for 2000 and 2001 are taken from Report on Trend & Progress of Banking in India. Figures for 2002 are provisional.
2. Figures in brackets indicate percentages to total outstanding deposits of NBFCs.

3.2 As on March 31, 2002, the quantum of public deposits (reported by 736 companies) stood at Rs 18,394 crore, equivalent to 1.53% of the aggregate deposits of scheduled commercial banks (SCBs). A year earlier, the public deposits of 981 reporting deposit holding companies (registered and unregistered) was of the order of Rs 18,085 crore which was 1.71% of SCB deposits. Public deposits of the reporting 5 RNBCs increased by 10.9% to Rs 12,889 crore as on March 31, 2002 as compared to the position of 7 reporting RNBCs as on March 31, 2001 (Rs 11,625 crore). It is also pertinent to note that 5 RNBCs account for 30.9% of the total assets and 70.07% of total deposits of the NBFC sector as on March 31, 2002, as against 30.1% and 64.3% respectively by 7 RNBCs as on March 31, 2001. This is indicative of the preponderant presence of a few RNBCs in the NBFC sector, in terms of total public deposits.

3.3 An analysis of returns submitted by the deposit holding NBFCs revealed that as on March 2002, as many as 40 NBFCs with negative NOF aggregating (-) Rs

1,313.18 crore were holding public deposits of Rs 647.58 crore. This is a cause of supervisory concern. Out of the above companies, 10 are having public deposits of more than Rs 10 crore and the total public deposit held by these medium / large size NBFCs aggregated Rs 612.67 crore.

Distribution of Deposits

3.4 The distribution of deposits among different categories of NBFCs is given in the table below :

(Rs in crores)

Sr. No.	Nature of Business	No. of NBFCs			Public Deposits		
		2000	2001	2002	2000	2001	2002
1.	Equipment Leasing (EL)	56	58	40	1,021 (5.2)	1,450 (8.0)	390 (2.12)
2.	Hire Purchase (HP)	465	470	355	4,084 (21.1)	3,659 (20.2)	3651 (19.85)
3.	Investment and Loan (IL)	188	170	204	2,517 (13.0)	786 (4.3)	897 (4.87)
4.	RNBCs	9	7	5	11,004 (56.9)	11,625 (64.3)	12,889 (70.07)
5.	Other NBFCs*	287	276	132	716 (3.7)	564 (3.1)	566 (3.08)
	Total	**1,005**	**981**	**736**	**19,342 (100.0)**	**18,065 (100.0)**	**18,394 (100.0)**

*Includes misc. non-banking companies (Chit Funds), unregistered and un-notified Nidhis, etc.

Note : Figures in brackets indicate percentages to total.

Source: Figures for 2000 and 2001 taken from Report on Trends and Progress of Banking in India. Figures for 2002 are provisional.

It may be observed therefrom that public deposits with equipment leasing companies which increased from Rs 1021 crore as on March 31, 2000 to Rs 1450 crore as on March 31, 2001, i.e., 42.0%, steeply declined to Rs 390 crore as on March 31, 2002, i.e., by 73.1%. The fall is mainly on account of exit of 31% of equipment leasing companies on account of declassification of the companies due to shift in business focus to hire purchase or loan, or due to exit from deposit acceptance activities. On the other hand, the public deposits of investment and loan companies increased by 14.12% during the same period as against a decline of 68.8% during the previous year. The increase in deposits was on account of declassification of several equipment leasing companies into hire purchase companies. At the same time, the number of deposit taking hire purchase companies substantially declined from 470 as on March 31, 2001 to 355 as on March 31. 2002. In spite of exit of a large number of hire purchase, companies, their deposit level remained nearly the same due to

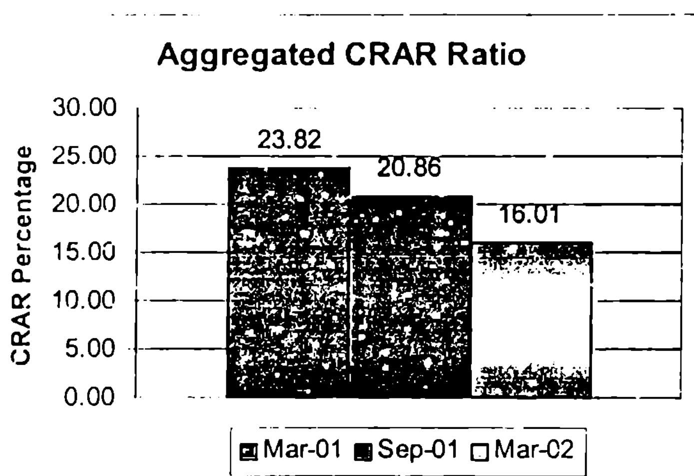
declassification of several equipment leasing companies into hire purchase companies attributable to change in the tax incentives in leasing finance activity.

3.5 The distribution of public deposits among the various components of NBFC sector was uneven. In the NBFC sector excluding the RNBCs, there was decline in deposit from Rs 6460 crore as on March 31, 2001 to Rs 5505 crore as on March 31, 2002, i.e., by 14.8% and the deposit growth was mostly confined to RNBCs which accounted for as high as 70.07% of NBFC sector deposits as a whole. The above analysis indicates that the distribution of deposits in NBFC sector is rather skewed and the aggregate deposit level is on the decline (i.e., Rs 54,000 crore in 1994 to just Rs 18,394 crore in 2002).

Macro Prudential Indicators of NBFCs

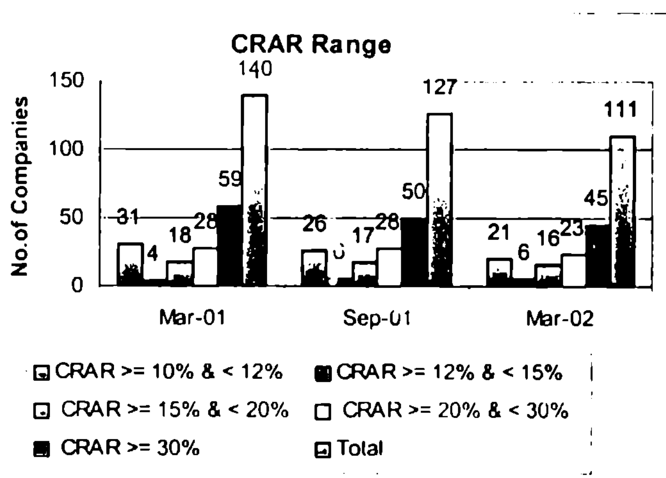
3.6 Certain important Macro Prudential Indicators of NBFCs are discussed hereunder:

Aggregated Capital Ratios: -



3.6.1 It may be seen from the Chart prepared on the basis of data received from companies having asset-size more than Rs. 10 crore that for the half years ended March 2001, September 2001 and March 2002, the aggregate capital ratio maintained by these companies, though well above the level prescribed by the Bank, has shown declining trend. The ratio has declined from 23.82% as on March 31, 2001 to 20.86% as on September 30, 2001 and further came down markedly to 16.01%.

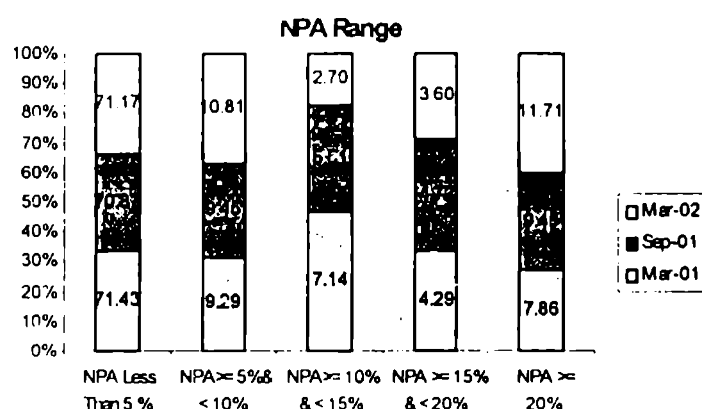
Capital Ratio ranges: -



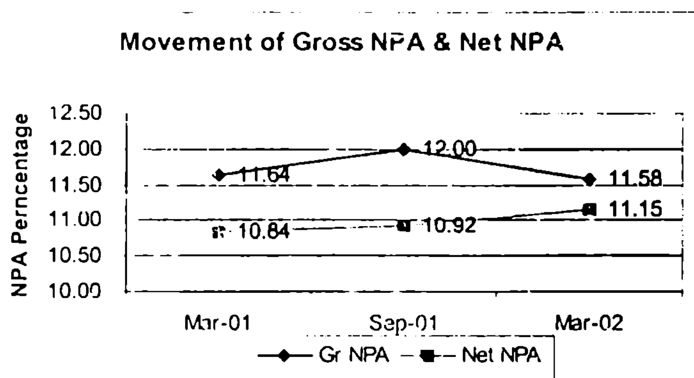
3.6.2 It may be observed that the number of reporting NBFCs having asset size of Rs. 10 crore and above had declined from 140 in March 2001 to 127 in September 2001 and further declined to 111 in March 2002. Keeping in line with this trend the

number of companies maintaining different ranges of CRAR had also declined, except in the range of 12% to 15%.

Non-Performing Advances Ratios



3.6.3 In the year 2001-2002 there was an increase in the number of NBFCs with NPAs exceeding 20%. The percentage of companies having NPAs above 20% of their advances was 7.86 in March 2001, which increased to 9.45 in September 2001 and further increased to 11.71 in March 2002.



3.6.4 The quantum of Non-performing advances (Net) had increased in 2001-2002. The Net NPAs increased from 10.84% to 10.92% and to 11.15% during the period. The reduction in the gap between the Net and gross NPAs as at March 2002 vis-à-vis March 2001 may be ascribed to lower provisions made by some companies, which again is a matter of concern. In the year 2001-2002, there was an increase in the number of NBFCs with Non Performing Assets exceeding 20%.

Summary

3.7 The analysis reveals the following major features about the business and risk profiles of the NBFC sector.

(i) The aggregate deposits of the NBFC sector as a whole constituted only 1.5% of the aggregate deposit of the scheduled commercial banks as at the end of March 2002 and the share of NBFC sector deposit is rather in a declining mode. Therefore, its impact from the systemic point of view is not considered very significant.

(ii) The public deposits of 5 RNBCs at Rs 12,889 crore as on March 31, 2002 constituted 70.07% of the total public deposits of the NBFC sector held by 736

companies. This indicates that the public deposits of the NBFC sector are rather concentrated in a mere few RNBCs. The remaining 731 companies numerically accounting for 99.3% of deposit taking NBFCs, hold only 29.01% of the total public deposits. Thus, there is a very skewed distribution of the public deposits in the NBFC sector and most of the companies are rather small in size.

(iii) As at the end of 2002, there were as many as 40 NBFCs which were having a negative NOF and were still holding aggregate public deposit of Rs 647.58 crore; of these 10 companies with public deposits of more than Rs 10 crore each, were holding Rs 612.67 crore of deposits accounting for 94.6% of total deposits of the companies with negative NOF.

(iv) The aggregate CRAR of the NBFCs is showing a persistent declining trend from 23.82% (March 31, 2001) to 16.01% (March 31, 2002), indicating deteriorating financial health of the sector. This evokes considerable supervisory discomfort.

(v) The net Non Performing Assets is quite high at 11.15% as on March 2002 and there is also a steady increase in the same indicating the riskiness of assets.

The above factors lead to the conclusion that the distribution of public deposits among the NBFCs is rather skewed and the financial weakness of the NBFC sector is fairly widespread.

CHAPTER-4

Need for and viability of insurance cover for deposits of NBFCs

Historical Background

4.1 In India the regulation of banking business started with the Banking Companies Act (later renamed as Banking Regulation Act, 1949). The NBFCs were kept out of any such regulations till 1963. The scheme of regulation of the deposit acceptance activities of the NBFCs was conceived in the 60's as an adjunct to monetary and credit policy of the country and to provide an indirect protection to the depositors, by insertion in the year 1963 of Chapter III B in the RBI Act, 1934. Till 1997, the incremental regulatory powers given to the Reserve Bank by amendment of the RBI Act, 1934 were limited to regulating or prohibiting the issue of prospectus or advertisement soliciting deposits, collecting information regarding acceptance of deposits and giving directions on matters relating thereto. Thus the emphasis of the regulation was focussed on the liability side of the company. During the 90's a spurt was observed in the volume of deposits of NBFCs, which was viewed with concern by the authorities. The total regulated deposits of NBFCs aggregated to Rs 17390 crore as at the end of March 1994, which was equivalent to 4.0% of bank deposits. In fact, in the three years following, the quantum of regulated deposits grew more than three-fold and as at end-March 1997, it aggregated Rs 53116 crore constituting nearly 8% of bank deposits. Recognising the importance of the NBFC sector in the Indian financial system and the relative inadequacy of the statutory and regulatory framework applicable to them, various expert committees which went into these aspects strongly recommended that more powers should be vested with Reserve Bank to regulate NBFCs in an effective manner.

The Regulatory and Supervisory Framework for NBFCs

4.2 The need for a healthy and vibrant NBFC sector and awareness of its useful role in creation of economic assets, resulted in the amendments to the RBI Act in 1997 effecting comprehensive changes in Chapter III B, III C and Chapter V of the Act, vesting more powers with the Reserve Bank and broadening the scope of the provisions. The amended Act provides, inter alia, for minimum entry point norms, by way of compulsory registration with Reserve Bank of all existing and newly incorporated NBFCs for carrying on and commencing of financial business, powers to RBI to give directions to the NBFCs and their directors, powers to file winding up petition against erring NBFCs and impose penalty directly on erring NBFCs, powers

to file criminal complaints against NBFCs and their directors for violation of Company Law Board order regarding repayment of deposits, etc. As a built-in safeguard, the NBFCs have been asked to maintain liquid assets (SLR) as a percentage of their deposit liabilities. The companies have also been directed to create Reserve Fund and transfer thereto each year at least 20 percent of the net profits to strengthen their owned fund base. The Reserve Bank has therefore put in place an effective regulatory framework to ensure that -

(i) The financial companies function on healthy lines; and

(ii) The quality of surveillance and supervision exercised by the Bank over the NBFCs keeps pace with the developments in this sector.

Strengthening of NBFC sector and protection of depositors' interest are the key themes of the above mission.

4.3 To meet the regulatory and supervisory aims of the amended provisions of the Act, a new supervisory framework was put in place in January 1998. Based on the recommendations of the various committees and the supervisory role / powers derived from the RBI (Amendment) Act, 1997, the Reserve Bank put in place a four pronged supervisory framework based on:

(i) On-site inspection on CAMELS pattern

(ii) Off-site surveillance supported by the state-of-the art technology;

(iii) Market intelligence; and

(iv) Exception reports of the statutory auditors of NBFCs.

4.3.1 On-site inspection on CAMELS pattern: The on-site inspection of NBFCs at periodic intervals is one of the main instruments of supervision of the NBFCs. To prioritise use of supervisory resources to address larger supervisory concerns, the deposit accepting large sized NBFCs are inspected by RBI once in a year whereas the other companies are inspected at interval of two-three years. Keeping in view the thrust on on-site inspection as an instrument of supervision, an inspection manual was introduced in August 1998 replacing the guidelines prepared in the mid 1980s. This inspection manual has now been thoroughly revised in 2002. A supervisory rating model has recently been introduced.

4.3.2 Off-site surveillance supported by state of the art technology: The Reserve Bank has introduced a system of off-site surveillance, which encompasses submission of the supervisory returns by the NBFCs for effectively monitoring their activities in an on going manner. The off-site surveillance system is supported by an

appropriate technology for the development of database as well as for effective scrutiny and monitoring of the returns. The Bank is also presently working on a project for enabling the NBFCs to submit their returns through Internet.

4.3.3 Market Intelligence: While off-site surveillance system and on-site inspections are effective tools in assessing the financial position and overall regulatory compliance of the registered companies, pro-active gathering of market intelligence can help pick up early warning signals. The market and especially peer companies can often give vital information on the state of affairs of different companies which could trigger on-site inspection followed by appropriate regulatory responses. Accordingly, a market intelligence outfit has been set up at the Bank's Regional Offices as well as at the Central office with the required infrastructure. The MI Cells at Regional Office are required to send daily, fortnightly and monthly reports to Central Office pertaining to MI activities, which are then analysed by Central Office, and suitable action is initiated.

4.3.4 Exception reports of statutory auditors of NBFCs: As the statutory auditors are having a role in certifying the balance sheets of the companies, the Bank has issued a Direction viz. Non Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1998, according to which, it is a statutory obligation on the part of auditors to submit exception reports to RBI in case any company is undertaking NBFI activity without proper COR or any company is engaged in acceptance of deposit without proper authorisation. This Direction has been issued under the statutory powers of the RBI Act and as such any violation of the Direction may entail imposition of penalty or prosecution by the Bank. Reserve Bank makes use of services of the statutory auditors as its extended arm, as a part of its supervisory strategy. Through appropriate use of this tool, the violations can be detected at an early stage and corrective action can be initiated.

Compulsory Registration of NBFCs

4.4 Till 1997, there was no statutory provision regarding **entry point regulations** for the NBFCs. After amendment of RBI Act in 1997, a system of registration of NBFCs, whether accepting deposits or not, was introduced. Reserve Bank received applications from 36703 companies, out of which 13,293 applications were approved and 22254 were rejected till date. Out of the total applications received, 5895 were received from the deposit accepting companies ('A' category), of which only 731 companies have been given registration till date and the remaining applications have

been rejected (2 cases pending). The present policy in respect of registration can be briefly summed up as under:

(a) The registered NBFCs should function on sound lines in due compliance with the regulations.
(b) The NBFCs whose applications for issue of COR have been rejected should wind up their NBFI activities and repay the public deposits, if any, as per the schedule.
(c) The companies which have not applied for COR and are engaged in NBFI activity should stop their unauthorised NBFI business, forthwith and should apply to RBI for registration with adequate NOF and also for regularisation / condonation for the lapse.
(d) If any NBFC is found to be engaged in NBFI activity whether including acceptance of deposit or otherwise, the punitive measures will be invoked in respect of such companies.

Implementation of Prudential Norms

4.5 In 1994, the Bank had issued guidelines relating to adherence of prudential norms by the NBFCs. However, these guidelines were not having the statutory backing, and as such, their implementation was not mandatory on the part of the NBFCs. After the amendment of RBI Act in 1997, the Bank issued a comprehensive set of Directions on January 31, 1998, named as "Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998" covering areas like income recognition, asset classification, provisioning requirement, disclosure in the Balance Sheet, requirement as to capital adequacy, restrictions on investments in land, building and unquoted shares, concentration of credit / investment, etc. Prudential Norms directions are applicable to all types of NBFCs including RNBCs. Though there has been sufficient progress in implementation of the Prudential Norms, the compliance level, as observed during on-site inspections, does not evoke sufficient degree of supervisory comfort.

Shortcomings/Weaknesses observed in the NBFC sector

4.6 The regulation and supervision of banks, as mentioned earlier, began in 1949 whereas NBFCs regulations in a comprehensive scale are just about 5 years old. Undoubtedly over the last five years, there has been progressive consolidation in the NBFC sector. However, it is yet to be stabilised. There are yet signs of fragility in this

sector as evidenced by failures of NBFCs in meeting the liability towards the depositors, albeit, with less frequency and with less contagion effect.

4.7 It has been experienced that nearly one third of the registered deposit taking ('A' Category) NBFCs exhibit laxity and a complete lack of professionalism by chronically submitting returns late to Reserve Bank and that too containing various discrepancies, which make these unreliable. (In order to inculcate a sense of discipline in this sector, it has been decided to take action in the case of NBFCs not submitting the returns. In the first instance, RBI would impose penalties as provided for in the Reserve Bank of India Act, 1934 as also launch court proceedings, besides considering rejection / cancellation of the COR of NBFCs having public deposits of Rs.50 crore and above.) There are plethora of court cases filed by Reserve Bank for enforcing the provisions of RBI Act in order to protect the depositors' interest. The Bank has filed as many as 55 winding up petitions in various High Courts and 54 criminal complaints in the Metropolitan Magistrate Courts. Besides the Bank has impleaded itself in certain restructuring cases filed under Section 391 of Companies Act. Police complaints for cheating under Section 420 of Indian Penal Code have also been filed by the depositors / creditors against several NBFCs. Though many cases are legacy of the past supervisory regime, there are also instances of several such cases filed by the Bank in the recent past or are in the process of being filed in respect of a number of companies, which have become weak and recalcitrant during the last couple of years.

4.8 Corporate governance in the NBFC sector in general falls short of other industry benchmarks and needs to be toned up. Part of this failure is related to inadequate disclosures of key corporate information to boards as well as to shareholders and other stakeholders leading to an asymmetry of information available to the depositors. But much has to do with poor board composition where directors, due to their close business and social relationship with promoters, do not feel the necessity of asking the right questions when occasions demand much more detailed scrutiny and debate. A promoter-driven Board cannot be normally expected to exercise independent oversight.

Differences in NBFC Regulation vis-à-vis Regulations for Banks

4.9 The extent and areas of regulation and supervision for NBFCs are not identical with that for banks and the difference flows from the characteristic features of the respective sectors with respect to their role and functions in the financial system.

Some of the areas where the present regulation of NBFCs is not on the same footing as that of banks are given below:

- The Reserve Bank does not have any role in exercising control over the management of the company.
- It has no powers to induct directors in the Boards of companies.
- The Bank has no powers for compulsory amalgamation / restructuring as in case of banks.
- There are no restrictions on voting rights.
- Unlike the case of banks, Reserve Bank's approval is not necessary for appointment of Chief Executive Officers of NBFCs.
- In case of banks, there are restrictions on carrying out certain businesses, and prohibition on trading activities. However NBFCs, at present, can carry out any non-financial activity simultaneously with NBFI business.

Even in the area of corporate governance the situation is not exactly analogous with the case of banks (commercial or co-operative), due to various statutory, regulatory and supervisory restrictions acting as checks and balances on the banks. In case of public sector banks, there are nominee directors appointed by the Bank and Government. In case of private sector banks, apart from the statutory restrictions imposed about constitution of the Board, the Reserve Bank can also appoint Directors on the Board, when felt necessary. In case of co-operative banks, there are state nominees as well. Moreover, State Governments have powers of supersession of the Board and RBI has also got full powers to seek liquidation or supersession of the Board.

Should there be complete harmony in regulation of NBFCs & Banks?

4.10 Given the fact that the Prudential regulation regime for NBFCs is less stringent in some areas as compared to banks, a question arises whether there should be complete harmony in NBFC Regulations with that of banks. Theoretically a strong case can indeed be made out for regulatory neutrality among all deposit taking institutions. However, pursuing the regulations of NBFCs to the point of full harmonization with that of banks will eliminate the *raison d' etre* of this sector and in all probability would cause its demise. In this regard the observation on this issue in the World Bank's publication titled "The Development of Non- Banking Financial Institutions" is very perceptive. It states "*....The essential point is that Institutions that take deposits from the public must be regulated to the point where the likelihood of*

their failing to honour their promises is acceptably small. In practice this should be achievable without the need to attain full regulatory harmonization of all deposit takers. In making such a decision, government needs to weigh the adjustment costs involved against the efficiency benefits of full regulatory neutrality"

4.11 Given the proposition that complete harmony in prudential regulations between NBFCs and banks is neither possible nor desirable, it is important to set out the areas that the regulations must address. It is recognised that the prudential regulations have to address the following core issues:

- Licensing / Regulation requirements
- Capital Adequacy requirements for credit risk and market risk.
- Loan loss provisioning guidelines
- Risk Management Guidelines

While in these areas full harmonization or convergence should be the objective and there may even be a case for closing some of the regulatory gaps as enumerated in paragraph 4.9, as discussed in paragraph 4.10, full regulatory harmonization cannot be the objective, to ensure that the niche and individuality of this sector are maintained.

Risk Profile of NBFCs

4.12 As may be seen from paragraphs 3.7, 4.9, 4.10 & 4.11, the NBFCs form an important segment of the financial sector, and add diversity and resilience to the sector; but they are inherently a riskier proposition than the banks. Their niche away from banks is in no small measure on account of this characteristic. The depositors / investors in NBFCs therefore get a higher interest/return compared to banks, as a risk premium. It is clear that such depositors/investors make an informed portfolio choice. On account of this aspect, the prudential regulations for NBFCs, while moderating the risk taking behaviour, are of some differential with the prudential regulations set for the banks. The question of extending deposit insurance to the deposits of NBFCs has to be decided in the backdrop of these facts.

The Role of Deposit Insurance

4.13 Financial safety net usually includes prudential regulation and supervision, a lender of last resort and deposit insurance; it is designed primarily for the banking sector, given the sector's crucial importance for the economy. The distribution of powers and responsibilities between the financial safety net participants is a matter of public-policy choice and individual country circumstances. For example, some

countries incorporate all financial safety net functions within the central bank, while others assign responsibility for certain functions to separate entities. Thus, deposit insurance is an integral component of financial safety net.

4.14 The theoretical underpinnings of deposit insurance schemes can be found in the classic work of Diamond and Dybvig (1983). Deposit insurance is an optimal policy in a model where bank stability is threatened by self-fulfilling depositor runs. If runs result from imperfect information on the part of some depositors, deposit insurance plays a role in preventing it by eliminating - or at least reducing – instances of poorly informed depositors attempting to withdraw their funds all at once from an illiquid but solvent bank. Thus, deposit insurance ensures the stability of banking sector and thereby of the whole financial sector as well.

4.15 As demonstrated in the Diamond and Dybvig model, providing stability to the banking sector has been the prime consideration in extending deposit insurance to banks as failure of any bank has systemic implication due to inter-linkages through the payment system and inter-bank exposures. The banks that accept deposits from the public are important in the economy because of their involvement in the payments system, their role as intermediaries between depositors and borrowers, and their function as agents for the transmission of monetary policy. Banks are in the business of assuming and managing risks. By their nature, banks are vulnerable to liquidity and solvency problems, among other things, because they transform short-term liquid deposits into longer-term, less-liquid loans and investments. They also lend to a wide variety of borrowers whose risk characteristics are not always readily apparent. The banks therefore meet an umbrella of customer needs by providing the core financial services of payments, liquidity, divisibility, store of value, information and pooling of risks. However the main limitation in providing these services even more efficiently is that the requirements of their payment and liquidity services (their main services) constrain the way in which they can provide other services: in order to provide certainty of value for payments, the bank deposits must be of low risk. This is precisely the reason why the deposit insurance cover is mainly extended to the banking sector.

4.16 Thus the Deposit Insurance setup in the world over seeks to achieve the following three objectives:

(i) protect banks from failure,

(ii) protect some or all depositors, particularly the small and unsophisticated depositors, who cannot be expected to monitor the soundness of their banks' asset portfolios, and

(iii) promote savings and better exploit the benefits of large-scale payment system.

From an economic perspective, the third is clearly the most important.

Moral Hazard Issues

4.17 A well-designed financial safety net contributes to the stability of a financial system; however, if poorly designed, it may increase risks, notably moral hazard. Moral hazard refers to the incentive for excessive risk taking by banks, financial institutions or those receiving the benefit of protection. Such behaviour may arise, for example, in a situation where depositors and other creditors are protected (or believe they are protected) from losses, or when they believe that the entity will not be allowed to fail. In these cases, depositors have less incentive to access the necessary information to monitor the banks / financial institutions. As a result, in the absence of regulatory or other restraints, weak entities can attract deposits for high-risk ventures at a lower cost than would otherwise be the case.

4.18 Moral hazard can be mitigated by creating and promoting appropriate incentives to control excessive risk taking by banks through good corporate governance and sound risk management of individual banks, effective market discipline and a framework of strong prudential regulation, supervision and laws. These elements involve trade-offs and are most effective when they work in concert.

4.19 Good corporate governance and sound risk management of individual banks help to ensure that business strategies are consistent with safe-and-sound operations, and thus can act as the first line of defence against excessive risk taking. Good corporate governance and sound risk management includes standards, processes, and systems for ensuring appropriate direction and oversight by directors and senior managers, adequate internal controls and audits, management of risks, the evaluation of performance, the alignment of remuneration with appropriate business objectives, and management of capital and liquidity positions.

4.20 Moral hazard can be mitigated by market discipline exercised by shareholders as well as by larger creditors and depositors who are exposed to the risk of loss from the failure of a bank / financial institution. However, for market discipline to work effectively, these groups must have the required knowledge to assess the risks the

banks, and in turn the depositors, face. Information should be readily available and be generally understandable by the public. Sound accounting and disclosure regimes are required, as well as ongoing attention to a bank's soundness by ratings agencies, market analysts, financial commentators and other professionals.

4.21 Many countries rely heavily on prudential regulatory and supervisory discipline to mitigate moral hazard and control excessive risk taking in banks. Regulatory discipline can be exercised through sound and effective regulations covering the establishment of new banks / financial institutions, the implementation of minimum capital requirements, the qualifications of directors and managers, sound-business activities, fit-and-proper tests for controlling the shareholders, standards for risk management, strong internal controls, and external audits. Supervisory discipline can be exercised by ensuring that the institutions are monitored for safety and soundness as well as compliance issues and that corrective actions are taken promptly when problems surface, including the closure when necessary.

4.22 Specific deposit insurance design features can also mitigate moral hazard. These features may include: placing limits on the amounts insured; excluding certain categories of depositors from coverage; using certain forms of coinsurance; implementing differential or risk-adjusted premium assessment systems; minimising the risk of loss through early closure of troubled banks; and demonstrating a willingness to take legal action, where warranted, against directors and others for improper acts.

4.23 Many of the methods used to mitigate moral hazard require certain conditions to be in place. For example, differential or risk-adjusted differential premium assessment systems may be difficult to design and implement in new systems and in emerging or transitional economies. Early intervention, prompt corrective action and, bank closure when warranted, require that supervisors and deposit insurers have the necessary legal authority, in-depth information on risk profile, financial resources, and incentives to take effective action. Personal-liability provisions and availability of sanctions can reinforce incentives of bank / financial institution owners, directors, and managers to control excessive risk, but they depend on the existence of an effective legal system that provides the necessary basis for action against inappropriate behaviour.

4.24 Policymakers should consider a country's conditions and factors that may determine the effectiveness of particular measures for mitigating moral hazard, the commitment and the ability to implement them, and the advancement of a reform agenda to eliminate gaps that may limit their effectiveness.

4.25 The pros and cons of deposit insurance have been debated for a century. Countries often adopt deposit insurance schemes to provide protection for unsophisticated and small depositors. Also, deposit insurance eliminates - or at least reduces - the probability of poorly informed depositors attempting to withdraw their funds all at once from an illiquid but solvent bank. Potential gains from a deposit insurance scheme however, come at a cost viz., the cost of moral hazard of creating perverse incentive to take greater risks. Deposit insurance encourages excessive risk-taking by bank managers since depositors have fewer incentives to monitor them.

4.26 The problem of moral hazard is a double-edged weapon. At one side being assured of the safety of funds through the insurance, the depositor tends to accumulate such riskier investments without attempting proper analysis of the financial position. At the same vein the institution coming under deposit insurance builds riskier assets with the depositors' money as they are not affected by the withdrawal of the depositors support and the risk is not costly to the institutions (i.e., alongside risk is not present). Due to such compounding of risk in the balance sheets of companies, the problem of moral hazard in the long run affects the interest of the depositors, the institution as well as the system. Thus, deposit insurance necessarily induces moral hazard to depositors and financial institutions. The former becomes indifferent to riskiness of financial assets and interested only in high returns while the latter becomes immune from market pressure to improve their performance.

4.27 The moral hazard index prepared by Demirguc-Kunt and Detragiache (2001) was based on the principal components to capture the presence and design features of deposit insurance system. The overall index of deposit insurance generosity, is composed of seven specific components as listed below:

(i) Explicit deposit insurance tends to create greater moral hazard than regimes with implicit insurance (India is an example of explicit deposit insurance).

(ii) Co-insurance - where depositors face a deductible on their deposits - limits the generosity of the deposit insurance regime and the extent of moral hazard (India has no co-insurance).

(iii) Higher the deposit insurance coverage - the coverage limit divided by bank deposits per capita - larger is the associated moral hazard.

(iv) When foreign currency deposit is covered, this increases moral hazard (India covers foreign currency deposits).

(v) When inter-bank loans are covered, this increases moral hazard. (India does not cover inter-bank deposits).

(vi) Fully funded schemes are more prone to moral hazard than partially or, or un-funded deposit insurance scheme (India is funded). Government funding of insurance schemes creates greater moral hazard than bank funded schemes (In India, it is bank funded).

(vii) Compulsory membership tends to reduce adverse selection of entities for insurance cover, so that compulsory systems reduce moral hazard to a greater extent than voluntary systems (In India, it is compulsory):

4.28 Thus, problem of moral hazard is the inherent evil in the system of deposit insurance. It is contained only through the several measures discussed earlier in this chapter. In case of NBFCs, the problem of moral hazard in extending insurance cover for NBFC deposits will be more pronounced and accentuated, for the following reasons:

(a) Most of the public deposit taking NBFCs are in the private sector and the probabilities of subjective credit decisions (behest credit) to the detriment of the depositors' interests are more pronounced.

(b) The risk profile of the assets of the financial companies is higher than that of the banks; with the insurance cover available to their deposits, the management of these financial companies may undertake more of the riskier businesses leaving the insurance agency in peril.

(c) The financial position of the most of these companies is not strong enough. The regulatory system for NBFCs is yet to stabilise; it cannot be on the same footing as in case of banks.

(d) DICGC is a self-supporting organization and the RBI provides no financial support. If insurance cover has to be extended to the deposits of financial companies, the premium being paid by the commercial and co-operative banks has to be hiked in order to cross-subsidise the risk cover for the

financial companies This adds to the moral hazard inasmuch as the managements of the finance companies may undertake more riskier businesses without the burden of the real cost of the insurance and the higher risk has to be supported by the excessive premium collected from banks.

NBFCs and Deposit Insurance

4.29 Notwithstanding the inhibiting factor of moral hazard, a case may exist for extending deposit insurance to NBFCs, if the attendant circumstances because of which deposit insurance is extended to banks also exist in the case of NBFCs. The discussion on this in the following paragraphs leads to the conclusion that no such case exists.

4.30 The NBFCs have little potential to cause systemic problems. The NBFCs do not form a part of the payment system and as such cannot cause systemic failure like banks including co-operative banks. The contagion risks are also very limited in scale. Therefore, from the point of view of systemic consideration, there is no pressing need for providing deposit insurance coverage to the deposits of NBFCs, particularly when viewed from the perspective of moral hazard and market discipline.

4.31 There is no 'lender of last resort' facility for the NBFCs, as available in case of banks. There is no provision in RBI Act for the purpose, and more important, there is no need for providing such a facility to non-banks from the systemic point of view. Besides, any signal that Reserve Bank of India will bail out the troubled NBFCs, will compound the problem of moral hazard. Thus, there are legal, practical and conceptual issues, which do not favour this proposition of 'lender of last resort' facility for the sector.

4.32 The case in favour of deposit insurance from the perspective of depositor protection is very weak for NBFCs. As discussed in paragraph 4.12, the operations of NBFCs are inherently riskier and the depositors make a deliberate portfolio choice in favour of high risk- high return. There is therefore not much of a case for extending a second benefit by way of deposit insurance to the depositors of NBFCs, as the problem of moral hazard in extending insurance cover for NBFCs is also more pronounced and can get accentuated as discussed in paragraph 4.28

4.33 Extension of deposit insurance will weaken market discipline for NBFCs. Market discipline is the best from of depositor protection and is very essential for long term stabilization of the sector and aversion of crisis. The position is same for bank deposits as well, but extension of deposit insurance to banks is necessary on account of systemic considerations.

4.34 There is a need to maintain a separate identity for this sector. The group concurs with the following views of the Narasimhan Committee : *"Deposit insurance for NBFCs could blur the distinction between banks, which are much more closely regulated, and the non banks as far as safety of deposit is concerned and consequently lead to a serious moral hazard problem and adverse portfolio selection. The Committee would advise against any insurance of deposits with NBFCs."*

4.35 All considered, the Group is not in favour of extending deposit insurance to NBFCs, either through or outside of DICGC. The sector is inherently riskier and is made more riskier by the inadequate compliance at present with the regulatory and supervisory framework. Moreover, the sector has a lopsided risk distribution. Unlike in the case of banking sector or co-operative sector, a few large NBFCs including RNBCs, command nearly 70% of the NBFC deposits and 111 large NBFCs out of a total number of about 700 registered 'A' Category NBFCs, (asset size of Rs 10 crore and above) account for nearly 95% of the total deposits of NBFC sector. While in banking, large banks have a low probability of default, this is not true for the NBFC sector: the entire sector carries higher risk across the spectrum. Big NBFCs doesn't necessarily mean strong and in the absence of systemic relevance the Too Big To Fail (TBTF) concept is not applicable to the non-banking sector.

4.36 A study has revealed that the deposit insurance scheme presently in operation is having a significant element of cross-subsidisation from the commercial banks to the co-operative banks during the year 2001-02 and this trend is likely to continue in the future for quite some time due to the pronounced weakness in the co-operative sector. As may be observed from the following table, during 2000-2001 the total amount of claims settled in favour of co-operative banks was as heavy as 65.33 per cent of the total premium collected although they contributed only 12.39 per cent to the collection of premium.

(In Rs Crore)

	1999-2000	2000-01	2001-02
Premium Received			
Commercial banks including LABs & RRBs	413.32	448.3	555.59
Co-operative Banks	58.6	66.89	78.58
Total	**471.92**	**515.19**	**634.17**
Claims settled			
Commercial banks including LABs & RRBs	0	17.24	0.03
Co-operative Banks	15.48	20.49	414.30
Total	**15.48**	**37.73**	**414.33**
Premium received from the co-operative sector	**12.42%**	**12.98%**	**12.39%**
Claims settled for co-operative banks as a Percentage of the total premium received	**3.28%**	**3.98%**	**65.33%**

The high degree of cross-subsidisation evident from the data above, is certainly neither fair nor sustainable over a long period. If the NBFC deposits are to be provided with the insurance coverage, going by the history of incidence of failure of the NBFCs and the riskiness of the sector, there would inevitability be cross-subsidisation of the sector from the banking sector, which will have to bear the brunt. It will be undesirable to force the banks to provide such a subsidy.

International best practices on providing deposit insurance to NBFIs

4.37 There is no definitive guidance available on this issue. The Financial Stability Forum issued "Guidelines for developing effective deposit insurance systems" in September 2001. It observes as under:

"Policymakers take different approaches to non-banking financial institutions that offer deposits and deposit like products. The rationale for extending membership beyond banks include: the desire not to introduce competitive distortions among different types of institutions offering similar products: the objective of enhancing the

stability of financial by including all institutions that accept deposits or deposit-like products; and desire to apply prudential regulatory and supervisory roles to all such institutions. There are many cases, however, where non-banking financial institutions are excluded from membership. The most common reasons are that such institutions may not be relevant as banks to a country's financial stability, that they may be subject to different regulatory and supervisory standards, and they may have different authorities overseeing their affairs. In such circumstance, policy makers may establish separate protection schemes to cover non-bank financial institutions."

Echoing similar views, the IMF Occasional Paper titled " Deposit Insurance- Actual and Good Practices" recommends that *"...where some institutions are not subject to the same stringent prudential regulations as commercial banks, they may be excluded from the system. A country may choose to institute a separate scheme to cover such depository institutions. This scheme may offer lower coverage, or charge higher premiums in order to cover the additional risks attendant on inferior prudential oversight."*

It may thus be seen that many countries do not extend deposit insurance cover to NBFIs. At best a case can be made for deposit insurance scheme in India, if only the premium structure reflects the riskiness of the NBFCs covered. As pointed out earlier due to the sector being inherently more risky, the premium is likely to be prohibitively high, higher than that for the banking sector. A separate premium structure may not therefore have the acceptance of the NBFCs, as it will add to the deposit raising cost substantially and it may even threaten the viability of the sector. In case the premium cost is to be passed on to the depositors, it will also not have the acceptance of the depositors, and the depositors' / investors' forum who are pleading for introduction of the scheme as the return on the deposits will be slashed down. In fact, Mr. Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, USA, has argued in the context of the recent efforts to reform the FDIC's deposit insurance, that if deposit insurance is properly priced to fully reflect the risk profile, it would result in much higher premium than what is charged or bearable by the institutions. This would be even truer in the case of NBFCs

Summary & Conclusion

4.38 A healthy sector of NBFCs contributes to the economic growth. Therefore, the regulatory structure of NBFCs is not just a critical factor in ensuring that these institutions perform their functions efficiently but also an important factor in

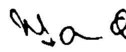
stimulating or retarding their growth and development as part of the financial system. Excessive regulation can stifle their emergence. Equally unhelpful, a poor incentive structure can encourage growth for the wrong reasons and in the wrong forms, leading ultimately to problems, if not crises. Deposit insurance, which is an integral part of the safety net system, is relevant to the banking sector from the point of view of its systemic importance. The NBFCs are not as relevant as banks to a country's financial stability; they are subjected to different supervisory and regulatory standards as appropriate to the characteristic of the sector. The problem of moral hazard is more pronounced in case of NBFCs because of its inherent weakness. Besides, none of the committees / working groups / task forces set up to study the matter has established a clear case for introduction of insurance for the depositors of NBFCs. In fact, the Narsimham Committee and Vasudev Committee have completely ruled out any such scheme for the NBFC sector on the ground of maintaining the distinction between banks and non-banks. It would be prudent to ensure the distinct division of identity between Banks and Non Banking Institutions of intermediation by keeping the latter out of insurance cover. This will help in inculcating a sense of discipline amongst depositors / investors in making a reasonably well-informed decision.

4.39 Moreover, a deposit insurance cover to the NBFC deposits may hinder the growth of market discipline, which is very essential for long-term stabilisation of the sector and aversion of crisis. The position may be partly the same for bank deposits as well, but it has its distinct importance from the systemic point of view including the payment system. Thus, from the systemic point of view, and as has been elaborated in the preceding paragraphs, on account of other considerations too, a deposit insurance scheme for deposits of NBFCs is not warranted. In any case, neither deposit insurance cover from DICGC nor a separate scheme of deposit insurance for the NBFCs is viable under the present circumstances.

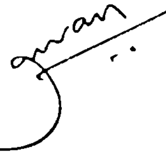
4.40 The objectives should be to provide a sound regulatory framework that enables NBFCs to flourish to the mutual benefit of all involved- neither forced to grow beyond the economy's needs nor prevented from playing their natural role of distinct financial efficiency. The NBFC sector, fragile so far as a result of their erstwhile growth in the pre 1997 regulatory vacuum in the country, is now improving. However it is yet to attain a regulatory comfort on the compliance yardstick. What is required is a renewed regulatory focus in the area of corporate governance and inculcating market discipline as the best form of depositors' protection. The Reserve Bank of

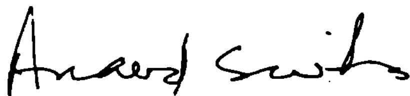
India is presently running audio-visual campaigns to educate the depositors so that only such depositors who can take informed decision about investment by weighing the risks involved, based on reliable and transparent information available about the company, vis-à-vis his expected return take to the NBFC deposits. In time a strong regulatory and supervisory environment will ensure availability of necessary reliable information over a wide spectrum. Development of Self-Regulatory Organisations on the lines of FEDAI, FIMMDA, AMFI, etc. in the NBFC sector will also help in evolving the best practices code and ensuring that the member organisations adhere to the same. The auditor-corporate relationship and good corporate governance will have also a bearing on it.

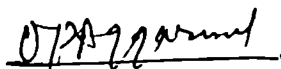
4.41 The committee's conclusion, with respect to its term of reference at S.No.1, is that there is no case for extending insurance cover to the depositors of NBFCs as it is neither a desirable nor a feasible proposition. The committee has not, therefore, dwelled on the term of reference at S.No. 2. However, wherever found necessary, all issues relevant to in the term of reference at S.No. 3, have been discussed in the Report.



(N. Sadasivan)
Chairman







(Anand Sinha) Member	(O.P. Aggarwal) Member	(C.C. Mitra) Member-Secretary