CHAPTER III

POLICY FRAMEWORK OF NBFCs IN INDIA:

AN OVERVIEW

3.1 Introduction

When taking in to account the percentage of shadow banks' assets in certain regions; In terms of GDP, it stood at 1190 percent, 147 percent, 90 percent and 82 percent in countries like Ireland, UK, Switzerland, and the United States respectively.

The dimension of the assets of shadow banks were below 10 percent of GDP in Turkey, Argentina, Saudi Arabia, Russia, and Indonesia.Hence, it can be inferred that, it is, the devloped economies, who possess a good share of assets for shadow banks in their financial system. Even, this correlation established between shadow banking and degree of development, is not necessarily to assure that these intermediaries contribute positively to that particular economy. Literature validate that such mediation itself has gravely augmented the problems related to the financial crisis. So supporters of shadow banks may or may not to be rationalised. Does India need shadow banks? This must be read together with the variations of performance, if any, of NBFCs in India from the expected standards. Government of India frame policies considering the supplementary or complementary role of NBFCs. This complementary process must be rationalised with effective channelization of savings and

thereby development. Most of the Governments frame policies related to NBFCs in consonance with the developments in banking sector. Share of shadow banking assets of Emerging Market Economies (EMEs) doubled from 6% in 2010 to 12% in 2014. The consonance with the banking sector is complex in these economies. Thus, financial sector development and innovation will bring out risks and it is essential to put in place an effective regulatory and supervisory mechanisms, and carry out structural reforms in developing the financial sector (Zhuang et al. 2009). Lack of comprehensive regulatory and policy frameworks for NBFIs is a major problem to develop the non bank finance industry in Asia and the Pacific (ADB, 2015). So the post crises plot of such economies, especially India, require a serious revision. This chapter overviews the policy framework of NBFCs in India.

3.2 An Overview of Past Efforts

Claus, Jacobsen, & Jera (2004), developed an analytical framework to discuss the link between financial systems and economic growth. The analysis conveys the magnitude of maintaining solid legal foundations since the financial system relies on these. In this context, it seems that this report is the pioneered work that cautiously necessiates such legal framework. Akinlo & Egbetunde (2010) examined the long run and causal relationship between financial development and economic growth for ten countries in sub-Saharan Africa. The study showed the need to develop the financial sector through appropriate regulatory and macroeconomic policies. Report of Muller et al. (2012) addresses the risks

run by non-bank financial institutions. As per their report, risks are credit, counterparty, liquidity, redemption, fire sales, etc. Further they report that the risk are magnified as a result of multipliers- size, interconnectedness and regulatory features. Their study examined in detail the money market funds, private equity firms, hedge funds, pension funds and insurance undertakings, central counterparties, etc. According to them, risks to financial stability are broadly considered as risks to financial intermediation. The risks would threaten the flow of capital from investors to users of funds. The finding was fortified when European Central Bank (2012) presented evidence to the increasing interlinkage among the sectors in financial system. The interlinkage makes every sector vulnerable to stress in other sectors, in particular the MFI sector. Then how can the problem be solved? As Ghilardi & Peiris (2014) observed, macro-prudential measures can usefully complement monetary policy. They developed an open-economy Dynamic Stochastic General Equilibrium (DSGE) model[5] with an optimizing banking sector to assess the role of capital flows, macro-financial linkages, and macroprudential policies in emerging Asia. The finding of Bruno, Shim, & Shin (2015) reinforces that; macroprudential policies are more successful when they complement monetary policy by reinforcing monetary tightening, than they act in opposite directions.

[5] A branch of applied general equilibrium theory that is influential in contemporary macroeconomics. The DSGE methodology attempts to explain aggregate economic phenomena, such as economic growth, business cycles, and the effects of monetary and fiscal policy, on the basis of macroeconomic models derived from microeconomic principles.

The view regarding a healthy financial intermediation is largely supported by a healthier banking and non banking mediation. The macro-prudential approach will sufficiently contribute towards the solidification of good legal framework.

Claessens, Kose, & Terrones (2011) documented that there are strong interactions between business and financial cycles. Their dataset includes 44 advanced and emerging economies over the period 1960 to 2007. The main variable they used to characterize business cycle is output. Credit, house and equity prices are three measures for financial cycle. The financial cycle is best captured by the joint behavoiur of credit and property prices (Borio, 2012). It is generally assumed that the credit behavoiur will be vigoured by the relaxation in monetary conditions. But that relaxed monetary conditions may increase the risk-appetite of banks (Ioannidou, Ongena, & Peydró, 2008). Non relaxation will result in a limited access to bank credit. The limited access has increased the pressure on small and medium size enterprises (SMEs), forcing them to scale down investments and consequently production. Klein (2014) explored the macroeconomic implications of such channel and found that countries with high prevalence of SMEs take more time to recover from global financial crisis than their peers. The “banking accelerator” transmission effect, a model of Goodfriend & McCallum (2007), claims that it works in much the same way as the financial accelerator does in other existing models. The authors accorded that monetary stimulus to spending, like employment and output stimulating monetary policy, increases the demand for bank deposits. All these note the critical role played by the interaction of the economic structure and access to

bank financing in economic recovery. Beck, Colciago, & Pfajfar (2014) surveyed the research on the role of financial intermediaries and financial frictions in the transmission of monetary policy. Within the category of small banks, changes in monetary policy are more important for the lending of those banks with the least liquid balance sheets (Kashyap & Stein, 2000).

3.3 Data and Methods

In India, NBFCs are categorized by RBI into two types on the basis of liability structure; Deposit-taking NBFCs (NBFCs-D) and non-deposit taking NBFCs (NBFCs-ND). There are 11522 NBFCs registered with the Reserve Bank of India (2017). Out of the registered NBFCs, 178 were NBFCs-D and 11344 were NBFCs-ND. There are 220 systemically important non-deposit taking NBFCs (NBFCs-ND-SI). These NBFCs are subject to more stringent prudential norms and provisioning requirements. This chapter deals with an overview of the regulatory framework of NBFCs in India. The period considered is from 2008 to 2016. Systemically important NBFCs showed an important role in the overall performance of NBFCs in India during this period. From 2010, RBI took serious measures to regulate NBFCs-ND-SI. So, to understand the impact of such initiatives, data for the period starting from 2010 was considered.

3.4 Policy Framework of NBFCs in India

The NBFC sector showed an evolutionary change in its asset size, operations, technological sophistication and entry into newer areas of financial services

and products. NBFCs today keep a deep interconnection with the financial entities. NBFCs are exposed to risks arising out of counterparty failures, funding and asset concentration, interest rate movement and risks pertaining to liquidity and solvency, as any other financial sector player. At the same time there are segments within the sector that do not show any significant risks to the system. The policy framework is founded on the interest of the whole participants of this system. Important land marks in the policy developments are discussed below.

3.4.1 Reserve Bank of India (RBI) Act 1934[6]

The policy framework for Indian NBFCs contains in the Reserve Bank of India (RBI) Act 1934.

The Chapter III B of this Act incorporates the provisions associated to Non-Banking Institutions receiving deposits and Financial Institutions. Thus, it mentions different aspects on the below given areas of NBFCs.

a. Obligation of registration and net owned fund.

b. Maintenance of percentage of assets.

c. Reserve fund

d. Regulation and prevention associated with the issue of prospectus or advertisement soliciting deposits of money.

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[6] Reserve Bank of India Act, 1934 (As amended up to June 27, 2016)

e. Power of RBI to establish policy and issue directions.

f. Power of RBI to assemble information from non-banking institutions as to deposits and to provide directions.

g. Power of RBI to demand information from financial institutions and to give directions.

h. Duty of non-banking institutions to furnish statements, etc., required by RBI.

i. Powers and duties of auditors.

j. Power of RBI to prohibit acceptance of deposit and alienation of assets.

k. Power of RBI to file winding up petition.

l. Inspection.

m. Deposits not to be solicited by unauthorized person.

n. Disclosure of information.

o. Power of RBI to exempt.

p. Penalties. [Rep. by the RBI (Amendment) Act, 1974, (51 of 1974), Section 22 (w.e.f. 13-12-1974).]

q. Cognizance of offence. [Rep. by the RBI (Amendment) Act, 1974, section 22 (w.e.f.13-12-1974).]

r. Chapter III B to override other laws.

s. Power of Company Law Board to offer repayment of deposit.

t. Nomination by depositors.

3.4.2 Narasimham Committee II (1998)

The main suggestion extended by Narasimham Committee II (1998) encompasses that mergers between banks and between banks and Development Finance Institutions (DFIs) and NBFCs require to be based on synergies and locational and business specific complementarities of the concerned institutions and must perceptibly make sound commercial sense. A non-banking finance company has been permitted to merge with a bank. It suggests that all NBFCs are statutorily required to have a minimum net worth of Rs.25 lakhs if they are to be registered. The Committee has an opinion that this smallest figure should be increasingly enhanced to Rs.2 crores which is permissible now under the statute and that in the first occurrence it should be raised to Rs.50 lakhs.

For new NBFCs who seek registration with the RBI and commence the business on or after April 20, 1999, this parameter as regards the minimum net worth has been increased to Rs.2 crore. 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. The Board for Financial Supervision (BFS) was constituted in November 1994 to supervise the money market institutions in the country. The Committee recommended

that an integrated system of regulation and supervision be put in place to regulate and supervise the activities of banks, financial institutions and NBFCs. The functions of regulation and supervision are organically linked and the committee proposed that this agency be renamed as the Board for Financial Regulation and Supervision (BFRS) to make this combination of functions explicit. An independent regulatory supervisory system which provides for a closely coordinated monetary policy and banking supervision will be the ideal to work towards. BFS needs to be strengthened before regulatory functions are vested with it. It was, therefore, felt that while the Committee's recommendations to set up an agency named Board for Financial Regulation and Supervision (BFRS) to provide an integrated system of regulation and supervision over banks, FIs and NBFCs could be a long term objective. For the time being, BFS may continue with its present mandate.

3.4.3 Shah Committee (1992)

The development and regulatory framework of finance companies was laid down by a study group headed by A C Shah set up by RBI in May 1992. The report was submitted in September of the same year. From April 1993, in phases, the scheme of recommendations was implemented. The regulatory framework has three basic objectives;

1. To encourage orderly growth of NBFCs

2. To Protect the interests of depositors and

3. To ensure the efficacy of monetary and credit policy.

The group, after studying the developments in other countries, observed that the regulators have to resist the temptations of over regulation on grounds of the growth of NBFCs. The general approach of the Group was that a thriving, healthy and growing non-banking financial sector was necessary for promoting the growth of an efficient and competitive economy. Further the committee urged to bring innovative financial services that would meet the emerging needs of the economy.

3.4.4 Department of Non-Banking Supervision, RBI[7]

The Department of Non-Banking Supervision regulates and supervises Non-Banking Financial Companies (NBFCs). The Department has 16 regional offices across the country. The major financial intermediaries regulated by the Department are (i) Deposit accepting NBFCs, (ii) Non-Deposit accepting NBFCs and (iii) Securitisation Companies (SCs) / Reconstruction Companies (RCs).

Broadly, the functions of the Department are:

(i) Regulatory Activities

a. Formulating regulatory framework and issuing directions to NBFCs.
b. Issuing / cancellation of certificates of registration for NBFCs.

[7] *Reserve Bank of India: Functions and Working*

c. Ensuring proper classification for NBFCs by classifying them into four categories namely, Asset Finance Companies, Loan Companies, Investment Companies and Infrastructure Finance Companies.
d. Conducting on-site inspection, scrutiny and follow up.
e. Off-site surveillance and scrutiny of various returns.
f. Attending to complaints relating to NBFCs and supplying data to various departments of the Reserve Bank and other organisations.
g. Initiating deterrent action against errant companies.
h. Market intelligence gathering.
i. Monitoring of receipt of auditors' exception reports/annual certificates

(ii) Activities with regard to Securitisation and Reconstruction Companies

a. Issuing certificate of registration for SC / RC under SARFAESI Act, 2002.
b. Attending to various operational issues raised by SCs / RCs.
c. Collection of returns and preparing reviews on SCs' / RCs' functioning.
d. Study of operations and inspection of SCs / RCs.

(iii) Developmental Activities

a. Co-ordination with State Governments and other regulators for enacting state legislations to curb unauthorised and fraudulent activities in the NBFC sector.

b. Publicity campaign for depositors' education and awareness, workshops/seminars of trade and industry organisations, depositors' associations.

The business of NBFCs contracted marginally during the period 2005-06. The reason, as reported by RBI, is a sharp increase in expenditure. During that period, asset quality improved well. According to Report on Trend and Progress of Banking in India, 2005-06, the proportion of NBFCs with the Capital to Risk-Weighted Assets Ratio (CRAR) above 30 per cent increased whereas, the proportion of NBFCs with CRAR of less than 12 percent declined.

In February 2006, guidelines on securitization of standard assets were issued by RBI for NBFCs. The guidelines mainly focused on norms relating to true sale, criteria to be met by Special Purpose Vehicles (SPVs), special features including representations and warranties and re-purchase of assets from SPVs.

Financial Stability Board (2013), in the final policy documents on 'Strengthening Oversight and Regulation of Shadow Banking', focusses on five specific areas in which policies are needed to mitigate the potential systemic risks associated with shadow banking. Following are the five areas;

1. Mitigation of the *spill-over effect*[8] between the regular banking system and the shadow banking system.

2. Reduction of the susceptibilty of Money Market Funds (MMFs) to "*runs*"[9].

[8] Spillover effects are economic events in one context that occur because of something else in a seemingly unrelated context.

3. Assessment and alignment of the incentives associated with *securitisation*.

4. Dampening risks and pro-cyclical incentives associated with securities financing transactions such as *repos* and *securities lending*. The risk and incentives may exacerbate funding strains in times of market stress.

5. Assessment and mitigattion of *systemic risks*[10] posed by other shadow banking entities and activities.

As per IMF (2016), the growth of the non bank sector has not waned the effect of monetary policy. The report demands additional research on non banks concerned with the design of monetary policy responses over the business cycle. In India, the depositors' and borrowers' cautious behaviour, unlike in the case of developed regions, largely check the spill-over effect between the banking and shadow banking system.

NBFIs, emerged out of the necessity to have specialized financial institutions to cater for the diversified needs of financial services, have not contributed very much to the instability or to the ineffectiveness of monetary policy in the SEACEN region (Adhikary, 1989)[11]. But the economic crisis (2007-08) brought some instability to the world financial market and thus developed a

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[9] A bank run occurs when a large number of customers of a bank or another financial institution withdraw their deposits simultaneously due to concerns about the bank's solvency.

[10] Systemic risk is the risk of collapse of an entire financial system or entire market, as opposed to risk associated with any one individual entity, group or component of a system that can be contained therein without harming the entire system.

[11] The aim of the project was to study the implications for monetary policy. The study examined whether the growth of NBFIs in the SEACEN countries has resulted in the difficulty of central bank's functions related with the implementation of monetary policy or not. Further the study examined the need to regulate the NBFIs in order to achieve an effective and efficient monetary management. The study confined to Indonesia, Malaysia, Nepal, Philippines, Sri Lanka and Thailand.

well categorisation and prudential norms. The post crisis period compelled the monetary authority in India to have some more prudential norms on non deposit taking NBFCs. Although systemic risk is not a serious problem in a well centrally managed banking system in India, the growth of total NBFCs are showing a declining trend, a farther figure from the growth of commercial banking. Table 3.1 shows the number of NBFCs registered with RBI.

Table 3.1

Number of NBFCs Registered with Reserve Bank of India

Year	All NBFCs	NBFCs Accepting Public Deposits	NBFCs-ND
2008	12809	364	12445
2009	12740	336	12404
2010	12630	308	12322
2011	12409	297	12112
2012	12385	271	12114
2013	12225	254	11971
2014	12029	241	11788
2015	11842	220	11622
2016	11682	202	11480
2017	11522	178	11344

Source: Report on Trend and Progress of Banking in India for various years, RBI

Post crisis period witnessed a fall in the number of NBFCs in India. Both household sector and firms are benefitted with the vast financial services provided by the commercial banks during this period.

Table 3.2

Growth in Total Assets and Net Worth of NBFCs-ND-SI[12] in India

Year	Net Worth (Rs Billion)	Growth (Percentage)	Total Assets (Rs Billion)	Growth (Percentage)
2007	731.86		3178.98	
2008	1055.45	44.21	4087.05	28.56
2009	1307.67	23.90	4829.07	18.16
2010	1635.93	25.10	5888.06	21.93
2011	1981.00	21.09	7613.00	29.30
2012	2415.00	21.91	9353.00	22.86
2013	2923.47	21.05	11601.27	24.04
2014	3168.00	8.36	12742.00	9.83
2015	3630.00	14.58	15232.00	19.54
2016	3425.00	-5.65	14832.00	-2.63
2017	4046.00	18.13	16917.00	14.06

Source: Report on Trend and Progress of Banking in India for various years, RBI

As in the case of the number of entities, growth in net worth and assets shows a significant fall (Table 3.2). Average growth rate of shadow banks' assets for the period is 19.27 percent. Growth of such intermediaries is a positive thing to our financial system. Because, as RBI noted, shadow banks are capable of providing some diversified services to the economy. But the emergence of shadow banks is primarily justified on account of the provision of long term finance to projects.

Financial Stability Board (FSB) seeks to address the systemic risks related with shadow banking sector through indirect regulation. Its aim is to reduce the

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[12] A non-banking financial company not accepting / holding public deposits and having total assets of Rs 500 crore and above as shown in the last audited balance sheet (Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company Directions, 2016, RBI).

systemic risks carried out by regulating regular banks. So FSB focusses at three areas:

1. Prudential consolidation of banks' interactions wth shadow banking entities.

2. Introduction of prudential limits for banks' exposures to shadow banking entities.

3. A possible increase in capital requirements for banks' exposures to shadow banking entities (e.g.inclusion of investments in funds).

In practice, the high premium rates offered by the NBFCs-ND-SI on debt instruments will result in a drain in the surplus savings of the community, which can otherwise, be received by the banking community. Capital requirements for NBFCs are reviewed periodically. Further, there are some established delays on account of the conflict between various levels of governance.

RBI has been strengthening the regulatory and supervisory framework for NBFCs since 1997. NBFCs were advised in 2006 to prescribe the broad guidelines on fair practices that are to be framed and approved by the boards of directors of all non-banking financial companies.

The objective was the making of the NBFC sector vibrant and healthy. These efforts were pursued further during 2006-07. During the year, a major thrust was on strengthening the regulatory framework with regard to systemically important non-banking financial companies so as to reduce the regulatory gaps.

Accordingly, systemically important non-deposit taking NBFCs were defined and prudential norms were specified for these companies.

All NBFCs-ND with an asset size of Rs five billion and more as per the last audited balance sheet are considered as systemically important NBFCs-ND (NBFC-ND-SI). No NBFC-ND-SI is allowed to (i) lend to any single borrower/group of borrowers exceeding 15 per cent/ 25 per cent of its owned fund; (ii) invest in the shares of another company/ single group of companies exceeding 15 percent/ 25 percent of its owned fund; and (iii) lend and invest (loans/investments taken together) exceeding 25 percent of its owned fund to a single group of parties. NBFCs were required to obey with all constituents of the modified framework with effect from April 1, 2007.

With a view to ensuring adherence to compliance with the regulatory framework for NBFCs-ND-SI as on December 12, 2006, such companies were advised on April 27, 2007 to put in place a system of capital funds and risk asset ratio, among others, as at the end of March every year. The first such return was required to be submitted for the year ended March 31, 2007.

During the same year RBI amended the NBFCs Prudential Norms (Reserve Bank) Directions, 1998.

NBFCs-ND-SI were advised in 2007 to undertake a scrutiny of their financial exposures to large borrowers for procurement of foodgrains and also to consider quick scrutiny of the accounts on whom they have large exposure to confirm themselves that the funds were not diverted for procurement of

foodgrains with a view to hoarding. NBFCs were advised in 2005 to include their advertisements that RBI does not accept any responsibility or guarantee about the financial position, correctness of any statements, deposits or any other liabilities of the NBFCs.

3.5 Regulation of NBFCs by Different Authorities in India[13]

Equipment Leasing Companies, Hire-Purchase Finance Companies, Loan Companies, Investment Companies and Residuary Non-Banking Companies are regulated by RBI. Miscellaneous Non-Banking Companies (Chit Funds) are regulated by RBI and Regstrar of Chits of the concerned States. Mutual Benefit Finance Companies (Nidhis and Potential Nidhis) are regulated by Department of Comapny Affairs, GoI. Micro Finance Companies are regulated by Department of Company Affairs, GoI. Housing Finance Companies are regulated by NHB. Insurance Companies are regulated by Insurance Regulatory and Development Authority of India (IRDA). Stock Broking Companies and Merchant Banking Companies are regulated by SEBI.

3.6 An Evaluation of Measures Taken by the Reserve Bank in View of the Financial Stress Faced by NBFCs

The economic crisis unfolded in advanced economies around mid-2007. Emerging market economies (EMEs) were significantly affected by the global economic and financial crisis. The financial stress caused by the crisis affected

[13] Report on Trend and Progress of Banking in India, 2003-04, RBI

financial intermediation in emerging market economies. The case in India was not different.

RBI initiated discussions with a large number of NBFCs-ND-SI in October and November 2008 and studied their balance sheet to examine liquidity issues. When the market including the CP market became illiquid, rollover became a problem. It resulted in redemption pressures as most of the assets were long term (RBI, 2009).

RBI undertook some measures in respect of NBFCs sector following the financial crisis;

1. NBFCs-ND-SI was authorized as a provisional measure to hoist short-term foreign currency borrowings under the approval of route subject to the completion of certain conditions. The resources raised were to be used only for refinancing of short-term liabilities and not for creation of fresh assets. It is claimed that regulation and oversight have been extended to systemically important non-deposit taking finance companies, and this has limited leverage and space to regulatory arbitrage (RBI, 2009). But, in practice, the leverage is not limited and the initiatives of the monetary authority helped to augment the leverage of NBFCs-ND-SI in India.

2. Banks were consented, on a momentary basis, to avail liquidity support under the LAF window through relaxation in maintenance of SLR to the extent of up to 1.5 per cent of their NDTL, exclusively for meeting the funding requirements of NBFCs and mutual funds.

The period 2008-2016 witnessed an average 33.26 per cent growth in secured bank borrowings of NBFCs-ND-SI. The average growth rate of unsecured borrowings from bank for the same period was 6.49 percent.

3. Another thing is that the weight of risk on bank's exposure to NBFCs-ND-SI was diminished to 100 per cent from 125 per cent irrespective of credit rating. Exposure to AFCs which attracted risk weight of 150 per cent was deducted to 100 per cent.

4. NBFCs-ND-SI were permitted to augment their capital funds by issue of Perpetual Debt Instruments (PDIs). The amount of PDIs raised by NBFCs-ND-SI would not be treated as 'public deposit' within the meaning of Reserve Bank directives.

RBI constituted a Working Group on the 'Issues and Concerns in the NBFC sector' (Chairperson: Smt. Usha Thorat) to scrutinize an assortment of rising issues pertaining to the regulation of NBFC sector. The Report, placed in August 2011, recommended Tier I capital for CRAR at 12 percent to be achieved in three years for all registered deposit taking and non-deposit taking NBFCs. Asset classification and provisioning norms similar to banks to be brought in phased manner for NBFCs. The committee recommended that disclosures for NBFCs with assets of Rs 100 crore and above might comprise provision coverage ratio, liquidity ratio, asset liability profile, extent of financing of parent company products, movement of NPAs, off-balance sheet exposures, structured products and securitizations/assignments.

There are complaints that some NBFCs are not scrupulously following the proper documentation process and Know Your Customer (KYC) norms. Gold imports have increased sharply and this rose up macroeconomic concerns. A Working Group (Convener: Shri K.U.B. Rao) was constituted to undertake a detailed study on these aspects. The major terms of reference of the Group were: (i) to assess the trends in demand for gold loans and how they influenced gold imports; (ii) to analyse the implications of gold imports for external and financial stability; (iii) to study the trends in gold prices and to examine whether NBFCs that extend gold loans play any role in influencing the price of gold; (iv) to examine the sources of funds of NBFCs for gold loans, especially their borrowings from the banking system; and (v) to examine the current practices of NBFCs involved in lending against the collateral of gold. The Working Group submitted its report in August 2012.

During 2012-13, the recommendations of the Working Group were broadly accepted by the RBI and guidelines were issued related with appropriate infrastructure for storage of gold ornaments, prior approval of the RBI for opening branches in excess of 1000 in number, standardization of value of gold in arriving at Loan-to-Value Ratio (LTV), verification of the ownership of gold jewellery and process and procedures for the auction of gold jewellery.

NBFCs are classified into two categories, based on the liability structure, viz., Category ‘A’ companies (NBFCs accepting public deposits or NBFCs-D), and Category ‘B’ companies (NBFCs not raising public deposits or NBFCs-ND).

NBFCs are classified in terms of activities into Asset Finance Companies (AFC), Investment Companies (IC), Loan Companies (LC), Infrastructure Finance Companies (IFC), Core Investment Companies (CIC), Infrastructure Debt Fund-Non-Banking Financial Companies (IDF-NBFC), Non-Banking Financial Company-Micro Finance Institutions (NBFC-MFI) and NBFC-Factors. During 2011-12, two new categories of NBFCs, viz., Infrastructure Debt Funds- NBFC (NBFC-IDF) and Micro Finance Institution (NBFC-MFI) – were created and brought under separate regulatory framework. During 2012-13, a new category of NBFC, viz., Non Banking Financial Company- Factors- was created and a regulatory framework in the form of entry point capital and prudential regulations was placed on them.

3.7 Salient Features of Revised Regulatory Framework for NBFCs in India

A review of the entire regulatory framework for the NBFC sector (2014) has been undertaken with a view to transitioning, over time, to an activity based regulation of NBFCs. Certain changes to the regulatory framework are sought to be made to a) address risks wherever they exist, b) address regulatory gaps and arbitrage arising from differential regulations, both within the sector as well as vis-a-vis other financial institutions, c) harmonise and simplify regulations to facilitate a smoother compliance culture among NBFCs, and d) strengthen governance standards. Following are the important

recommendations made by the Working group on Issues and concerns in the NBFC Sector.

i) There was a minimum criterion for Net Owned Fund (NOF) for existing NBFCs (those registered prior to April 1999). It has been elevated in to Rs 20 million. NBFCs have been allowed till March 2017 to achieve the required minimum levels.

ii) In order to harmonize and strengthen deposit acceptance regulations across all deposit taking NBFCs (NBFCs-D) credit rating has been made compulsory for existing unrated asset finance companies (AFCs) by March 31, 2016. Maximum limit for acceptance of deposits has been harmonized across the sector to 1.5 times of NOF.

Both deposit taking and non deposit taking NBFCs, recently, focus on non deposit funds. There is a significant increase in the issue of debentures by NBFCs. These debt instruments, from the point of view of savers, are safe on account of charge but lacks insurance as in the case of deposits.

iii) The doorsill for defining systemic significance for non-deposit taking NBFCs has been revised to Rs five billion from the existing limit of Rs one billion. This has been done by viewing the overall increase in the growth of the NBFC sector. Thus, the Non-deposit taking NBFCs can be fetched under two broad categories: NBFCs-ND (those with assets less than Rs five billion) and NBFCs- ND-SI (those with assets of Rs five billion and above – deemed as systemically important) and regulations will be applied accordingly. NBFCs-

ND will be exempted from capital adequacy and credit concentration norms while a leverage ratio of 7 has been introduced for them.

The increase in the Net Owned Funds (NOF) of NBFCs will, theoretically, guarantee protection that to be ensured in the systemic drive. Listed (Financial) companies are capable of attracting capital on the branding of enlarging businesses. A proportionate enlargement could be found in the volume of businesses, diversification (like used vehicles finance) and total assets. Further, almost all NBFCs in India kept a high positive deviation from the regulatory minimum (NBFCs maintained an average 29 percent CRAR).

iv) More toughened prudential rules were suggested- including necessity for minimum Tier I capital got elevated to 10 per cent (from earlier 7 per cent in a phased manner by end of March 2017), asset classification norms (from 180 days to 90 days in a phased manner by the end of March 2018) accompanied with that of banks and increase in provisioning requirement for standard assets to 0.40 per cent in a phased manner by March 2018. With instant effect, the exclusion already provided for AFCs from the prescribed credit concentration norms of 5 per cent has been withdrawn. Additional corporate governance standards and disclosure norms for NBFCs have been issued for NBFCs-D and NBFCs-ND.

v) NBFCs with assets of less than Rs five billion shall not be subjected to prudential norms if they are not accessing public funds and those not having customer interface will not be subjected to conduct of business regulations.

The part is silent about the regulation of such NBFCs, if they fund using deposit like instruments. General public is not much rational and be scientific on the making of decisions related with investments in India. Further, there is little action from the part of monetary authority to convince the true characteristics of non banks funds and frauds. This is elaborate in the case of commercial banking.

vi) There is a norm that assets of multiple NBFCs in a group shall be aggregated to decide if such aggregation falls within the asset sizes of the two categories. Regulations as applicable to the two categories will be applicable to each of the NBFC-ND within the group. Reporting regime has been rationalized with only an annual return prescribed for NBFCs of assets size less than Rs five billion.

The regulatory framework concentrates on the following aspects of NBFCs;

1. Net owned funds of NBFCs

2. Maximum limit on acceptance of deposits

3. Systemic significance

4. Tier I capital

5. Prudential norms

6. Multiple NBFCs

3.8 Systemic Significance

RBI conducted its eleventh systemic risk survey (SRS) in October 2016. It was designed to capture the perceptions of experts, including market participants, on the major risks faced by the financial system. The survey considered the global risks as a medium one. The macroeconomic and institutional risks also fallen under medium risk category. Market risks and general risks have been under low risk category. The Indian Financial System remained stable.

Stress tests on credit risk were also conducted on non-banking financial companies. It was based on a single factor sensitivity analysis. On the basis of historical Standard Deviation (SD), the impact on CRAR was studied under three different scenarios[14].

1. Scenario I: Gross Non Performing Assets (GNPA) increased by 0.5 SD from the current level.
2. Scenario II: GNPA increased by 1 SD from the current level.
3. Scenario III: GNPA increased by 3 SD from the current level.

In the first scenario, CRAR of the sector declined and reached at 21.0 from 23.1. In the second scenario, it declined and reached at 15.3 percent. At an individual level, under first and second scenarios, around 5 percent of companies will not be able to comply with the minimum regulatory capital requirement (15 percent). 9 percent of companies will not be able to comply

[14] Financial Stability Report, December 2016 RBI

with the minimum regulatory CRAR norm under the third scenario. Table 3.3 shows network of the financial system in India.

Table 3.3

Network of Financial System in India

Financial Intermediaries	Percent of The Total Bilateral Exposures
SCB	57
NBFCs	13
AMC-MFs	11
AIFIs and Insurance Companies	9
UCBs and PFs	1

Source: Financial Stability Report, RBI, September 2016
AMC-MFs- Asset Management Company Mutual Funds, AIFIs- All India Financial Institutions, UCBs- Urban Cooperative Banks, PFs- Pension Funds

The degree of interconnectedness in the banking system is measured by the connectivity ratio. SCBs dominate accounting a 57 percent of the total bilateral exposures. This is followed by NBFCs with 13 percent.

Table 3.4 shows net lending/ borrowing by the institutions in India.

Table 3.4

Net Lending (+ve)/ Borrowing (-ve) by the Institutions

Rank	Net Lender	Net Borrower
I	AMC-MFs	NBFCs
II	Insurance Companies	AIFIs
III	UCBs	PVBs
IV	PSBs	FBs
V	PFs	

Source: Financial Stability Report, RBI, September 2016
PVBs- Private Sector Banks, FBs- Foreign Banks, PSBs- Public Sector Banks

NBFCs are being ranked as the first net borrower in the general financial system. Recent innovations on various instruments paved the way for the

exposure. A serious observation on the maturity of the aggregate advances of NBFCs is necessary in this context. First net borrower has a responsibility to develop the financial system by means of rational mediation. The nation expects huge increase in the value of fixed assets through the mechanisms of these NBFCs. 55 percent of the exposure of NBFCs is to the Pension Funds whereas 36 percent to Scheduled Commercial Banks (RBI, 2016)[15].

Aggregate funds of Scheduled Commercial Banks (SCBs), generally, show a lesser maturity. If these funds are being channelized directly by banks, it will improve the financial system more rapidly. The view is on a macro level. Table 3.5 shows bank exposure of NBFCs-ND-SI.

Table 3.5

Bank Exposure of NBFCs-ND-SI (As on March 2010)

(Amount in Rs Crore)

Bank Group	Term Loans	Working Capital Loans	Debentures	Others	Total
Nationalised Banks	37,863	5,666	3,773	2,001	49,303
Percentage to Total	-59.1	-37.1	-32.9	-37	-51.3
State Bank Group	5,866	3,756	1,160	19	10,802
Percentage to Total	-9.2	-24.6	-10.1	-0.4	-11.2
Old Private Banks	4,995	794	516	342	6,647
Percentage to Total	-7.8	-5.2	-4.5	-6.3	-6.9
New Private Banks	10,823	4,388	2,479	1,530	19,219
Percentage to Total	-16.9	-28.7	-21.6	-28.3	-20
Foreign Banks	4,483	674	3,552	1,510	10,218
Percentage to Total	-7	-4.4	-30.9	-28	-10.6
All Banks	64,029	15,279	11,480	5,402	96,190
Percentage to Total	-100	-100	-100	-100	-100

Source: Report on Trend and Progress of Banking in India 2009-2010, RBI.

[15] Financial Stability Report, RBI, September 2016

A high exposure is seen with nationalized banks. Both nationalised and new private banks are interested in providing working capital loans to NBFCs-ND-SI. Foreign banks are interested in advancing in the form of debentures. Table 3.6 shows the share of major items of NBFCs-ND-SI.

Table 3.6

Percentage Contribution to Total Assets/Liabilities of NBFCs-ND-SI

Year	Share Capital	Secured Debentures	Secured Borrowings from Banks	Unsecured Debentures	Unsecured Borrowings from banks	Loans and Advances	Investments
2010	6.19	9.95	7.79	14.02	7.40	59.19	20.34
2011	5.02	12.93	13.21	9.89	6.06	61.85	19.80
2012	5.60	18.67	15.90	13.05	4.88	65.68	16.51
2013	5.58	18.22	14.97	13.90	4.09	65.51	16.77
2014	5.22	20.10	14.53	13.68	4.10	67.67	15.44
2015	4.88	18.48	13.70	16.76	3.49	73.65	10.75
2016	4.75	16.53	14.13	17.04	3.79	74.95	10.18

Source: Report on Trend and Progress of Banking in India for various years, RBI

Share of owned funds has decreased whereas the secured borrowings increased. Unsecured debentures show an increase whereas unsecured borrowings from banks show a decrease. Table 3.7 shows growth of major items of NBFCs-ND-SI.

Table 3.7

Growth of Major Items of NBFCs-ND-SI

Year	Secured Debentures	Secured Borrowings from Banks	Unsecured Debentures	Unsecured Borrowings from banks	Loans and Advances	Investments
2011	67.95	119.41	-8.78	5.79	35.12	25.81
2012	77.44	47.81	62.15	-1.08	30.45	2.46
2013	21.05	16.83	32.10	4.12	23.72	26.00
2014	16.26	2.26	3.71	5.62	8.85	-2.95
2015	-2.84	-0.35	29.45	-10.15	15.02	-26.45
2016	-1.06	14.06	12.42	20.30	12.54	4.73

Source: Report on Trend and Progress of Banking in India for various years, RBI

Growth of Loans and advances from NBFCs-ND-SI shows a serious fall and it is the major item in the total assets. This recognizes two achievements, the strengthened banking practices in the country and a better allocation of resources by NBFCs towards advances. So, in this context, it may be concluded that the supervisory role of monetary authority, in this respect, is effective.

An evaluation of policy framework of NBFCs compels to explore the implication of commercial banking practices on the growth of NBFCs. From the above observations, it is understood that banking policies and practices affect the growth of NBFCs in India. NBFCs' growth is sufficiently equipped with the growth in banking sector. In a centralized banking system like India, support for such NBFCs would be highly related with the discretionary decisions of individual banks. Banks in India are able to produce superior results within the policy framework. Generally, the policy framework pegs

around two things; financial stability and growth. Here, individual performance of banks is also important and thus the individual practices would be different and are sometimes justifiable. This individual practice may sometimes support the secondary mediators. The practice is largely on the basis of profit motive. The secondary mediators, the beneficiary of such breaking of policy framework, in most of the circumstances, would be NBFCs. At theoretical level, growth of most of the NBFCs in India is the growth of deposits[16]. Table 3.8 shows growth in aggregate public deposits of NBFCs-D and Banks.

Table 3.8

Growth in Aggregate Public Deposits of NBFCs-D and Banks

Year	NBFC Deposits (Rs Billion)	Growth (Percent)	Bank Deposit Growth (Percent)
2007-08	20.4	-1.7	22.4
2008-09	19.7	-3.5	19.9
2009-10	28.3	43.6	17.2
2010-11	41	44.8	15.9
2011-12	57.4	39.9	13.5
2012-13	70.9	23.5	14.2
2013-14	108.1	52.5	14.1
2014-15	289.4	167.8	10.7
2015-16 P	379	31	9.3

Source: Report on Trend and Progress of Banking in India 2015-16, RBI. P= Provisional

We could not contend the NBFCs practices for the changes in bank deposits and related businesses. These two, deposits of banks and deposits of NBFCs are interdependent. In a few years it seems that the change in one item affects the other.

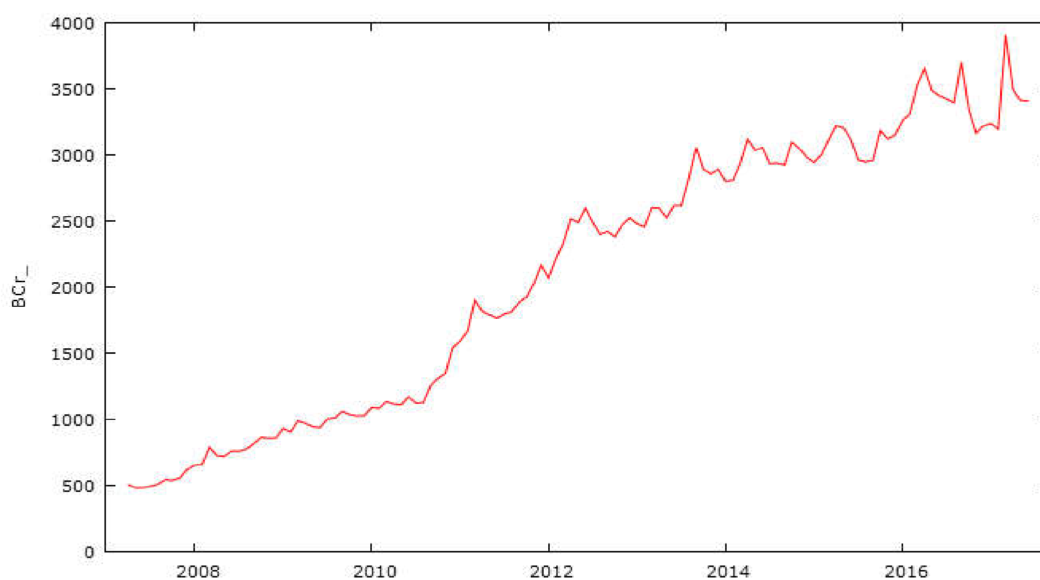
[16] Deposit Taking NBFCs. In India, Deposit taking NBFCs outperforms the non-deposit taking NBFCs in number.

3.9 Banking Practices and Growth of NBFCs

Figure 3.1 shows bank credit to NBFCs. After the economic crisis, both the volume and volatility in the bank credit to NBFCs increased.

Figure 3.1

Bank Credit to NBFCs

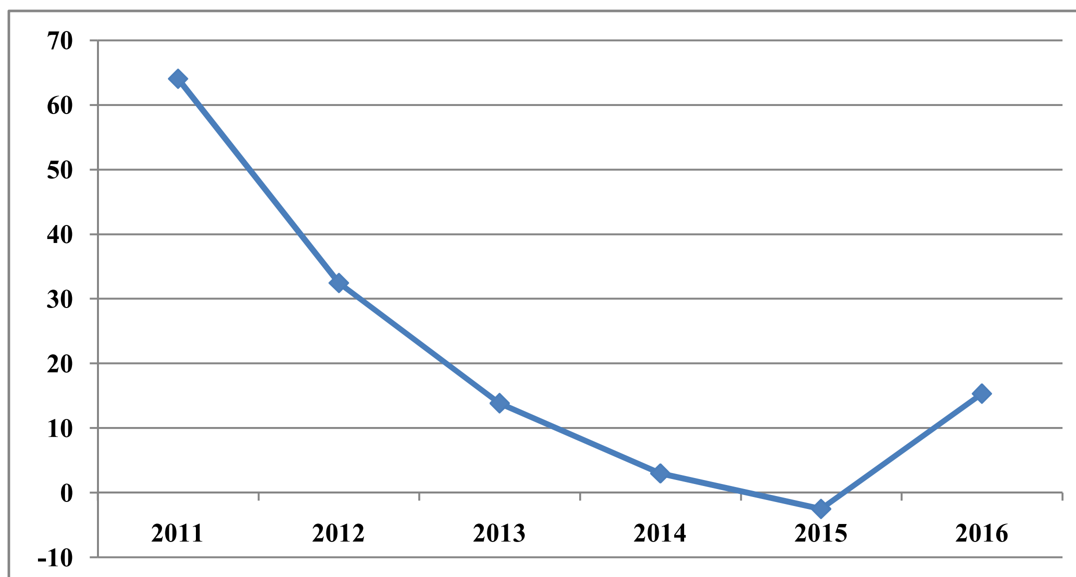


Source: Handbook of Statistics on the Indian Economy, RBI
BCr stands for Bank Credit to NBFCs in Billion Rupees

In a well elaborated financial system, shadow banks have substantial role in the making and maintaining the system. These financial mediators help in the financial development through lengthening and deepening the financial system. In Indian context, we cannot see exact representatives of shadow banks as in the case of developed economies. Figure 3.2 shows growth in total bank borrowings of NBFCs-ND-SI.

Figure 3.2

Percentage Growth in Total Bank Borrowings of NBFC-ND-SI



Source: Report on Trend and Progress of Banking in India for various years, RBI.

After 2010 RBI regulated NBFCs-ND-SI as in the case of deposit taking NBFCs. The reason for the stringency was the contagious nature and systemic importance of these NBFCs[17]. In effect, the overall dependence of these NBFCs fell down and the growth in bank dependence touched negative figure recently (2015). If we construct a model only with the borrowing from bank as singe determiner as shadow banking, we can deduce that, the volume of shadow banking is substantially fell down. As long as the central bank consolidates the bank advance to such entities, the demand for debt securities (from the part of NBFCs) would increase. With the smaller volume of NBFCs, we cannot expect a change in interest rates of debt. Regulatory measures

[17] Systemic risk, contagious nature, runs, and consequential failures are experienced phenomenon in developed economies.

developed during this period for whole NBFCs are not as elaborated as in the case of NBFCs-ND-SI.

According to the policy framework, NBFCs-D has to primarily depend on Tier I capital and public deposits. NBFCs-ND has to depend more on owned capital. Efforts had been taken to exclude irrational bank advances to the whole NBFCs so as to eliminate systemic and contagious risk. Growth in deposit volume and investment of banks may affect the growth of deposit of NBFCs. Savings of the economy is generally reflected in the growth rate of bank deposit. The relationship shall be explained using the following regression equation.

$$\boldsymbol{NBFCDep_{gr} = \alpha + Time\ Dep_{gr} + Inv_{gr} + \varepsilon}$$

Where,

α = Constant

$NBFCDep_{gr}$ = Deposit growth of NBFCs

$TimeDep_{gr}$ = Growth in time deposits of commercial banks

Inv_{gr} = Growth in investments in approved securities by commercial banks

ε = Error term

Deposit growth of NBFCs is a function of time deposits and growth of investments (on approved securities) of commercial banks. Investment decisions contribute towards the growth of NBFCs deposits. Theoretically, it is assumed that increase in deposit of commercial banks will help in the decline

of the deposits of NBFCs. Surplus generating units (households, firms and Governments) are primarily concerned with the interest rate on deposits. Whenever the banks cause an increase in the deposit rates, NBFCs cannot proportionally increase the rate. There are various reasons; some are structural and some are related with macro economic factors. Central banks intentionally adjust the rates of interest seeking a genuine mix of stability and growth. Such intentional adjustment is not possible in the case of NBFCs. At the same time, an unintentional change in the volume of deposits of NBFCs is apparent. Banks' investment decisions will affect the deposits growth in NBFCs. If banks are interested in channelizing much to investments, the same will act as a barrier to other investors. This will enhance the demand for deposits of NBFCs. Table 3.9 shows the regression results.

Table 3.9

Regression Results: Impact of Time Deposits and Investments of Banks on NBFC Deposits

	$NBFCDep_{gr}$
Intercept	104.43(.01)
$TimeDep_{gr}$	-.38(.06)
Inv_{gr}	.75(.004)
t Value;	
$TimeDep_{gr}$	-2.33
Inv^{*}_{gr}	4.63
R Square	0.85
Adjusted R Square	0.80
Std. Error of the Estimate	20.64
F Value	17.16 (.003)
N (No of Years)	9

Figures in parenthesis show the level of significance. *Investment in approved securities by banks.

Regression results support the theoretical expectations. Growth in banks' time deposits negatively but marginally affects the growth of NBFCs' deposits. So increase in the interest rates of time deposits will not be effective to regulate the flow of NBFCs deposits. Further, it will not be prudential in all circumstances. Thus, it can be interpreted that depositors of NBFCs will not be the substitutes for banks. Likewise, growth in banks' investment positively contributes towards the growth of deposits of NBFCs. This relationship may be due to the availability of good investment avenues.

3.10 Impact of Policies on NBFCs-ND-SI

The following laws, regulations, directions, orders applicable specifically to the NBFCs-ND-SI in India:

a. The Reserve Bank of India Act, 1934.
b. Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

The direction was to enable the RBI in regulating the financial system to the advantage of the country and to prevent the affairs of any NBFC-ND-SI and NBFC-D from being conducted in a manner detrimental to the interest of investors and depositors or in any manner prejudicial to the interest of such NBFCs. Further, the direction enables the RBI to implement the powers conferred under sections 45JA, 45K, 45L and 45M of the Reserve Bank of

India Act, 1934 (Act 2 of 1934) and section 6 of the Factoring Regulation Act, 2011.

c. Non-Banking Financial Companies – Corporate Governance (Reserve Bank) Directions, 2015

d. Master Direction- Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016

Monetary authority expects that NBFCs-ND-SI could chiefly operate with share capital. Further on the backing of such owned share capital, these NBFCs can acquire funds as debt. So, in the case of NBFCs-ND-SI, share capital performs a dual role; as a source of funds and as a determiner of debt. The regulation of these intermediaries[18]- in the name of systemic significance- resulted in a fall in the share of owned capital, from 6.19 percentage to 4.75 percent of total assets/ total liabilities. This is a serious fall in the implication of the related policy. This means that, NBFCs-ND-SI tend to borrow more from the public. The borrowing is less costly compared to ROE. Using of debt results in better profits and leads to multiplication of leverage which would further augment shadow banking in India. Lesser increase in capital and greater increase in advances signifies this leverage and shadow banking.

[18] RBI took serious regulatory measures for NBFCs-ND-SI from 2010 onwards.

3.11 Credit Rating of NBFCs

NBFCs are broadly grouped under four heads (i) asset finance companies, (ii) loan companies, (iii) investment companies, and (iv) infrastructure finance companies for regulatory compliance by the Reserve Bank. Shah Committee recommended credit rating for deposit taking NBFCs in 1992. In January 1998, new regulatory framework came into existence and RBI made it mandatory for NBFCs to get rated in order to protect the interest of the retail depositors.

Credit rating agency evaluates the company's business and financial risks, and uses this evaluation to project the level and stability of its future financial performance in various likely scenarios. The broad parameters are based on Business Risk and Financial Risk. Operating environment, Ownership Structure, Franchise and Size, Competitive Position, management, Systems and Strategy and Governance structure are the constituents of Business Risk. Asset Quality, Liquidity, Profitability and Capital Adequacy are the constituents of Financial Risk.

3.12 Recent Initiatives

1. Regulations on the framework for revitalizing distressed assets, reporting frauds and options on refinancing of project loans.
2. Issue of designing an appropriate ombudsman scheme for NBFCs.
3. In September 2016, the Reserve Bank started off a novel sort of NBFCs as NBFC-Account Aggregators (AAs) primarily for facilitating a consolidated view of individual investors' financial asset holdings,

especially when the entities fall under the purview of different financial sector regulators.

3.13 Conclusion

RBI shall develop norms concerned with the *volatility* in the share capital of NBFCs. Charge on the assets, practically, would not fully compensate for the loss occurred to the fund providers of NBFCs. The loss mentioned here may be perceived from many perspectives. More acceptable views are related with the practical difficulties faced by the debenture holders. The regulatory frame work, on grounds of increasing volume of the debt of NBFCs, does not bother about it. Stringent and well reviewed measures must be developed to manage such problems. Mere increase in the minimum capital requirements is a traditional method to overcome the systemic risks. Minimum CRAR determination shall be pegged around important macroeconomic factors and the scale of operation of NBFCs. RBI, through media, must inform the public about different avenues of investments and possible frauds.

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