

# **Working Group on the Issues and Concerns in the NBFC Sector**

## **Report and Recommendations**



**RESERVE BANK OF INDIA**  
**August 2011**

**LETTER OF TRANSMITTAL**

Chairperson

Working Group on the Issues and  
Concerns in the NBFC Sector

Dr. D. Subbarao  
Governor  
Reserve Bank of India  
Mumbai

Sir,

We have great pleasure in submitting the Report on the Issues and Concerns in the NBFC Sector. The Report has been prepared as per the Terms of Reference given to the Working Group.

The approach adopted by the Working Group was to review the existing regulatory and supervisory framework, the historical background and circumstances under which the framework was put in place, the global experiences and best practices for banks and non-banks in order to arrive at recommendations for the regulation and oversight of the sector. In the process of the study, the Group has had intensive discussions with all the stakeholders from the industry, including industry bodies and financial regulators concerned.

We sincerely thank you for entrusting us with this responsibility.

With regards,

Yours sincerely,



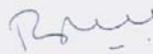
(Usha Thorat)  
Chairperson



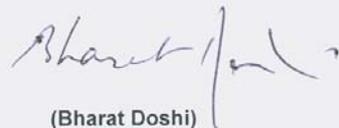
(Sanjay Labroo)  
Member



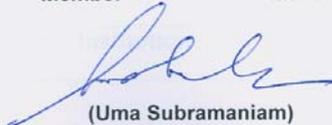
(Preeti Kar)  
Member



(Rajiv Lall)  
Member



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Member



(Uma Subramaniam)  
Member Secretary

Mumbai  
August 23, 2011

## ABBREVIATIONS AND ACRONYMS

<b>AFC</b>	<b>Asset Finance Company</b>
<b>ALM</b>	<b>Asset Liability Management</b>
<b>BIS</b>	<b>Bank for International Settlements</b>
<b>CIC-ND-SI</b>	<b>Systemically Important Non-Deposit Taking Core investment Company</b>
<b>CME</b>	<b>Capital Market Exposures</b>
<b>CoR</b>	<b>Certificate of Registration</b>
<b>CP</b>	<b>Commercial Paper</b>
<b>CRAR</b>	<b>Capital to Risk Weighted Assets Ratio</b>
<b>CRE</b>	<b>Commercial Real Estate</b>
<b>FCRB</b>	<b>Financial Companies Regulation Bill</b>
<b>FDI</b>	<b>Foreign Direct Investment</b>
<b>IC</b>	<b>Investment Company</b>
<b>ICD</b>	<b>Inter Corporate Deposits</b>
<b>IFC</b>	<b>Infrastructure Finance Company</b>
<b>IPO</b>	<b>Initial Public Offering</b>
<b>IRDA</b>	<b>Insurance Regulatory and Development Authority</b>
<b>JPC</b>	<b>Joint Parliamentary Committee</b>
<b>KYC</b>	<b>Know Your Customer</b>
<b>LC</b>	<b>Loan Company</b>
<b>LCR</b>	<b>Liquidity Coverage Ratio</b>
<b>LOLR</b>	<b>Lender Of Last Resort</b>
<b>MFI</b>	<b>Micro Finance Institution</b>

<b>M&amp;A</b>	<b>Mergers and Acquisitions</b>
<b>NBFC</b>	<b>Non Banking Financial Company</b>
<b>NBFC-ND-SI</b>	<b>Systemically important Non Deposit taking Non Banking Financial Company</b>
<b>NBFC-D</b>	<b>Deposit taking Non Banking Financial Company</b>
<b>NBFC-ND</b>	<b>Non Deposit taking Non Banking Financial Company</b>
<b>NBFI</b>	<b>Non Banking Financial Institutions</b>
<b>NCD</b>	<b>Non-convertible debentures</b>
<b>NOF</b>	<b>Net Owned Funds</b>
<b>NPA</b>	<b>Non-Performing Asset</b>
<b>OTC</b>	<b>Over-the-counter</b>
<b>PFI</b>	<b>Public Financial Institution</b>
<b>PSL</b>	<b>Priority Sector Lending</b>
<b>RBI</b>	<b>Reserve Bank of India</b>
<b>RNBC</b>	<b>Residuary Non Banking Company</b>
<b>RoA</b>	<b>Return on Assets</b>
<b>RoE</b>	<b>Return on Equity</b>
<b>SARFAESI</b>	<b>Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest</b>
<b>SCB</b>	<b>Scheduled Commercial Bank</b>
<b>SC&amp;RC</b>	<b>Securitisation and Reconstruction Companies</b>
<b>SEBI</b>	<b>Securities and Exchange Board of India</b>
<b>SLR</b>	<b>Statutory Liquidity Ratio</b>
<b>SME</b>	<b>Small and Medium Enterprise</b>

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## **1. Introduction**

1.1.1 Over the last four decades since 1964, when Chapter III B was inserted in the Reserve Bank of India Act 1934, giving limited powers to the Bank to regulate deposit taking companies, the Reserve Bank has been taking gradual steps to bring the non banking financial (NBFC) sector of the country within the ambit of its regulation. In January 1997, sweeping changes were made to the RBI Act, 1934, particularly Chapters III-B, III-C, and V of the Act with the primary objective of putting in place a comprehensive regulatory and supervisory framework, aimed at protecting the interests of depositors as well as ensuring the sound functioning of NBFCs.

1.1.2 In the period following the last amendment of the Act in 1997, the non-banking financial sector has evolved considerably in terms of operations, variety of market products and instruments, technological sophistication, etc. Over recent years the NBFCs have assumed increasing significance and have added considerable depth to the overall financial sector. The regulatory responses on the part of RBI have also kept pace with the evolution of this sector. In particular, regulation has adequately addressed the issue of depositor protection, a major concern of RBI. There has been a gradual, regulation induced reduction in the number of deposit taking NBFCs, including Residuary Non-Banking Finance Companies (RNBCs), from 1,429 in March 1998, to 311 in March 2010. The deposits held by these companies (including RNBCs) decreased from Rs. 23,770 crore, comprising 52.3 percent of their total assets, to Rs. 17,273 crore, comprising 15.7 percent of their total assets.

1.1.3 The NBFC sector more generally has seen a fair degree of consolidation , leading to the emergence of larger companies with diversified activities. This consolidation and acquisition activity has contributed to growth in the number of NBFCs with an asset base in excess of Rs. 100 crore. To ensure the sound development of these companies the regulatory response has been to introduce exposure and capital adequacy norms, for NBFCs with assets of Rs. 100 crore and above.

1.1.4 The recent global financial crisis has however highlighted the importance of widening the focus of NBFC regulations to take particular account of risks arising from regulatory gaps, from arbitrage opportunities and from the inter-connectedness of various activities and entities comprising the financial system. The regulatory regime for NBFCs is lighter and different in many respects from that for the banks. The steady increase in bank credit to NBFCs over recent years means that the possibility of risks being transferred from the more lightly regulated NBFC sector to the banking sector in India can no longer be ruled out. That said, given the growing importance of this segment of the financial system, it has become equally important to ensure that the dynamism displayed by NBFCs in delivering innovation and last mile connectivity for meeting the credit needs of the productive sectors of the economy is not curbed. There has emerged therefore a need to rationalise the type and nature of NBFCs being regulated so that the objectives of regulation are met in an optimal and balanced manner.

1.1.5 In light of the above, the objective of this report is to revisit the broad principles that underpin the regulatory architecture for NBFCs (excluding MFIs and RNBCs). The report intends to examine in depth the risks in the NBFC sector in the current scenario and recommend appropriate regulatory and supervisory measures to address these risks with the aim of creating a strong and resilient financial sector which is vital for all round economic growth of the country.

## **1.2 Constitution of the Working Group**

1.2.1 Against the backdrop of the developments in the NBFC sector described above, the BFS in its meeting held on September 29, 2010, desired that a Working Group be constituted with experts to study the issues and concerns in the NBFC sector. Accordingly, a Working Group (WG) was set up under the Chairmanship of Smt. Usha Thorat, Director, Centre for Advanced Financial Research and Learning (CAFRAL) with Shri Sanjay Labroo, Director, Central Board, Reserve Bank of India, Dr Rajiv B. Lall, Managing Director and Chief Executive Officer, Infrastructure Development Finance Corporation, Shri Bharat Doshi, Executive Director and Group Chief Financial Officer, Mahindra & Mahindra, Shri Pratip Kar, Director, Globsyn

Business School, Kolkata, to examine a range of emerging issues pertaining to the regulation of the sector. Ms Uma Subramaniam Chief General Manager In-Charge DNBS was Member Secretary.

### **1.3 Terms of Reference**

1.3.1 The terms of reference for the Working Group are as under:

- To review the concept of "principal business" for the purpose of requiring registration of NBFCs and to re-examine the need for separate regulatory categories of NBFCs as well as the practicality of having differentiated regulation by type of non-bank financial activity;
- To reassess the entry point norms for NBFCs in terms of their capital structure
- To revisit the current framework on exemptions to certain categories of NBFCs with the objective of addressing regulatory arbitrage issues.
- To review the policy framework on permitting multiple NBFCs within a single group and to review the risks arising out of registering captive NBFCs floated by manufacturing or industrial houses;
- To examine the need for convergence of regulation of NBFCs with that of best regulatory practices of banks;
- To recommend comprehensive 'Disclosure norms' for NBFCs;
- To examine the need, if any, to prescribe professional qualifications for Independent Directors on the Boards of NBFC-ND-SIs;
- To examine the need, if any, for monitoring assets in one or other type of NBFC;
- To arrive at a set of principles to guide the frequency and depth of supervision/inspection/regulation of various types and sizes of NBFCs based on their interconnectedness with other institutions.

### **1.4 Approach adopted by the Working Group**

1.4.1 In all the Working Group held twelve meetings over a period of 5 months. The Group met with representatives of various trade associations of NBFCs, and also had consultations with SEBI and other market participants. Responses on the issues under examination were also invited from a range of stakeholders.

## **1.5 Organization of the Report**

1.5.1 The report is divided into thirteen sections. The introductory section is followed by a section on historical background and assessment of the evolution of the sector in the decade since the amendment to the RBI Act in 1997, and includes a short summary of the changes in the regulatory framework of NBFCs. The remaining sections deal in depth with the issues examined by the Group. The recommendations of the Group are summarized in the last section.

## **1.6 Acknowledgements**

1.6.1 The Working Group is indebted to Smt. Shyamala Gopinath, former Deputy Governor, RBI for the support and guidance provided to the Group. The Committee is especially grateful to Shri G. S. Hegde, Principal Legal Advisor, for his valuable insight and contributions at every stage of its deliberations. The Working Group would like to convey its deepest gratitude and admiration for the superlative effort of team RBI comprising of C.R. Samyukhta, Archana Mangalagiri, Reena Banerjee, Tuli Roy, Sindhu Pancholy and Mangesh Deshpande. They brought their extensive knowledge to the rich debate within the group. They also worked tirelessly to meet challenging deadlines to bring this Report to its completion. In addition, K.R.Krishnakumar, M.Sreeramulu, S.Pitre and P.D.Dey worked enthusiastically behind the scenes, to provide data analysis, charts and diagrams.

## **2. Background – The NBFC Sector**

### **2.1 Types of NBFCs**

2.1.1 NBFCs have been classified on the basis of the kind of liabilities they access, the type of activities they pursue, and of their perceived systemic importance.

## **2.2 Liabilities Based Classification**

2.2.1 NBFCs are classified on the basis of liabilities into two categories, viz, Category 'A' companies, (NBFCs having public deposits or NBFCs-D), and Category 'B' companies, (NBFCs not having public deposits or NBFCs-ND). NBFCs-D are subject to requirements of capital adequacy, liquid assets maintenance, exposure norms (including restrictions on exposure to investments in land, building and unquoted shares), ALM discipline, reporting requirements, while till 2006 NBFCs-ND were subject to minimal regulation.

## **2.3 Activity Based Classification**

2.3.1 Presently NBFCs are classified in terms of activities into five categories, viz., Loan Companies (LCs), Investment Companies (ICs), Asset Finance Companies (AFCs), Infrastructure Finance Companies (IFCs) and Systemically Important Core Investment Companies (CICs-ND-SI). The eligibility criteria for such a classification are given in Annex II.

## **2.4 Size Based Classification**

2.4.1 In 2006, non-deposit taking NBFCs with assets of Rs. 100 crore and above were labelled as Systemically Important Non-Deposit taking NBFCs (NBFCs-ND-SI), and prudential regulations such as capital adequacy requirements, exposure norms along with, reporting requirements were made applicable to them. CME and ALM reporting and disclosure norms were made applicable to them at different points of time.

## **2.5 Profile of the NBFC Sector**

2.5.1 The total number of NBFCs was 12,662 as on March 31, 2010, comprising 311 deposit taking NBFCs (NBFCs-D), 295 systemically important non deposit taking companies, (NBFCs-ND-SI) and 12,056 other non-deposit taking NBFCs (NBFC-ND).

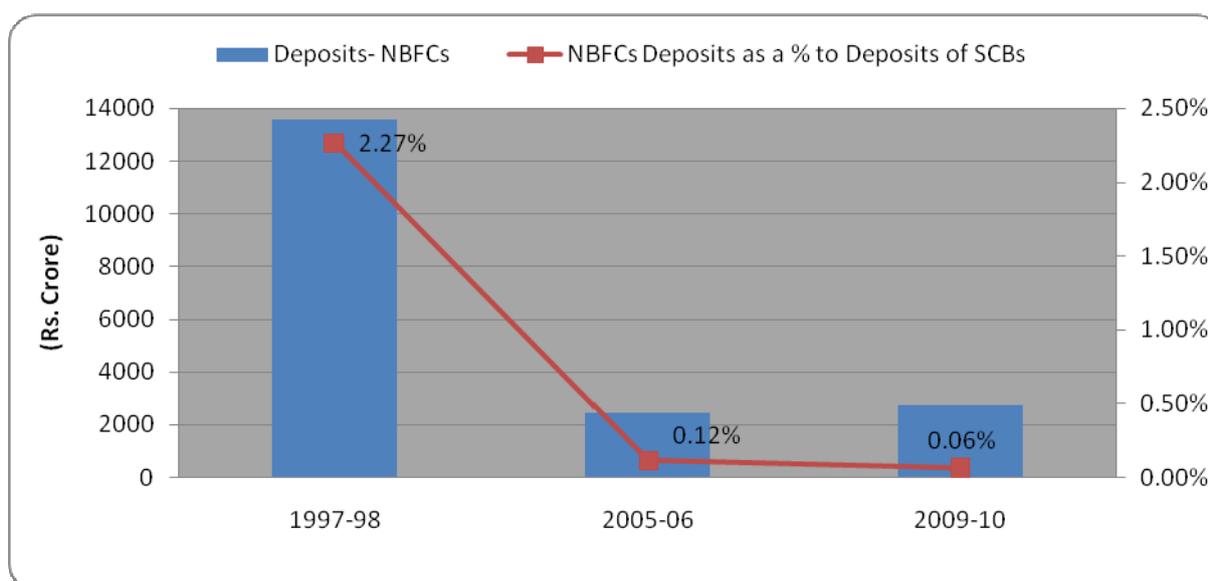
2.5.2 The number of NBFCs-D (excluding RNBCs) and the amount of deposits held by them have been showing a sharp decline over the years. Table 1 and Chart 1 below show the trend in the amount of deposits held by them as a share of bank deposits for the years 1998, 2006 and 2010.

**Table 1: NBFCs@ - Acceptance of Public Deposits**  
(Rs. Crore)

Year	No. of Reporting Companies	Public Deposits	Public Deposits as % of Bank Deposits
<b>1997-98</b>	1420	13572	2.27%
<b>2005-06</b>	428	2448	0.12%
<b>2009-10</b>	280	2753	0.06%

@ Excluding RNBCs

**Chart 1: NBFCs-acceptance of Public Deposits**



2.5.3 At the same time, the NBFC-ND-SI sector, which constitutes 70 per cent of total assets of NBFCs, recorded significant growth. Their number increased from 151 in March 2006 to 295 in March 2010, and their assets grew from Rs. 250,765 crore, to Rs. 566,853 crore in the same period. Table 2 and Chart 2 give the growth of assets in the NBFC sector as a whole, (NBFC-D and NBFC-ND-SI), since 1997-98.

**Table 2: NBFCs@@ - Growth of Assets**

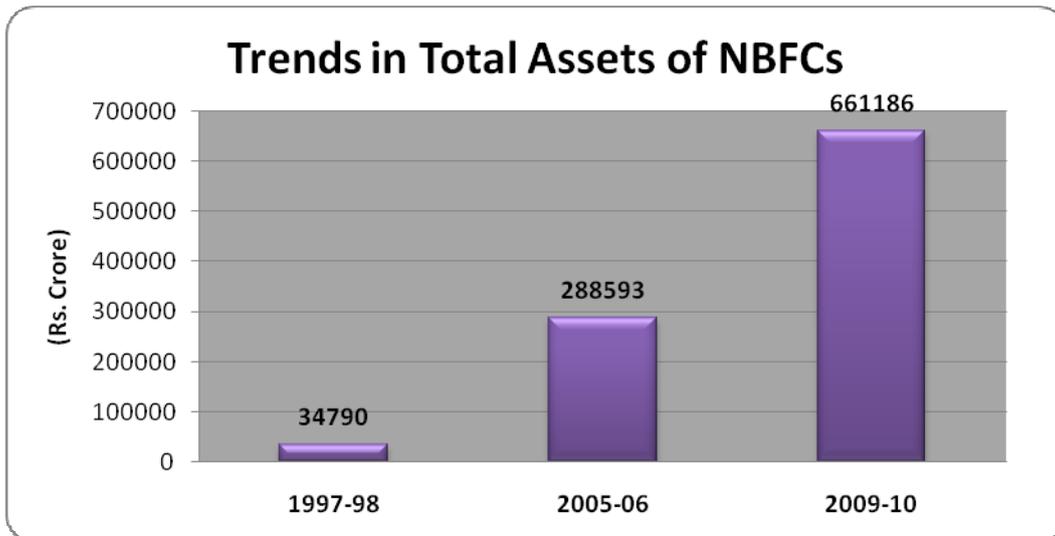
(Rs. Crore)

Year	No. of Reporting Companies	Total Assets	CAGR (%)	Total Assets as % of total Bank Assets
1997-98	1420	34790		4.4
2005-06	586	288593	30.3	11.1
2009-10	575	661186	23.0	11.0

@@ Excludes RNBCs but includes deposit taking (NBFCs-D) and systemically important non-deposit taking NBFCs (NBFCs-ND-SI) which account for about 90% of total assets of the sector

Data for the year 1997-98 includes only deposit taking NBFCs while other two periods, 2005-06 and 2009-10 includes deposit taking NBFCs and NBFCs-ND having assets size Rs. 100 crore & above (ND-SI)

**Chart 2: Trends in Total Assets of NBFCs**



2.5.4 Table 3 and Chart 3 indicate that bank borrowings constitute an important source of funds for NBFCs. The NBFCs-ND-SI are significant from the systemic point of view as they also access public funds indirectly through commercial papers, debentures and inter-corporate deposits apart from bank finance. Table-4 and Chart 4 give the details in this regard.

**Table 3: NBFCs@@ - Borrowings from Banks as Source of Funds**

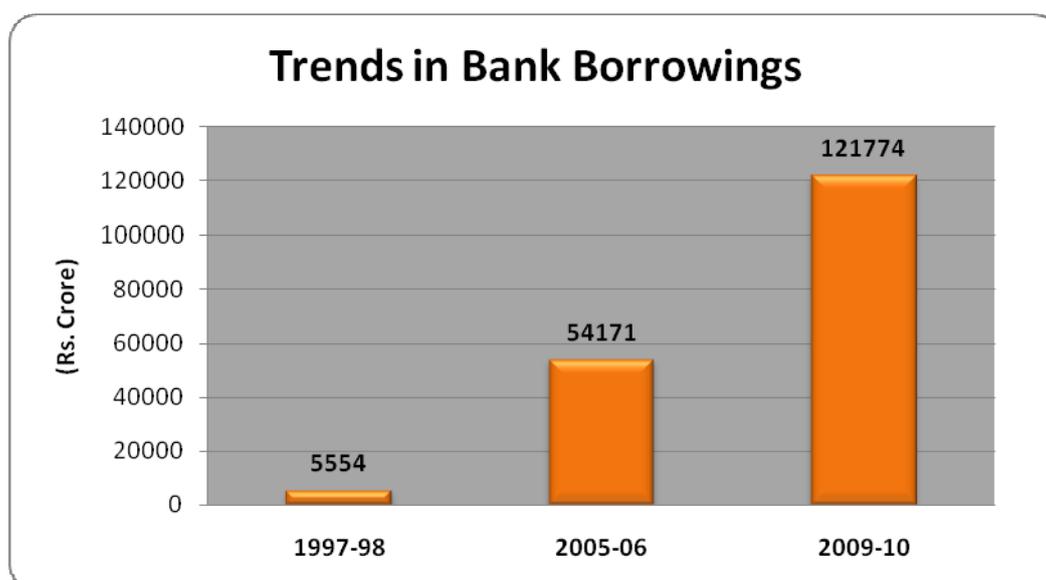
(Rs. Crore)

Year	No. of Reporting Companies	Total Assets	Bank Borrowings	CAGR (Bank Borrowings)	Bank Borrowings as % of Total Assets
<b>1997-98</b>	1420	34790	5554		16.0
<b>2005-06</b>	586	288593	54171	32.9	18.8
<b>2009-10</b>	575	661186	121774	22.4	18.4

@@ Excluding RNBCs but include deposit taking and non-deposit taking NBFCs which account for about 80% of total assets of the sector (Source : Returns)

Note: Data for the year 1997-98 includes only deposit taking NBFCs while other two periods, 2005-06 and 2009-10 includes deposit taking NBFCs and NBFCs-ND having assets size Rs. 100 crore & above (ND-SI)

**Chart 3: Trends in Bank borrowings**



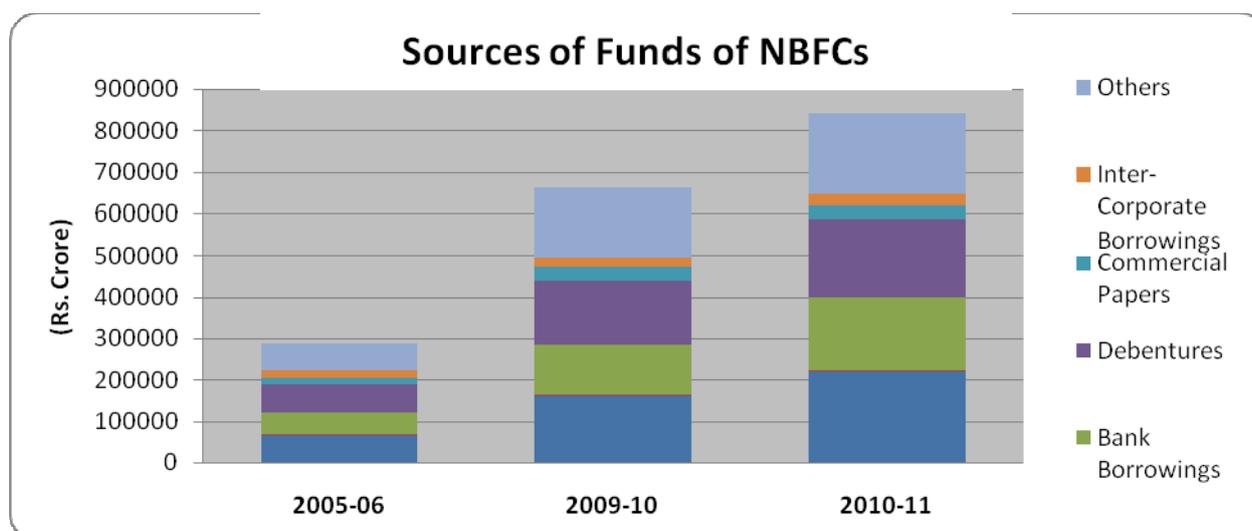
**Table 4: NBFCs@@ - Sources of Funds**

(Rs. Crore)

Year	2005-06	2009-10	2010-11
Owned Fund	65068	161288	218454
	(22.5)	(24.4)	(25.9)
Public Deposits	2667	2753	3935
	(0.9)	(0.4)	(0.5)
Bank Borrowings	53188	120986	176879
	(18.4)	(18.3)	(21.0)
Debentures	68138	154109	186883
	(23.6)	(23.3)	(22.2)
Commercial Papers	13785	35546	33672
	(4.8)	(5.4)	(4.0)
Inter-Corporate Borrowings	19718	19898	25972
	(6.8)	(3.0)	(3.1)
Others	66029	166607	196854
	(22.9)	(25.2)	(23.4)
<b>Total Assets</b>	<b>288593</b>	<b>661187</b>	<b>842649</b>
	(100.0)	(100.0)	(100.0)

@@ Excludes RNBCs but include deposit taking (NBFCs-D) and systemically important non-deposit taking NBFCs (NBFCs-ND-SI) which account for about 90% of total assets of the sector  
 Note: Data for the year 1997-98 includes only deposit taking NBFCs while other two periods, 2005-06 and 2009-10 includes deposit taking NBFCs and NBFCs-ND having assets size Rs. 100 crore & above (ND-SI)  
 Note: Others include interest accrued, borrowings from relatives, deferred credits and other borrowings

**Chart 4: Sources of Funds**



## 2.5.5 Category wise profitability of NBFCs:

Table 5 and Chart 5 show the growth of assets as per type of NBFCs while Table 6 and Chart 6 gives the ROE, ROA and leverage ratio for various types of NBFCs.

**Table 5: Growth of Assets as per type of NBFCs (yoy %)**  
NBFCs

Year	2006-07	2007-08	2008-09	2009-10	2010-11
Asset Finance Companies	52261	73598	97686	113951	138074
		(40.8)	(32.7)	(16.7)	(21.2)
Investment Companies	119191	115677	121267	143244	153683
		-(2.9)	(4.8)	(18.1)	(7.3)
Loan Companies	182351	244884	371102	403992	497580
		(34.3)	(51.5)	(8.9)	(23.2)
<b>Total Assets</b>	<b>353803</b>	<b>434159</b>	<b>590055</b>	<b>661187</b>	<b>789337</b>
		(22.7)	(35.9)	(12.1)	(19.4)

(Rs. Crore)

Figure in brackets represents percentage growth rates on year-on-year basis

Note: Loan companies include infrastructure finance companies, MFIs and gold loan companies and Govt. companies

Note : The above data pertains to both NBFC-D and NBFC-ND-SI

**Chart 5: Trends in total assets of NBFCs**

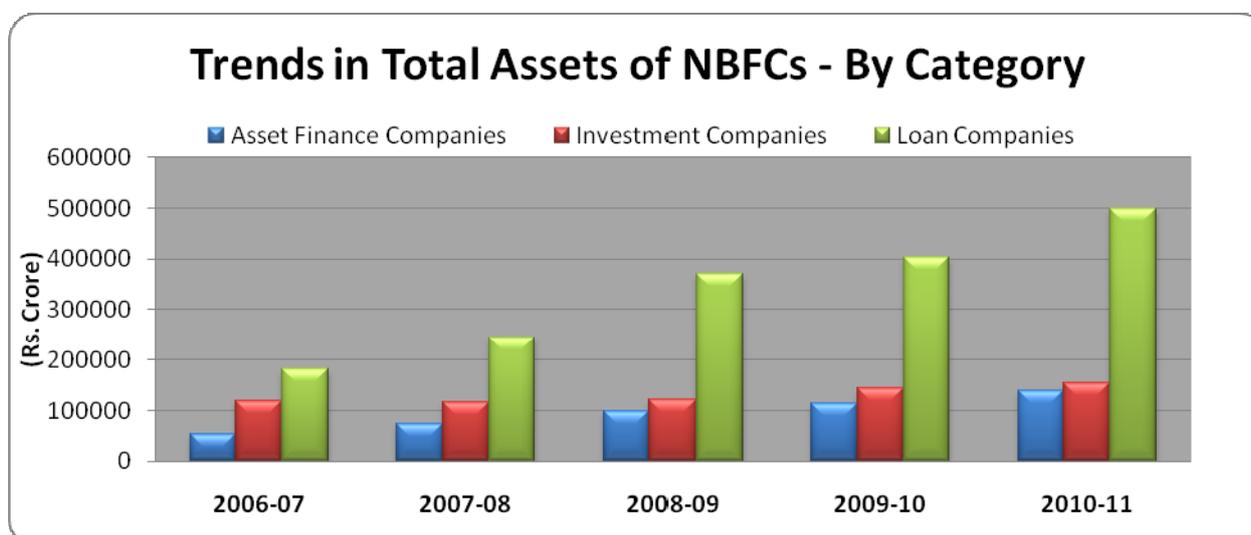


Table 6: Profitability Indicators of NBFCs, As on Mar 31, 2010							
Type of NBFC	Total Assets	Return on Assets (%)		Return on Equity (%)		Leverage Ratio (%)	
		NBFCs-D	ND-SI	NBFCs-D	ND-SI	NBFCs-D	ND-SI
Public Sector NBFCs	61988	2.9	1.1	22.2	11.0	13.1	10.1
IFCs	196158	NA	2.8	NA	16.3	NA	17.1
AFCs	113951	2.8	1.3	19.8	8.5	14.2	15.1
Gold Loan Companies	8650	4.6	3.9	19.4	37.4	23.9	10.5
MFIs	13675	NA	3.7	NA	21.4	NA	17.4
Other Loan & investment Companies	266764	4.5	1.7	6.0	3.8	75.9	44.5
<b>All NBFCs</b>	<b>661186</b>	<b>3.0</b>	<b>2.0</b>	<b>19.4</b>	<b>7.1</b>	<b>15.6</b>	<b>28.6</b>
Note:1. NBFCs-D=Deposit taking NBFCs and ND-SI=non-deposit taking systemically important NBFCs (NBFCs-ND with assets size Rs. 100 crore & above)							
Note:2. Leverage Ratio = Tier-I Capital as a % to Total Assets							
Source: Annual Returns on NBFCs-D and ND-SI							

## 2.6 Extant Regulatory Framework

2.6.1 Annex IV lists the various regulatory changes since 1964 for the NBFC sector. Amendments to the Act in 1997 bestowed comprehensive powers on RBI to regulate and supervise NBFCs. The salient features of the amendments made to Chapter IIIB of the RBI Act in 1997 include, (a) making it mandatory for NBFCs to obtain a Certificate of Registration (CoR) from RBI and to maintain a minimum level of Net-Owned Funds (NOF); (b) requiring deposit taking NBFCs to maintain a certain percentage of assets in unencumbered approved securities; (c) requiring all NBFCs to create a reserve fund and to transfer a sum which is not less than 20 per cent of their profits every year; (d) empowering RBI to determine policy and issue directions with respect to income recognition, accounting standards etc.; (e) empowering RBI to issue directions to NBFCs or their auditors with respect to their balance sheets, profit and loss account, disclosure of liabilities, etc.; (f) empowering RBI to order a special audit of NBFCs; (g) empowering RBI to prohibit NBFCs from alienating assets and (h) empowering RBI to file winding up petitions against NBFCs.

2.6.2 The initiatives taken with respect to deposit taking NBFCs had brought in discipline in their functioning, besides reducing the instances of default in repayment obligations to the depositor community. ALM guidelines were introduced in 2001 to address the liquidity risk faced by deposit taking companies; capital adequacy and credit concentration norms made them more robust. A floating charge over liquid assets in favour of depositors was stipulated in 2005. In addition a Fair Practices Code for lending was prescribed in 2006, directed towards ensuring transparency in pricing of loans and ethical behaviour towards borrowers. Corporate governance framework was introduced in 2007 to ensure more professionalism in NBFCs and KYC norms were also made applicable to them.

2.6.3 The objectives of NBFC regulations have undergone refinement over the past decade to keep pace with new developments. The emergence of large non-deposit taking companies posing increasing systemic risk came to be recognised. In November 2004, the scope of the off-site monitoring system was widened to include reporting by large non-deposit taking companies with asset size of Rs 500 crore and above, in recognition of the fact that their inter-linkages with the broader financial system incorporating both the banks as well as the capital market could pose increasing systemic risk. The scope of reporting was expanded in September 2005 to include NBFCs with asset size of Rs. 100 crore and above. All non-deposit taking NBFCs with an asset size of Rs. 100 crore and above were termed Systemically Important in December 2006, and the focus of regulation and supervision of these entities was made sharper with the introduction of capital adequacy and exposure norms.

2.6.4 Since then, additional regulatory measures have been introduced in a calibrated manner to reflect the RBI's emerging focus on non-deposit taking NBFCs and systemic risk related issues. Capital adequacy requirements and credit concentration norms were imposed on NBFCs-ND-SIs, with effect from April 2007 and ALM reporting and disclosure norms on CRAR, exposure to real estate sector and maturity pattern of assets and liabilities were introduced in August 2008 for these companies. In September 2008 reporting requirements were introduced for NBFCs with an asset size of above Rs. 50 crore. In August 2010 the dispensation

previously granted to Core Investment Companies was removed, bringing systemically important core investment companies also under the regulatory framework.

## **2.7 Scope of the Working Group**

2.7.1 The terms of reference of the Working Group limit it to the areas enunciated therein. In particular the Working Group did not have the remit to address legislative changes and therefore has worked within the existing legal framework. Nonetheless in certain areas, the Group has found it fit to make some suggestions for legal amendments whenever such a possibility arises in the future. It should also be clarified that micro finance regulation is not covered by the Group (being separately dealt with by the proposed new bill in Parliament). Primary dealers in government securities and asset reconstruction companies are also not dealt with by the Working Group. While primary dealers are registered as NBFCs, they are regulated by the Internal Debt Management Department of RBI. Securitization and Reconstruction Companies (SC&RC) are governed and regulated by a separate framework under SARFAESI Act. RNBCs are also not covered.

## **3. Definition and Classification of NBFCs**

### **3.1 Entry Point Norms**

3.1.1 In terms of Section 45IA of the RBI Act, 1934, no NBFC shall commence or carry on the business of NBFIs without having NOF of Rs. 25 lakh or such other amount not exceeding Rs. 2 crore as may be specified by RBI. NOF has been defined in the Act.<sup>1</sup> There is a statutory ceiling on the maximum amount that may be specified by RBI as the entry level NOF requirement. However, for considering an

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<sup>1</sup> Net Owned Funds has been defined in the RBI Act 1934 as (a) the aggregate of paid up equity capital and free reserves as disclosed in the latest balance sheet of the company, after deducting there from (i) accumulated balance of loss, (ii) deferred revenue expenditure and (iii) other intangible asset; and (b) further reduced by the amounts representing (1) investment of such company in shares of (i) its subsidiaries; (ii) companies in the same group; (iii) all other NBFCs and (2) the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to and deposits with (i) subsidiaries of such company and (ii) companies in the same group, to the extent such amounts exceed ten percent of (a) above.

application of a company for grant of a Certificate of Registration (CoR), the RBI is required to satisfy itself that the NBFC concerned has an adequate capital structure and earning prospects<sup>2</sup>.

3.1.2 The RBI Act 1934 capped the NOF at Rs. 2 crore in 1997. Although the requirement of NOF presently stands at Rs. 2 crore, companies that were already in existence before April 21, 1999 are allowed to maintain NOF of Rs. 25 lakh and above. With effect from April 1999 the Bank has not been registering any new NBFC the NOF of which is below Rs. 2 crore. This notwithstanding, NBFCs may maintain NOF more than Rs. 2 crore. Since then, the NBFC sector has undergone a sea change from being small family run businesses, primarily using own funds, to large sized NBFCs dependant largely on public funds. The general increase in the price level since 1999 by itself would call for an increase in the capital requirements necessary for NBFC registration. Apart from this, any financial intermediary must also invest in technology to be efficient and competitive and reap economies of scale, which requires more capital. NBFCs have entered into many of the newer areas of financial services such as the payments system, capital markets which include underwriting, IPO financing, margin financing, and M&A financing. NBFCs are now also into derivatives and structured products. They have entered into the markets for raising funds through CPs and NCDs apart from accessing bank funds directly. Given these developments, a requirement of Rs. 2 crore in start up NOF is grossly inadequate from the perspective of financial soundness and solvency. A higher threshold for start up capital is also warranted to ensure that only serious players enter the sector. The Working Group is in agreement with the view that section 45IA(1)(b) of the RBI Act with respect to NOF needs to be amended. Instead of specifying a ceiling for the NOF that an NBFC should have, the Act should stipulate a minimum NOF to be specified by the RBI that any NBFC must have in order to be registered. The Working Group is of the view that these legal changes may be considered at the appropriate time.

3.1.3 The basic objective of regulating non deposit taking NBFCs is to address systemic risk issues. It is not the intention of the regulator to protect wholesale

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<sup>2</sup> Section 45IA(4)(d) of RBI Act, 1934.

lenders and investors who are expected to exercise prudence while lending to NBFCs. However if NBFCs reliant on a large amount of public funds deploy such funds into high risk assets there is a risk of contagion to other financial institutions. The Working Group feels that the very act of registration with the RBI confers a certain legitimacy to the NBFC as a regulated entity and may give lenders to that NBFC a sense of unwarranted comfort. Increasing the minimum start up capital required for NBFCs seeking registration would require amending section 45IA of the RBI Act. Although an NBFC may have the NOF of Rs. 2 crore required under the Act, it cannot commence or carry on the business of NBFC without a CoR issued by RBI. While Section 45IA(4)(d) requires RBI to be satisfied about the capital structure of a company before granting CoR, RBI may specify a certain minimum capital base and asset size for granting CoR and grant exemption<sup>3</sup> from the requirement of registration to those NBFCs that do not meet the minimum capital base or asset size threshold specified by it. The spirit behind such exemptions is not to create entry barriers for small innovative players from entering the NBFC sector especially for lending to small businesses, but to refocus regulatory resources to where the risks may lie. Regulatory directions issued by RBI to registered NBFCs would also apply to NBFCs that may be exempted from the requirement of obtaining CoR. All other provisions of Chapter IIIB of the RBI Act and the directions, orders, circulars and guidelines issued there under continue to apply to such NBFCs.

3.1.4 The Working Group is of the view, that as these are not deposit taking NBFCs there would be hardly any systemic risk emanating from smaller non deposit taking NBFCs. Hence, the Working Group proposes that small non deposit taking NBFCs with assets of Rs. 50 crore or less could be exempt from the requirement of RBI registration. Not being deposit taking companies and being small in size, no serious threat perception is perceived to emanate from them. This would at the same time also reduce the cost of regulation. Such a measure would not prevent small but potentially dynamic and innovative start up companies from entering the area of financial activity. In fact, it might incentivise such companies to increase their capital and assets to the minimum levels that would allow them to get registered over a reasonable period of time. If the asset sizes of existing NBFCs with asset sizes

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<sup>3</sup>under section 45NC of RBI Act

below Rs. 50 crore, increase to over the threshold within a period of two years, a fresh CoR from the Bank will not be required. However, if they are unable to reach this threshold within the two year period they have to apply to the Bank for a fresh CoR on their achieving an asset size of Rs. 50 crore.

3.1.5 The Working Group deliberated on whether NBFCs that fund their activities out of their owned funds should be exempt from registration with the regulator on the grounds that they do not pose any risk to any public funds. The Working Group however feels that even entities that do not rely on public funds could pose systemic risks if the size of their operations are material especially in certain sensitive markets. Further, if excluded from registration requirements there could be a temptation to try to avoid regulatory oversight through the use of a variety of instruments that are ostensibly equity but could be quasi debt. Indeed, the Working Group is given to understand that there are a number of registered NBFCs that are apparently capitalised only with equity, but in fact the investment in their equity capital is based on funds borrowed offshore. These companies undertake investment and lending activity in India, thereby circumventing the capital controls on external borrowings. Besides, even if currently engaged in activities without any public funds in India, such large asset sized entities have the potential to take on such leverage at any point in time. NBFCs that are not leveraged or do not have any access to public funds up to a certain minimum size could however be considered for exemption from registration, but not regulation. As and when the regulator observes risks arising out of the activities of such exempted NBFCs, the exemption may be adequately modified to cover such risk generating NBFCs or may be withdrawn totally as the situation warrants. Based on these considerations, the Working Group recommends that NBFCs with asset size below Rs. 1000 crore and not accessing any public funds may be exempted from registration. Those, with asset sizes of Rs. 1000 crore and above, need to be registered and regulated even if they have no access to public funds.

3.1.6 Currently, only deposit taking NBFCs are required to take prior approval of the Bank for any change in their management, either due to sale, takeover or amalgamation. There is no such requirement of prior approval of Reserve Bank for

change in the controlling interest of a registered non-deposit taking NBFC. There are cases where companies do not apply for a Certificate of Registration but acquire an existing registered NBFC. This circumvents the due diligence process carried out by the Bank on the fit and proper criteria of management. The Working Group recommends that all registered NBFCs, both deposit taking and non-deposit taking, should take prior approval from the Reserve Bank, where there is a change in control or transfer of shareholding directly or indirectly - in excess of 25 percent of the paid up capital of the company. 'Control' may be defined as "right to appoint majority of the directors or to control the management or policy decisions exercisable by a person individually or persons acting in concert<sup>4</sup>, directly or indirectly, by virtue of shareholding or shareholder agreements or by any other name. Prior approval of RBI should also be required for any mergers of NBFCs under Section 391-394 of the Companies Act, 1956 or acquisitions by or of an NBFC, which are governed by the SEBI Regulations for Substantial Acquisitions of Shares and Takeover.

### **3.2 The Working Group recommends that**

- i. the Reserve Bank should, under Section 45NC, exempt all non deposit taking NBFCs from the requirement of registration if their individual asset sizes are below Rs. 50 crore;**
- ii. the Reserve Bank should, under Section 45NC, exempt from registration all NBFCs with asset size below Rs. 1000 crore that are not accessing public funds (public funds are raised either directly or indirectly through public deposits, commercial papers, debentures, inter-corporate deposits, guarantees and bank finance or any other debt instrument, but exclude funds raised by issue of share capital and/ or instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue from registration with RBI). However, an annual certificate of their Statutory Auditors certifying the NOF, total asset size and whether they have accessed any public funds in the financial year should be submitted to Reserve Bank. NBFCs with asset size more than Rs. 1000 crore should be registered and regulated**

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<sup>4</sup> "Persons acting in Concert" as defined in Regulation 2, sub-regulation (1) clause (e) of the SEBI Regulations for Substantial Acquisitions and Take-Overs

- even if they are carrying on the business of an NBFC with their own funds;
- iii. existing NBFCs-ND with asset size of less than Rs. 50 crore may be encouraged to deregister with the RBI;
  - iv. NBFCs-ND which do not get themselves deregistered will have to apply afresh under section 45IA for obtaining a CoR if their asset size exceeds Rs. 50 crore after two years (from the date on which RBI issues suitable Notification under section 45NC);
  - v. the minimum NOF requirement for all new NBFCs wanting to register with the Bank could be retained as at present viz., Rs. 2 crore (till the RBI Act is amended), but a minimum asset size of more than Rs. 50 crore should be insisted upon by the RBI;
  - vi. all registered NBFCs, both deposit taking and non-deposit taking, should take prior approval from the Reserve Bank, where there is a change in control or transfer of shareholding directly or indirectly in excess of 25 percent of the paid up capital of the company.
  - vii. Prior approval of RBI should also be required for any mergers of NBFCs under Section 391-394 of the Companies Act, 1956 or acquisitions by or of an NBFC, which are governed by the SEBI Regulations for Substantial Acquisitions of Shares and Takeover.

#### **4. Principal Business – a Relook at the Definition**

4.1.1 Section 45I(c) of the Reserve Bank of India Act defines the expression 'Financial Institution' as financing, acquisition of shares, stocks, bonds etc., letting or hiring of goods, insurance business, management of chits and kuries and collection of monies for awarding prizes or gifts. In the changed scenario, there is a need to revisit this list of businesses, which, if carried on by a non-banking institution, makes it a financial institution.

4.1.2 It may be noted that the expression financial institution has been defined in the RBI Act for the purpose of identifying the institutions which need to be regulated by RBI under Chapter IIIB of the RBI Act. With insurance business now being regulated by a dedicated regulator, namely, IRDA under the IRDA Act, 1999, it is

clear that insurance business need not be included in Section 45I (c). Similarly, the Chit Funds Act, 1982, which regulates chit funds is adequate to deal with chit funds and it should not be necessary to bring chit funds again under this section. There is every reason for not bringing the companies carrying on the business of prize chits under the regulatory purview of RBI as the same is a banned activity dealt with under the Prize Chits and Money Circulation schemes (Banning) Act, 1978.

4.1.3 An NBFC is defined in terms of Section 45I(c) of the RBI Act 1934 as a company engaged in granting loans/advances or in the acquisition of shares/securities, etc. or hire purchase finance or insurance business or chit fund activities or lending in any manner provided the *principal business* of such a company does not constitute any non-financial activities such as (a) agricultural operations (b) industrial activity (c) trading in goods (other than securities) (d) providing services (e) purchase, construction or sale of immovable property.

4.1.4 Further in terms of Section 45I(f)(ii) of the RBI Act, a company would also be an NBFC if its *principal business* is that of receiving deposits under any scheme or arrangement. The Act has however remained silent on the definition of 'principal business' and has thereby conferred on the regulator, the discretion to determine what is the principal business of a company for the purposes of regulation. In case of companies that carry on multiple activities which are both financial and non-financial, it would be necessary to define what constitutes the 'principal business' and lay down a base criterion to decide whether a company is an NBFC or not. Accordingly, the test applied by RBI to determine what is the principal business of a company was articulated in the Press Release 99/1269 dated April 8, 1999 issued by RBI. As per the said press release, a company is treated as an NBFC if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets) and income from these financial assets is more than 50 per cent of its gross income. Both these tests are required to be satisfied in order for the principal business of a company to be determined as being financial for the purpose of RBI regulation.

4.1.5 The extant definition of principal business allows companies to carry on a multiplicity of activities including non financial activities that are not regulated by the RBI. Besides, unlike in the case of banks, a registered NBFC can conduct non-financial activities like real estate development, construction and manufacturing and

trading activities which could pose risk to its financial activity. Registration with the RBI provides the NBFC with opportunities to raise leverage to levels not normally available to non-financial companies. High leverage can in turn lead to investments in unregulated risky ventures, impact their balance sheets, and contribute to systemic risk. The RBI also faces operational issues in monitoring such entities, both off-site and on-site and any adverse development could result in reputational risk to the RBI. The Working Group is of the view that the 'part' of the business (referred to in section 45I(c) of the RBI Act) of a company which has to be financial in nature in order for the company to be treated as a financial institution should necessarily be a significant part of the overall business of the company. The intent of the statute that RBI should not get involved in regulating non financial business is clearly spelt out in the relevant clauses of section 45I(c) which exclude from the definition of financial institution entities whose principal business is agriculture, industrial activity, trading or construction. If a material part of the business of a company is agriculture, industrial activity, trading or purchase, sale or construction, the Working Group is of the view that RBI should not be required to regulate such companies.

4.1.6 The Working Group examined a) whether there is a need to have a twin criteria of financial assets and financial income for defining 'principal business' and b) whether or not the threshold percentage of a company's assets and the income accruing from those assets should be raised to a level above the current 50 percent. The members were of the view that financial assets alone would be an insufficient indicator of the principal business of a company. There could, for instance, be smaller professional service enterprises that might need to deploy the bulk of their surplus funds into financial assets – it would be inappropriate to capture such companies into the NBFC regulatory fold. Unless the income criterion is applied, such professional service companies will also be brought into the NBFC regulatory fold. The income of such companies from their professional service will be much more than the income from their financial assets. They will not come under the NBFC regulatory fold if the twin criteria of assets and income are applied, As such, the Working Group is satisfied that it is appropriate to continue to have the twin criteria of financial assets and financial income for determining the 'principal business' of a company for bringing it into the NBFC regulatory fold.

4.1.7 In general, the Working Group is of the view that financial activity is a specialised one and should not be combined with non financial activity. At the same time it is acknowledged that it is not legally possible to prohibit any entity from combining the two activities. Hence the attempt should be to encourage companies classified as NBFCs to move gradually towards undertaking essentially only financial activities and other such activities that are allied with or incidental to the principal activity of lending and investing. While the members are of the view that the extant practice of using both the financial asset and the income criteria to identify a company as an NBFC is appropriate and should be retained, for the purpose of defining a company's principal business it is felt that the minimum share of financial assets, and the income deriving there from, be increased to 75 per cent from the current level of 50 percent so that the primary content of business reflects financial activity as defined in the RBI Act. The increase in the threshold percentage level should ensure that a financial company focuses primarily on financial business.

4.1.8 For the purpose of computing total financial assets, cash and bank deposits maturing within 30 days, government securities, treasury bills eligible for repos, investments in money market mutual funds or investments in money market instruments maturing within 30 days which are kept for liquidity purposes and advance payment of taxes and deferred tax payments, may be deducted from the numerator and denominator<sup>5</sup>.

4.1.9 While using the income criteria, it was noted that financial income as a share of a company's total income could fluctuate quite considerably on account of market factors. Therefore, the income criteria to be used should be average income for three years on moving average basis.

4.1.10 Increasing the threshold percentage in this manner could mean that several companies currently classified as NBFCs with more than 50 per cent of their total assets in financial assets and more than 50 per cent of their income arising from

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<sup>5</sup> For the sake of clarity: A) Total Assets are total balance sheet assets. B) Total Financial Assets are all those assets that are financial in nature. C) Liquid Assets are i) cash and bank deposits maturing within 30 days; ii) government securities, treasury bills and eligible for repos; and iii) investments in money market mutual funds or money market instruments maturing within 30 days and advance payment of taxes and deferred tax payments. D) A company would be deemed to have met the financial asset test if the ratio  $(\text{Total Financial Assets} - \text{Liquid Assets}) / (\text{Total Assets} - \text{Liquid Assets})$  is greater than 75%.

such financial assets, would suddenly cease to be NBFCs. The Group felt that a reasonable time frame should be allowed to existing NBFCs either to cease to be NBFCs by deregistering or continue to be NBFCs by increasing their financial assets and income to the 75 per cent level within a period of three years. Deposit taking NBFCs that fail to reach the level of 75:75 within three years should not be allowed to accept fresh deposits or renew fresh deposits. They should prepay deposits within a timeframe and convert to non banking non financial companies.

4.1.11 The Working Group recognises that its recommendation of increasing the bar from more than 50:50 to 75:75 and more could have the impact of several currently significant participants in financial markets falling outside the purview. The Working Group at the same time realises that the main driver for registering as an NBFC is the leverage that it allows. Companies not fulfilling the 75 per cent bar could be significant players in the financial markets but would for all purposes be treated as non financial companies. These companies would not enjoy the same perception that the market normally has of companies that are regulated by the RBI and so would not be able to leverage in excess of what is normally feasible for non-financial companies. Nevertheless, the Working Group feels it necessary to underline the fact, that there could be some very large companies that have large borrowings from the market and banks and though not deemed to be financial companies have material presence in the financial markets and need to be monitored. The Working Group recommends that this may be considered by the Financial Stability Development Council. It was noted that the latest Financial Stability Report of RBI released in June 2011 has highlighted the point that financial stability / systemic risk concerns may be present even in a single or in a group of non-financial companies that have access to all sources of market borrowing including CPs, loans from abroad.

## **4.2 The Working Group recommends that**

- i. the twin criteria of assets and income for determining the principal business of a company need not be changed. However, the minimum percentage threshold of assets and income should be increased to 75 per cent. Accordingly, the financial assets of an NBFC should be 75 per cent or more (as against more than 50 per cent) of total assets and**

- income from these financial assets should be 75 per cent or more (as against more than 50 percent) of total income;
- ii. existing non deposit taking NBFCs should be given a period of three years to comply with the revised definition of principal business. An incremental approach may be adopted to graduate to the revised criteria and milestones may be specified for NBFCs so that they do not slip back in fulfilling the criteria within the 3 year period. If they are unable to reach the asset and income thresholds respectively within the three year period, they should be deregistered by RBI as an NBFC through a public notification. Existing deposit taking NBFCs failing to achieve deposit taking the 75:75 criteria in three years time should not be allowed to accept fresh deposits or renew fresh deposits thereafter. They should prepay deposits within a timeframe and convert to non banking non financial companies;
  - iii. for the purpose of computing total financial assets, cash and bank deposits maturing within 30 days, government securities, treasury bills eligible for repos, investments in money market mutual funds or investments in money market instruments maturing within 30 days which are kept for liquidity purposes and advance payment of taxes and deferred tax payments, may be deducted from the numerator and denominator. For the purpose of computing income, the three year moving average may be used;
  - iv. the financial activities as given in the Act may be suitably amended to exclude insurance business, management of chits and kuries and collection of monies for awarding prizes or gifts.

**4.2.1 The matrix given in Annex III summarizes the recommendations for entry point norms recommended for NBFCs.**

## **5. Categories of NBFCs and the Practicality of Differentiated Regulation by Type of Activity**

5.1.1 No defined homogenous pattern has emerged in terms of business models, nature of operations, funding patterns or asset size for NBFCs. Therefore different

categories of NBFCs with differential regulatory dispensations have evolved in tune with the demands of the economy and the industry.

5.1.2 An activity based categorisation of NBFCs was laid down in the Non-Banking Financial Companies Acceptance of Public Deposits (RBI) Directions, 1998. NBFCs were divided into 4 categories: Equipment Leasing Companies (EL), Hire-Purchase Companies (HP), Investment Companies (IC), and Loan Companies (LC).

5.1.3 Subsequently, in 2006, based on a request from the industry, a separate category of NBFCs, termed Asset Finance Companies (AFC) was created to differentiate NBFCs engaged in tangible lending from riskier NBFCs which were either into unsecured lending or were investing in stock markets/real estate and whose assets were subject to greater volatility. NBFCs that were essentially financing hire-purchase and leasing assets were reclassified as AFCs. An AFC was defined as a company where more than 60 percent of its business was in the financing of physical assets supporting productive/economic activity. Similarly, in 2010, NBFCs primarily financing infrastructure projects were classified as a separate category of Infrastructure Finance Companies (IFCs), provided a minimum of 75 percent of total assets of the company were deployed in infrastructure loans. Such companies were allowed higher exposure norms and access to bank funds. They were also allowed access to ECB which is not allowed for other NBFCs.

5.1.4 A new category of Systemically Important Core Investment Companies (CIC-ND-SI) was created in 2010 for those companies with an asset size of Rs. 100 crore and above that were only in the business of investment for the sole purpose of holding stakes in group concerns, not trading in these securities and accepting public funds. A regulatory framework in the form of Adjusted Net Worth and leverage limits was put in place for CIC-ND-SIs and they were given exemption from NOF, capital adequacy and exposure norms. CICs-ND-SI were required to hold a minimum of 90 percent of net assets in the form of exposure to group companies of 60 percent was to be invested in the equity of group companies.

5.1.5 Thus presently there are five categories of NBFCs, viz., Asset Finance Companies (AFCs), Investment Companies (ICs), Loan Companies (LCs), Infrastructure Finance Companies (IFCs) and Systemically Important Core

Investment Companies (CIC-ND-SIs). Table 7 below gives the number of such companies as on March 31, 2011.

**Table 7: Different Categories of NBFCs (As on March 2011)**

Sr. No.	Type of Company	Number
1.	Asset Finance Companies	415
2.	Investment Companies	7,499
3.	Loan Companies	4,706
4.	Infrastructure Finance Companies	6
5.	Systemically Important Core Investment Companies	Reclassification in progress

5.1.6 A Table on the differential regulation for the 5 categories of NBFCs is provided in Table 8 below.

**Table 8: Differences in Regulation for Different Categories of NBFCs**

SI No	Category	Differences in Prudential Norms
1.	AFC	<p>NOF of Rs. 25 lakh (2 crore for companies incorporated after April 1999)</p> <p>An NBFC NDSI which is an AFC can exceed credit concentration norms by 5 percent with the approval of the Board</p> <p>Can accept deposits without credit rating; can accept higher level of deposits than LCs/ICs, if holding minimum investment grade rating and in compliance with prudential norms</p> <p>Impaired Hire Purchase assets and overdue lease rentals treated as NPAs after 12 months. Loans overdue for more than 6 months are classified as NPAs</p> <p>Bank exposure to AFCs may exceed those for LCs/ICs by 5%.</p> <p>Banks to risk weight claims on AFCs as per the ratings assigned to the AFCs by rating agencies.</p>

2.	LC	NOF of Rs. 25 lakh (2 crore from April 1999) No difference in prudential norms between LC and IC
3.	IC	Not permitted to accept deposits without credit rating Asset Classification – Loans overdue for more than 6 months are classified as NPAs Impaired Hire Purchase assets and overdue lease rentals treated as NPAs after 12 months
4.	IFC	NOF of Rs. 300 crore Credit Rating of minimum A grade CRAR 15 percent with minimum Tier I at 10 percent Can exceed Credit Concentration norms in lending to single and group borrowers by 10 and 15 percent and for lending and investment to single and single group of borrowers by 5 and 10 percent Cannot accept deposits Allowed to borrow under ECB route. Bank exposure to IFCs may exceed that for LCs/ICs by 5%. (10% if for on-lending for infrastructure sector) Banks to risk weight IFC loans as per the ratings assigned to NBFCs by rating agencies Impaired Hire Purchase assets and overdue lease rentals treated as NPAs after 12 months. Loans overdue for more than 6 months are classified as NPAs
5.	CIC- ND-SI	Exempt from capital adequacy and credit concentration norms Capital requirements in the form of Adjusted Net Worth to be 30 percent of risk weighted assets and outside liabilities capped at 2.5 times of the Adjusted Net Worth

5.1.7 The Working Group re-examined these various categories with a view to ascertaining the need for maintaining different categories of NBFCs and different corresponding regulatory frameworks.

i. Loan and Investment Companies: A Loan Company is defined as a financial institution carrying on as its principal business the providing of finance whether by

making loans or advances or otherwise for any activity other than its own,. An Investment Company means any company which is a financial institution carrying on as its principal business the acquisition of securities. Most NBFCs, other than CIC-ND-SIs and IFCs, are into a mix of loan and investment activities and the number of pure loan or pure investment NBFCs is negligible. As on March 31 2011, there were a total of 312 NBFCs-ND-SI. Of these, 189 companies were categorized by RBI as investment companies and 103 were categorized as loan companies, the remaining being IFCs and AFCs. Out of 189 NBFCs-ND-SI categorized as investment companies, only 35 were purely into investment activities and only 21 companies out of the remaining 106 NBFCs-ND-SI, categorized as loan companies, were purely into lending activities. The remaining companies were carrying on a mix of investment and loan activities. Since there is no difference in the regulatory and supervisory framework for loan and investment companies, a company may freely alter the business model depending on market forces. Thus there does not appear much relevance in continuing with two separate categories.

ii. Asset Finance Companies: AFCs are defined as

*“.. any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive / economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising there from is not less than 60% of its total assets and total income respectively”*

5.1.8 As stated above, NBFCs were initially categorized on the basis of activity, i.e., loan, investment, hire purchase or equipment leasing. Differential regulatory prescriptions were put in place based on perceptions of realizability of assets, i.e., as HP and EL companies were financing real goods, they were allowed to accept deposits without rating and also accept a larger amount of deposits. The category of AFC was created in 2006, based on the request of industry that NBFCs financing productive assets or the real sector should be differentiated from those NBFCs whose operations in the sensitive sectors had implications for financial stability.

5.1.9 Though the withdrawal of tax deductions led to several NBFCs moving away from hire purchase or equipment leasing activities, they continued to be characterized as AFCs in view of the change in definition to “financing of real/productive assets”, such assets typically being capital equipment, commercial vehicles, tractors, automobiles etc. While many of these activities may be also carried out by loan companies, there is merit in the argument that financing of productive assets is a major contributor to economic growth. Further, the argument advanced in 2006 by the industry and accepted by RBI, that broad brush approach for all NBFCs may not be followed, remains valid.

5.1.10 However, it is undeniable that the distinction between the financing models of Loan Companies and AFCs is often blurred. To avoid this, not only do AFCs need to be more focused in their business model, but the regulatory framework also needs refinement. On the same analogy as that applied for IFCs, the minimum requirement for classification as AFC should be that their principal business be asset financing, i.e., at least 75 percent of their assets should be deployed in financing of real/productive assets and 75 percent of their income should be derived from such assets. However, funds deployed for purposes of liquidity management should be excluded from assets for the purpose of calculating this threshold percentage. Thus assets would exclude cash and bank deposits maturing within 30 days, government securities, treasury bills, investments in money market mutual funds or money market instruments maturing within 30 days, and advance payment of taxes and deferred tax payments. Existing AFCs may be given a period of three years to comply with the revised criteria.

5.1.11 Presently, LCs and ICs complying with all prudential requirements and with minimum investment grade rating may accept public deposits up to 1.5 times NOF. Unrated AFCs may accept public deposits up to 1.5 times NOF or Rs. 10 crore, whichever is lower. However, an AFC with minimum investment grade rating may accept public deposits up to 4 times its NOF. There is no particular logic in allowing acceptance of such differential amounts of deposits, as acceptance of liabilities cannot be linked to type of asset. Thus rated AFCs should not accept deposits more

than 2.5 times their NOF. AFCs presently exceeding the limit may not renew or accept fresh deposits till such time as they reach the revised limit.

5.1.12 IFCs were created on the request of industry that there should be a separate category of infrastructure financing NBFCs in view of the critical role played by them in providing credit to the infrastructure sector. A differential regulatory framework was also put in place for CICs-ND-SI in view of perceptions of interconnectedness and systemic risk. The Working Group does not feel it necessary to bring any change to the IFC category. However, in alignment with the recommendation for AFCs, a similar method may be adopted for calculating the quantum of assets deployed in infrastructure finance, i.e., funds deployed for purposes of liquidity management should be excluded from total assets for the purpose of calculating whether or not a company meets the 75% of assets and income tests.

## **5.2 The Working Group recommends that**

- i. in view of the fact that there is no difference in the regulatory framework for loan companies and Investment companies and since most of the NBFCs-ND-SI are a mixture of loan and investment companies, a single category of loan/investment company should be made;**
- ii. AFCs should be retained as a separate category of NBFC provided however such companies are predominantly engaged in the asset finance business;**
- iii. principal business for AFCs may be redefined: a minimum of 75 per cent of the assets of AFCs (as against 60 per cent presently) should be in asset financing activities and at least 75 per cent of total income should be from these asset financing activities. Existing AFCs may be given a period of three years to conform to the revised principal business criteria without any slip back as and when it reaches a higher percent of asset financing;**
- iv. for the purpose of calculating if a company meets the 75 per cent asset and income thresholds, the revised definition of financial assets**

- as given in footnote 5 on page 26 may be adopted for all NBFCs including Asset Finance and Infrastructure Finance Companies;
- v. the limit for acceptance of deposits for rated AFCs should be reduced from 4 times NOF to 2.5 times NOF. AFCs presently exceeding this limit may not renew or accept fresh deposits till such time as they reach the revised limit.

**Table 9: Recommendation on Rationalisation of Categories of NBFCs**

<b>Category</b>	<b>Recommendation</b>
<b>Loan Companies</b>	<b>Should be merged into a single category of Loan and Investment Companies</b>
<b>Investment Companies</b>	
<b>Asset Finance Companies</b>	<b>Should be retained as a separate category</b>  <b>A minimum of 75 per cent of the assets and income should be from asset financing activity</b>  <b>The limit for accepting deposits by AFCs be reduced to 2.5 times their NOF</b>
<b>Infrastructure Finance Companies</b>	<b>Retained as a separate category</b>
<b>Core Investment Companies</b>	<b>Retained as a separate category.</b>

## **6. Regulatory Arbitrage and Convergence in Regulation:**

6.1.1 There are differences and similarities between banks and NBFCs. On the liabilities side, banks mobilize retail deposits, offer checking accounts and form the bulwark of the payment system. They also access the wholesale funding markets. On the other hand, NBFC-NDs obtain wholesale funding or access the capital markets through CPs, NCDs, ICDs and bank borrowing. On the assets side there is hardly any difference as both banks and NBFCs undertake loaning and investment activities. Some NBFCs may, however, be more focused on capital market related

activities. Unlike in many countries, NBFCs in India are not barred from undertaking non financial activities such as, real estate activity, along with financing and investing activities.

6.1.2 The policy and regulatory framework in India deals with NBFCs and banks very differently. On the policy side, banks are required to maintain a cash reserve requirement which stands at 6 percent of their net demand and time liabilities on which they earn no interest and statutory liquidity ratio (SLR) of 24 percent of net demand and time liabilities on which the average yield was at 6.97 percent in 2010-2011. Banks require RBI approval for branch expansion, although there have been some relaxations for under banked areas, as the spread of branches in banked areas has now been linked to their extending their presence in unbanked areas. Banks have limits on their exposure to capital markets and they are not allowed to finance the purchase of land or mergers and acquisitions (with a few exceptions). They are expected to have Board approved limits on exposure to the real estate sector. Banks have mandated Priority Sector Lending (PSL) targets at 40 per cent of their total credit. On the other hand, non deposit taking NBFCs have no cash reserve requirements or SLR, no restrictions on branch expansion, no PSL targets, no restrictions on their financing activities such as for M&A and capital market while NBFC-D have limited restrictions on branch expansion, capital market and real estate. Even the SLR prescribed for deposit taking NBFCs is at 15 percent of their deposit liabilities as compared to 24 percent stipulated for banks. There are restrictions on foreign and foreign bank ownership in banks whereas for NBFCs, 100 percent FDI is allowed under automatic route for 18 permitted activities.

6.1.3 As far as prudential regulations are concerned, there are a number of differences. The CRAR for NBFCs is higher at 15 per cent compared to 9 percent for banks taking into account their size, concentration risk and lighter touch regulation in other areas. The period for classifying loans as NPAs in case of NBFCs is higher at 180/360 days compared to 90 days for banks. There are some differences in the provisioning framework as well. The regulatory framework for ownership and governance are also very different. The Banking Regulation Act 1949 empowers the RBI to stipulate the qualifications of Directors of a bank and to appoint and remove them. These powers are not available to the RBI under the RBI Act, 1934 in respect of the NBFCs.

6.1.4 A revised framework was put in place in 2006 to address the regulatory gaps and arbitrage between banks and the NBFCs sponsored by them. The capital adequacy, credit concentration norms and CME exposure limits were made applicable to the bank group as a whole, including the bank sponsored NBFCs. However, despite these efforts, some elements of regulatory arbitrage still persist between bank sponsored NBFCs and banks, inasmuch as the restrictions on (i) loans against shares to individuals (restricted at Rs. 20 lakhs per individual for banks), (ii) financing mergers and acquisitions, (iii) financing purchase of land are applicable to banks but not applicable to their own NBFCs. Further, while banks are required to fix, with the approval of their Boards, limits on their real estate exposure, unsecured exposures and exposure to other sectors, these do not apply to the bank group as a whole.

6.1.5 The Working Group debated on the need for bringing in policy and regulatory convergence between banks and NBFCs to minimize regulatory arbitrage opportunities. The Financial Sector Assessment Handbook, 2009 has recommended that bank like financial institutions that provide similar products/services should be regulated similarly. Internationally, the role of non-banks or "shadow banks" has been under the scanner and it is increasingly felt that financial entities should be regulated on the basis of the activities undertaken by them not on the basis of their structure. Since the products of the NBFCs are by and large the same or similar to those provided by banks (viz., loans and advances and investments in securities), there is a case for making at least the prudential regulation of NBFCs, at the minimum, similar to that of banks.

6.1.6 While there are forceful arguments for regulatory convergence, there are equally forceful views against it. In this alternative perspective, NBFCs and banks are not viewed as similar to each other, but rather as complementary entities. NBFCs serve niche areas and are more flexible and borrower friendly. In many cases, particularly in the rural and semi-urban areas, they have contributed to last mile connectivity and offered products which banks have not been able to. They have served the needs of clients in the SME sector and in the transport industry where banks have been hesitant to cater to. The NBFCs have also provided funding for equipment purchase, second hand truck purchases, various types of mergers and acquisitions, infrastructure and real estate projects that add productive capacity in

the economy. Thus NBFCs play a valuable economic role which must be supported through an appropriately designed regulatory framework. It is argued by some that the absence of regulatory diversity may lead to convergence of business conduct which results in amplifying systemic instability, especially during periods of stress. A range of regulatory regimes could in fact encourage market participants to pursue a variety of business strategies within the financial sector such that the sector may be more resilient to contagion from systemic financial stress.

6.1.7 In view of the above, the Working Group has consciously refrained from pursuing the option of bringing in exact bank like policies for NBFCs such as limits on capital market exposures, real estate lending, priority sector lending, CRR, SLR and so on. The Working Group is of the view that the policy and regulatory arbitrage between banks and NBFCs would be best addressed through the calibrated use of prudential measures such as, higher capital (already part of regulation) higher risk weights for sensitive sectors like real estate and capital markets, and liquidity ratio for NBFCs. In addition it was felt that the rapidly evolving NBFC sector could benefit from the introduction of some of the best practices of banks in the areas of governance, compensation, accounting and disclosure norms (including off balance sheet exposures). In making its recommendations the Working Group is mindful, that the aggregate assets of NBFCs are only 10 per cent of that of the banking sector. (Table 2).

6.1.8 The regulatory arbitrage between bank sponsored NBFCs and banks has largely been addressed by the regulatory changes made in 2006. In addition, the Working Group recommends that the Board approved limits for bank's exposure to real estate should be applicable for the bank group as a whole, where there is an NBFC in the group. However in case of NBFCs that are not sponsored by banks or are not part of any banking group, the regulatory gaps still persist. These could get addressed to a certain extent by the recommendations of the Working Group for higher risk weight for capital market exposure and commercial real estate (CRE) exposure to be applicable to NBFCs that are not bank sponsored or do not have a bank in the Group. In case of bank sponsored NBFCs, the risk weights for CME and CRE should be the same as specified for banks.

6.1.9 The Working Group is of the view that asset classification and provisioning norms, including those for standard assets, should be similar for banks and NBFCs, irrespective of the entity in which they reside. On the same analogy, the deductions (based on an appropriate method) for provisions for taxation purposes, applicable to banks should be available to NBFCs.

6.1.10 In the event there is a rapid increase in the NBFCs' access to public funds or borrowing from banks, leading to a possible build-up of systemic risk, RBI would always have the option to take appropriate measures. In this context the Working Group also feels that the RBI should start collecting data on the sectoral flow of credit from about 80 odd NBFCs that account for 80 per cent of the total assets of all NBFCs to be in tandem with similar data for sectoral flow of credit from banks.

6.1.11 In view of the growing importance of NBFCs in financing sensitive sectors, the Working Group feels that whenever RBI takes macro prudential measures for banks, such measures should also be applicable to the NBFCs. Thus, whenever RBI raises/ lowers risk weights and provisioning norms for banks as a part of macro prudential measures to address systemic risk, such measures should also be applicable to similar assets of NBFCs.

6.1.12 On the other hand, the Working Group recognizes the anomaly that unlike banks and PFIs, most NBFCs (except those registered as PFIs under Section 4A of the Companies Act) do not enjoy the benefits deriving from the SARFAESI Act even though their clients and/or borrowers may be the same.

6.1.13 Financial institutions all over the world are moving towards rationalisation and standardisation of accounting norms. The RBI may review the accounting norms prescribed for NBFCs and apply the same norms for them as laid down for banks and further encourage NBFCs to follow the principles enunciated in AS 30.

## **6.2 The Working Group recommends that**

- i. the Tier I capital for CRAR purposes should be specified as 12 per cent to be achieved in three years for all registered deposit taking and non-deposit taking NBFCs;**

- ii. the Board approved limits for bank's exposure to real estate should be applicable for bank group as a whole, where there is an NBFC in the group;
- iii. the risk weights for NBFCs that are not sponsored by banks or that do not have any bank as part of the Group may be raised to 150 per cent for capital market exposures and 125 per cent for CRE exposures. In case of bank sponsored NBFCs, the risk weights for CME and CRE should be the same as specified for banks;
- iv. the Liquidity Ratio should be introduced for all registered NBFCs such that cash bank balances and holdings of government securities fully cover the gaps, if any, between cumulative outflows and cumulative inflows for the first 30 days;
- v. the asset classification and provisioning norms (including standard asset provisioning norms) should, in a phased manner, be made similar to that of banks for all registered NBFCs irrespective of size;
- vi. the tax treatment for provisions made by NBFCs for regulatory purposes should be similar to that for banks;
- vii. whenever RBI implements any macro prudential measures to address systemic risk, such measures should be made applicable to NBFCs as well;
- viii. NBFCs may be given the benefit under SARFAESI Act, 2002;
- ix. the RBI may review the accounting norms prescribed for NBFCs and apply the same norms for them as laid down for banks and further encourage NBFCs to follow the principles enunciated in AS 30.

### **6.3 Gaps in Regulation between Stock Broking firms, Investment/Merchant Banks and NBFCs**

6.3.1 The RBI (in exercise of the powers conferred to it by Section 45NC of the RBI Act) has so far granted exemption from registration, maintenance of liquid assets and creation of reserve funds to NBFCs carrying on the business of stock broking and merchant banking provided they are not accepting deposits, are registered by SEBI and acquire securities as part of their merchant banking/stock broking activities. This exemption was given as they were undertaking predominantly non

fund based activities. It was also perceived that these would not pose any risk or compromise depositors' interest, as they are non-deposit taking entities and function directly under the oversight of SEBI. Hence dual regulation is avoided. It was also the understanding that the leverage of stock broking entities and merchant bankers would be extremely limited and banks are allowed to finance their working capital activities. The Working Group understands that stock brokers are involved in fund based margin financing subject to SEBI regulations. It is understood that SEBI has allowed stock brokers to access public funds to the extent of 5 times NOF for margin financing with additional stipulation that margin should be at least 50 percent. Merchant bankers also raise public funds for their underwriting obligation and IPO financing. Both stock brokers and merchant banks access public funds in the form of bank borrowing, CPs, NCDs from the market including from mutual funds. Anecdotal evidence suggests that stock broking entities also receive funding support from the NBFC arms within the group. There are, however, no prudential CRAR type prescriptions on such entities.

6.3.2 The Working Group deliberated on whether it should recommend withdrawal of the exemption provided under Section 45NC of the RBI Act to NBFCs carrying on the business of stock broking and merchant banking activities, if such entities were accessing public funds in excess of their owned funds and had credit exposures beyond Rs. 100 crore, to bring them under the prudential regulation applicable to NBFCs viz. capital adequacy, liquidity, exposure norms etc.

6.3.3 However to be effective, the Working Group noted that this would involve change in the definition of principal business to include fee based income in the income criteria, with the result of bringing a variety of activities into the NBFC regulatory net with unintended consequences. Moreover it would again raise the issue of dual regulation with its concomitant implications. Instead the members feel that the NBFCs may be subject to similar regulations as banks, for lending to stock brokers and merchant banks<sup>6</sup>. They could also be subjected to similar regulation as stipulated by SEBI for stock brokers while undertaking margin financing. Also, the

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<sup>6</sup> Reference is drawn to circular DBOD.No.Dir.BC.6/13.03.00/2011-12 dated July 1, 2011

supervisory framework for larger NBFCs that have brokers and merchant bankers in the group should look into the implications of the spill-over risks of such entities on the parent or group NBFC arm and adopt a financial conglomerate approach for supervision of such entities. The Working Group would however urge that the issue of SEBI regulated entities undertaking fund based business without CRAR type of stipulations may be reviewed by the Sub-Committee of the FSDC.

#### **6.4 Gaps in Regulation under Companies Act 1956**

6.4.1 The Working Group observed that gaps in regulation are also seen in the context of private placement of capital by companies registered under the Companies Act and registered as NBFCs as they are exempt from the provisions of private placement specified under Section 67 of the Companies Act 1956. This has resulted in some NBFCs raising unlimited amounts of retail money that tantamount to surrogate deposits, which is in essence an NBF activity, but escapes regulation as such. RBI may take steps to ensure that this gap is plugged, if necessary, with inter-regulatory co-ordination.

#### **6.5 Government Owned NBFCs and other NBFCs**

6.5.1 Government owned companies have so far been exempted from Section 45 IB and 45 IC of the RBI Act as also from the Prudential Norms Directions, except reporting requirements. They are thus not subject, for example, to any of the NBFC regulations pertaining to prudential norms, including capital adequacy and credit exposure. This was done in consultation with Government, and it was assumed that the functioning of these entities would be overseen by the respective ministries to which they were attached. At the time this decision was taken few supervisory concerns were envisaged, particularly regarding to repayment of deposits held by such entities.

6.5.2 In 2006, when the focus of regulatory concern widened to encompass issues of systemic importance and systemic risk, it was realised that Government owned NBFCs, even if monitored by their respective ministries, could pose high risk on account of their significantly large balance sheets and their interconnectedness with the broader financial system. Besides, they were recipients of large funds from the budgets and hence accountable to the public. Accordingly, both Centre and State

owned NBFCs were advised in December 2006 to prepare and submit, in consultation with Government, a road map to RBI by March 31, 2007 for compliance with NBFC regulations.

6.5.3 The Working Group noted that very little progress has been made in this regard.

## **6.6 The Working Group recommends that**

- i. NBFCs should be subject to similar regulations as banks while lending to stock brokers and merchant banks. Further they could be subject to similar regulation as stipulated by SEBI for stock brokers while undertaking margin financing;**
- ii. the supervisory framework for NBFCs that have brokers and merchant bankers in the group, where the total assets in the group exceeds Rs 1000 crore, should adopt a financial conglomerate approach and examine the implications of the spill-over of risk of such entities on the parent NBFC or group NBFC arm and issue appropriate directions for cushioning such risk;**
- iii. in general, all Government owned entities that qualify as NBFCs under the prescribed principal business criteria should be required to comply with the regulatory framework applicable to NBFCs at the earliest.**

## **6.7 Regulatory Convergence between Banks and Deposit taking NBFCs**

6.7.1 Regulation of NBFCs was introduced in 1964 as an adjunct to the monetary and credit policy of the country and for protection of depositors' interests. The RBI Act 1934 was amended in 1997 with the objective of strengthening the regulation of deposit taking companies. Since then, RBI has taken steps to improve discipline and transparency in the sector. Apart from regulatory and legislative initiatives, RBI has stepped up industry consultation, depositor education and coordination with other regulators. Various measures have been taken to improve capital adequacy and reporting standards of deposit taking NBFCs, including Residuary Non-Banking Finance Companies.

6.7.2 The number of NBFC-D deposit and their aggregate outstanding deposit liabilities have been declining since 2002 (Table I, Chart 1). Following the RBI's direction to RNBCs to cease and desist from taking fresh deposits, the Aggregate Liabilities to Depositors held by the two RNBCs has also registered a decline. Out of the total number of 280 odd reporting deposit taking entities as on March 2010, only twenty have assets of over Rs. 100 crore and can be considered systemically important. Approximately 90 percent of the reporting NBFCs-D have assets less than Rs. 50 crore, and NOF of around 4 percent of NRFCs-D is less than Rs. 2 crore.

6.7.3 As the regulatory stance of the RBI has been to discourage the acceptance of deposits by non banking entities no new NBFC incorporated after July 1997 has been given permission to accept deposits. The Working Group is of the view that the present stance of RBI in not allowing registration of any new deposit taking company, should continue. As long as deposit taking companies continue to exist, the regulatory and supervisory framework for them should be similar to that for banks. Internationally, regulations for deposit acceptance are similar for all entities accepting deposits, whether banks or non-banks. Many of the suggestions made in earlier sections bring about convergence in the regulations between banks and NBFCs. Elsewhere, the Working Group has already recommended that the deposits raised by AFCs should be reduced to 2.5 times NOF from the present 4 times NOF (See para 5.1.11).

#### **6.8 The Working Group recommends that**

- i. the present policy stance of RBI not to allow registration of any new deposit taking company should continue;**
- ii. all existing NBFCs-D should be credit rated. Unrated AFCs should not be permitted to accept deposits;**
- iii. existing unrated NBFCs-D should be given a period of one year to get themselves rated if they wished to continue to accept deposits. Thereafter, they should not be allowed to accept any fresh deposits or renew existing deposits till they get themselves rated.**

## **7. Multiple NBFCs**

7.1.1 The database on registered NBFCs has revealed that there are many companies which have multiple NBFCs within their group. The industry has represented before the Working Group that each NBFC served a different purpose and the regulatory treatment itself has spawned multiple NBFCs. Operational efficiencies arising out of specialisation, dynastic reasons, tax planning were some of the other reasons given for multiple NBFCs.

7.1.2 While corporate groups may find it useful to set up multiple NBFCs within the group, the Working Group is of the view that multiple NBFCs that are part of a corporate group or are floated by common set of promoters should not, for regulatory and supervisory purposes, be viewed on a stand-alone basis, but should be viewed in aggregate. The total assets of all NBFCs must be taken together to determine whether they satisfy the cut-off limit of Rs. 100 crore, as certified by their Statutory Auditors. For this purpose, the definition of 'group' should be the same as applicable for CICs.

## **7.2 The Working Group recommends that**

- i. for the purpose of applicability of registration and supervision, the total assets of all NBFCs in a group should be taken together to determine the cut off limit of Rs. 100 crore. Capital adequacy, exposure and other prudential regulatory norms in such cases would be applicable to each entity in the group as applicable to NBFCs with assets of over Rs. 100 crore;**
- ii. their respective Statutory Auditors may certify the asset sizes of all the NBFCs within the group for this purpose;**
- iii. the concept of 'group' should be the same as applicable for CICs.**

## **8. Captive NBFCs**

8.1.1 A recent phenomenon in the NBFC sector is the establishment of captive NBFCs. A captive finance company is one where a major portion of its portfolio in receivables is generated by the sales of products and services of the parent or the group. It functions as an extension of a corporate's marketing activities. In most

cases such captives operate as a core but separate subsidiary of the parent and in some cases as a distinct operating division. In most cases in India, captive NBFCs are generally wholly owned by the parent company. However, they may engage both in captive finance and financing unrelated parties, depending on the strategic mission of the captive NBFC. Typically, this model is adopted by the automotive, agricultural and construction equipment industries.

8.1.2 Captive NBFCs are set up to put the company's products within the reach of consumers and to ensure that the company has a steady pool of buyers. The business franchise of such NBFCs is inextricably linked to the fortunes of its parent. A key feature of a captive NBFC is that its credit decision takes into account not only the return from granting captive loans, but also the return from the sale of products purchased with captive loans. Internationally captives are also found to be highly leveraged as they are supported by direct finance from banks on their own standing and are often recipients of subordinated loans from their parents. Conversely, as in India, since the captive NBFC is a regulated entity, it has a greater ability to mobilize funds from the capital markets, which it can then lend to its parent. Hence even with an arm's length relationship, interconnectedness between the parent and the captive can be high. The parent company can exercise a high degree of control over the captive, besides very often, also sharing management and strategy. Again, since the fortunes of the captives are linked to that of the parent, it is likely that credit underwriting standards are weaker and they hold credits that are riskier in nature<sup>7</sup>. Asset recalls, if any, can further stress such NBFCs. Economic cycles, competitive trends and regulatory changes are likely to affect both the parent and the subsidiary NBFC in the same way, potentially amplifying risk. Any major challenges confronting the parent could threaten the operations and asset values of the captive NBFC, and in the worst case scenario jeopardize its existence as an going operating entity even if it is managed on arms length basis.

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<sup>7</sup> In an empirical study conducted by John M. Barron, Andrew B Chong and Michael B. Staten viz., "The Emergence of Captive Finance Companies and Risk Segmentation of the Consumer Loan Market" the authors have used the regression model to compare consumer loans extended by banks and captive finance companies. According to the authors, "the empirical analysis provides clear evidence that a captive automobile loan is less likely to be repaid than a bank automobile loan....results verify.....that a captive finance company's credit standard is more lenient than that of a bank, which shows that the consumer automobile loan market in the US is segmented by banks and captive finance companies on the basis of consumers' risk characteristics."

8.1.3 The Working Group notes that internationally, many automobile manufacturers hold a finance arm within the group. In many cases, by virtue of being regulated entities, the finance arms of these corporates have fared better than their parent entities. Besides, the parents of captives often provide credit risk mitigation in the form of full or partial residual value guarantees, receivable purchase agreements, first loss guarantees and rental guarantees that protect their captive financial arms from the adverse impact of asset concentration. Captive NBFCs generally have a more diversified liability base compared to their parent companies. There are also compelling economic incentives for the parent to support its financial arm through capital infusions given that captives can account for a substantial portion of the parent's profitability and cash flows and may also share the same brand name.

8.1.4 Rating agencies often find it difficult to assess the credit profiles of captive NBFCs on a stand-alone basis. There is reluctance on the part of rating agencies to assign a rating higher than its parent to the captive finance arm of a corporate. By nature, a captives' business focus is narrower than its counterparts with a greater degree of product and customer concentration, thereby increasing the credit risk on its asset portfolio. That said, several captive NBFCs registered with the RBI have diversified into lending not related to the parent's product. In general, the Group felt that a higher cushion of capital than for normal NBFCs may be warranted for captives.

## **8.2 The Working Group recommends that**

- i. as a model, captive NBFCs are commercial business decisions and hence should be permitted to exist;**
- ii. captive NBFCs, the business models of which focus mainly (90 per cent and above) on financing parent company's products, should be asked to maintain Tier I capital at 12 per cent from the time of registration;**
- iii. the supervisory risk assessment should take into account the risk of the parent company on the captive NBFC.**

## **9. Liquidity Management of NBFCs**

9.1.1 Liquidity is the ability of financial institutions to meet their payment obligations by quickly realizing value from their assets. As financial institutions are involved in maturity transformation, liquidity risks are endemic to them, with assets being mostly illiquid and of longer tenure than their liabilities. A variant of liquidity risk is funding risk, or the difficulty experienced by financial institutions in their ability to raise funds from market and other sources. One of the important hallmarks of the 2008 financial crisis, across jurisdictions, was the inability of financial institutions to roll over or obtain new short-term funding. Supervisors also failed to recognize the degree to which providers of wholesale funding had changed from banks to money market mutual funds. The heightened volumes in over-the-counter (OTC) derivatives also added to the demands on liquidity.

### **9.2 Basel III: International framework for liquidity risk measurement, standards and monitoring:**

9.2.1 The Basel Committee on Banking Supervision has developed two internationally consistent regulatory standards for liquidity risk supervision, which are the Liquidity Coverage Ratio and the Net Stable Funding Ratio. The Liquidity Coverage Ratio stipulates that an institution should maintain adequate levels of liquid assets which can be converted to cash at very short notice to enable it to survive a 30 day time horizon. The objective is to promote short-term resilience of the liquidity risk profile of institutions by ensuring that they have sufficient high-quality liquid assets to survive a significant stress scenario lasting 30 calendar days. The Liquidity Coverage Ratio has two components: (a) value of the stock of high-quality liquid assets in stressed conditions; and (b) total net cash outflows.

LCR is defined as: Stock of high quality liquid assets  
Total net cash outflows over the next 30 calendar days

9.2.2 The stock of liquid assets should enable the institution to survive until Day 30 of the stress scenario, by which time it is assumed that appropriate corrective actions

would be taken by management and/or the supervisory authorities for an orderly resolution of the situation.

9.2.3 The second objective of the Basel Committee recommendations is to promote resilience over a longer time horizon by creating additional incentives for institutions to fund their activities with more stable sources of financing on an ongoing basis. The Net Stable Funding Ratio has a time horizon of one year and has been developed to capture structural issues to provide a sustainable maturity structure of assets and liabilities should there be: a significant downgrade of the institution's credit rating, a partial loss of its deposits, a sharp reduction in its secured or unsecured wholesale funding, and/or an increase in its derivative collateral calls or its contractual off-balance sheet exposures. The Net Stable Funding ratio seeks to calculate the proportion of long term assets which are funded by long term stable funding which it prescribes should be greater than 100 percent.

9.2.4 The tightening of liquidity in the immediate wake of the global crisis of 2008-09 impacted the Indian NBFC sector which largely funded itself in the wholesale markets from banks and mutual funds. NBFCs that were more leveraged, more dependent on CPs and short term bank borrowing with little flexibility in shedding assets faced more stress. There were several pockets of stress in the sector. Sanctioned credit lines from banks were frozen. In response, several NBFC businesses either downsized their balance sheets or rationalised their branches and deferred their expansion plans. Business activities of NBFCs decelerated with loan book and investment growth slowing down considerably.

9.2.5 NBFCs that had overseas parents were able to mobilize some temporary liquidity support. The Reserve Bank had to step in with a series of measures to provide respite to financially stressed NBFCs in 2008-2009. They were allowed to raise short term foreign currency borrowings under certain conditions and borrow from the central bank liquidity adjustment facility through the commercial banks as a temporary measure. NBFCs were given access, against collateral of CPs of good quality issued by them, to an indirect lender of last resort facility (traditionally available only to banks) through an SPV structure. They were also allowed further time to comply with the increased capital adequacy requirements. Risk weights on bank exposure to NBFCs were brought down. Systemically important non deposit

taking NBFCs were permitted to augment their capital by issuing perpetual debt instruments qualifying as capital.

9.2.6 The crisis of 2008 more than emphasized the need for effective liquidity management to cope during times of stress. Hence there is a need for additional regulatory measures on liquidity maintenance.

### **9.3 Extant Regulatory Requirements on liquidity for the NBFC Sector**

9.3.1 Having recognized the liquidity risks that NBFCs-D could face, RBI has stipulated maintenance of a statutory liquidity requirement (SLR) at 15 percent of aggregate deposits on a daily basis. This percentage is lower than what the banks are required to hold because NBFCs do not have access to current account or savings deposits. ALM guidelines have been made applicable to NBFC-Ds with deposits of Rs. 20 crore and above. The ALM guidelines monitor structural liquidity, short term dynamic liquidity and interest rate sensitivity. Gap analysis is used to measure the mismatches over various time intervals. The main focus is on the short term mismatches of up to 30/31 days. Under these guidelines NBFC-Ds are required to ensure that the negative gap in the 1-30/31 day bucket does not exceed 15 percent of the cash outflows under normal circumstances.

9.3.2 The crisis of 2008 brought home the realization that the norms relating to ALM and liquidity risk management are of equal importance to NBFCs-ND, as they do not have access to low cost deposits, nor are they permitted to operate in the call money market. Their fund raising capabilities are mostly restricted to raising commercial papers, non-convertible debentures with maturities between 3 months to one year, inter-corporate deposits and borrowings from banks, which are typically all of shorter maturity than their assets. Asset Liability Management (ALM) guidelines have been mandated for NBFC-ND-SIs with assets of Rs. 100 crore and above and for deposit taking NBFCs with deposits more than Rs. 20 crore. Such NBFCs are required to maintain a gap not exceeding 15% of their net cash outflows in the 1-30/31 day bucket. There is no such requirement for smaller NBFCs with asset sizes below Rs. 100 crore that do not hold public deposits.

9.3.3 The liquidity issues facing NBFCs were debated by the members of the Working Group. Members noted that while minimum CRAR for NBFCs is higher than

that for banks, in times of turbulence this may not be sufficient to deal with potential liquidity stress. Hence, the issue of liquidity risk for NBFCs remains inadequately addressed. Apart from a quarterly return, no other regulatory requirements have been stipulated for NBFCs-ND below asset sizes of Rs. 100 crore.

9.3.4 However, liquidity issues are different for different subsets of NBFCs. A one-size-fits-all approach may not be appropriate. The large NBFCs, especially IFCs, have very long term assets and comparatively short term liabilities, thus carrying ALM mismatches and possible refinancing risk in their balance sheets. ALM mismatches for NBFCs which are into retail financing may not be as marked as in the case of IFCs. Retail focused NBFCs are often able to reduce the maturity of their assets through securitization and bilateral assignments. An analysis of the liquidity mismatches for 177 large NBFC-ND-SIs shows that more than 60 percent have positive mismatches in their ALM in the first two buckets.

9.3.5 Under the new liquidity related stipulations of Basel III, banks are categorized as wholesale banks and retail banks, and the new norms are applicable to both. Taking all aspects into consideration, the Working Group is of the view that all NBFCs should have a liquidity cushion for any stress faced up to the 30 day period. All NBFCs, both deposit taking and non deposit taking should hold Government securities equal to the gap between their total inflows and outflows up to the 30 day period. While some members of the Group felt that NBFCs being in the nature of wholesale banks (at least on the liabilities side of the balance sheet) should have access to the RBI repo window, it was acknowledged that the LOLR facility is normally reserved for banks which are subject to a much tighter regulatory regime than NBFCs. It was noted that NBFCs would in any event have the opportunity to use committed credit lines or government securities maintained by them as part of a liquidity buffer for repos in the market in the event of stress.

#### **9.4 The Working Group recommends that**

- i. all registered NBFCs – deposit taking and non deposit taking - should maintain high quality liquid assets in cash, bank deposits maturing within 30 days, government securities, treasury bills eligible for repos,**

**investment in money market instruments maturing within 30 days equal to the gap between total net cash inflows and outflows over the 1 to 30 day time bucket as a liquidity coverage requirement.**

## **10. Issues in Corporate Governance**

10.1.1 The need for adopting good corporate governance practices has been the focus of attention of all financial entities. This is critical from the perspective of investors and stake holder confidence more generally. In recognition of this, RBI has prescribed a governance code for NBFCs as part of best practices. Corporate governance guidelines have been prescribed for all deposit taking companies with deposits above Rs. 20 crore and above and systemically important non-deposit taking NBFCs. These entail constitution of Risk Management, Audit and Nomination Committees as well as some regulations on disclosure and transparency. Listed NBFCs are also expected to adhere to the corporate governance rules under the Clause 49 Listing Agreement of SEBI. While due diligence is undertaken on significant shareholders and directors at the time of registration there are no prescriptions for qualifications for directors or a system for continuing due diligence as in case of banks. Further in the event the RBI feels that any director is not fit or proper there are no powers for removal of such a person. In addition, there are no guidelines on connected lending or remuneration practices which are engaging regulators universally.

10.1.2 With the increasing size, interconnectedness and systemic significance of NBFCs, it is important that the directors and share holders who are responsible for steering the company are fit and proper and have the necessary qualifications. At the time of granting CoR to a company, RBI is required to satisfy itself that the conditions specified in Section 45IA(4) of the Act are fulfilled. Those conditions include, (a) that the affairs of the NBFCs are not being or not likely to be conducted in a manner detrimental to the interest of its present or future depositors and (b) that the general character of the management or the proposed management of the NBFC shall not be prejudicial to public interest or the interest of its depositors. In order to satisfy itself about the general character of the management of an NBFC and how its affairs are conducted, it will be necessary for RBI to know as to who are or will be managing

the company. As such, due diligence is conducted with respect to significant shareholders and the directors. However, there is no specific provision in the Act which requires an NBFC to take the approval of RBI for any change in the management of NBFC.

10.1.3 In paragraph 3.2 above, the Working Group has recommended that any change in control or change in shareholding, directly or indirectly above 25% should be with the prior approval of RBI. It has also recommended prior approval of RBI for any mergers of NBFCs under Section 391-394 of the Companies Act, 1956 or acquisitions by or of an NBFC, which are governed by the SEBI Regulations for Substantial Acquisitions of Shares and Takeover. As a long term measure, the Working Group recommends that suitable amendments may be carried out in the RBI Act giving powers to RBI over management of NBFCs similar to that available and proposed in the case of banks.

10.1.4 The restrictions on the number of directorships with respect to NBFCs are governed by the provisions of sections 275 and 278 of the Companies Act, 1956. As regards NBFCs, there are no restrictions on the number of directorships on the lines of the restrictions set forth in section 16 of BR Act for banking companies. Because under section 278 of Companies Act, the directorships in private companies are not counted for the purposes of section 275 of that Act (under which a person cannot be a director of more than fifteen companies), persons who are directors in more than fifteen companies also become directors of NBFCs. It is observed that directors of many companies applying for Certificate of Registration are on the Boards of a large number of companies, including NBFC group companies and foreign companies. Instances of as many as 24 directorships have been observed. Multiple directorships are inconsistent with principles of good governance.

10.1.5 It is equally important to extend the due diligence and fit and proper norms to the principal shareholders of the companies. In small privately held businesses shareholders play an active role in the affairs of the company. The same principle is applicable to large, professionally managed NBFCs where the Board of Directors is different from the shareholders, and where the shareholders are represented in the Boards and hence play an active part in shaping the policies of the NBFCs. It may be mentioned that at present, under the acknowledgement procedure put in place by

RBI, any change in shareholders beyond 5 percent in banking companies invites a due diligence exercise on the new shareholders by the RBI. Appropriate statutory provisions<sup>8</sup> in this regard are proposed to be inserted in the BR Act. The Working Group is satisfied that similar statutory provisions should be made for NBFCs also.

10.1.6 An equally important corporate governance issue not addressed by regulation is adoption of appropriate measures to contain connected lending in NBFCs. In view of their growing systemic significance and professionalization of management, many large NBFCs have themselves adopted such measures. Nevertheless, there is need to put appropriate regulation in place to avoid instances of diversion of funds, including borrowed funds, to Directors, their relatives, or to firms that the Directors are associated with or have substantial or beneficial interest in. The Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision in September 1997 state that in order to prevent a contagion risk, and to prevent abuses arising from connected lending, banking supervisors must ensure that lending to related companies and individuals are on an arm's length basis, and that such credits are clearly identifiable, effectively monitored and appropriate steps are taken to control (in terms of quantitative limits) or mitigate risks.

10.1.7 The global financial crisis of 2008 has demonstrated the risks from ill designed incentive based compensation packages being offered to the management. The remuneration packages encouraged short term performance goal setting at the cost of long term success of companies resulting in excessive risk taking by the management of companies. The disconnect between performance based compensation and actual value added to companies has been one of the core issues of the financial crisis and has prompted the Financial Services Board to recommend that sound compensation principles must be embedded in any financial reform. These include risk alignment and variable pay structures, claw back clauses besides appropriate disclosures. While these issues are being debated for suitable adaptability in the Indian context, they are nevertheless pertinent from a governance perspective.

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<sup>8</sup> Clause 5 of The Banking Laws (Amendment) Bill, 2011 (Bill no 18 of 2011) proposing insertion of Section 12B in BR Act.

10.1.8 The Working Group in their deliberations on corporate governance in the NBFC sector agreed that due diligence of Directors is important. The Joint Parliamentary Committee (JPC) on the Stock Market Scam has also observed in their report that it is imperative for the banks to follow strategies and techniques which are basic to the tenets of sound corporate governance, which include capable and experienced Directors, efficient management, coherent strategy and business plan and clear lines of responsibility and accountability. The Working Group is of the view that all NBFCs with asset size of Rs. 1000 crore and above whether listed or not should comply with clause 49 of SEBI's listing agreement. These requirements ought to be mandatory for all NBFCs with asset size of Rs. 1000 crore and above and could be advised but not mandatory for those below it. The uniform application of clause 49 of SEBI's Listing Agreement stipulations should result in the necessary improvement in the qualification, professionalism, and independence of NBFCs Directors, impose appropriate limitations on the number of directorships that can be held by one person, and induce greater disclosure.

10.1.9 Clause 49 mandates that there should be an independent and qualified audit committee in which all members are to be financially literate and at least one to have expertise in accounting or financial management. It also requires that a Director shall not be a member in more than 10 committees across all companies in which he is a director. There is also the requirement of submission of quarterly reports, disclosure of compensation to its non-executive directors, disclosure of all related party transactions, remuneration to directors etc.

10.1.10 The G-20 has made recommendations for the design of remuneration systems of risk taking entities. The Working Group also feels that it is useful to mandate NBFCs to adopt a remuneration policy based on the general principles now accepted internationally to curb excessive risk taking.

## **10.2 The Working Group recommends that**

- i. in regulating NBFCs, RBI should have the legal powers relating to management similar to those available under BR Act for banks. This may be considered at the time of comprehensive legislation change for the financial sector;**

- ii. **all registered NBFCs with assets of Rs. 1000 crore and more whether listed or not, should be required to comply with Clause 49 of SEBI listing Agreements, including induction of Independent Directors and disclosures pertaining to connected lending. NBFCs with assets of Rs. 100 crore and more but less than Rs. 1000 crore may be encouraged to adopt Clause 49 principles in their governance practices;**
- iii. **compensation guidelines when finalised for banks may also be issued to NBFCs;**
- iv. **all Boards of NBFCs with assets of Rs. 1000 crore and above should have in place a Remuneration Committee to decide on the compensation to be paid to the Management of NBFCs. Broad principles must be laid down to ensure that remuneration practices do not lend themselves to excessive risk taking by managers of NBFCs;**
- v. **NBFCs below the Rs. 1000 crore asset size threshold may consider adopting these best practices, though the Working Group is not mandating their adoption;**
- vi. **continuing due diligence on directors may be ensured;**
- vii. **there should be disclosures on connected lending and other exposures to connected parties in the published annual report;**

## **11. Disclosures for NBFCs**

11.1.1 Presently, balance sheet disclosures by NBFCs are largely guided by those laid down by the Companies Act 1956, SEBI disclosure regulations for listed companies, and a few items mandated by the RBI. The disclosures mandated by RBI require all NBFCs (irrespective of whether they hold public deposits or not) to attach a schedule to their balance sheet containing additional particulars of assets and liabilities and details of their non-performing assets. NBFCs-ND-SI, have to disclose their Capital to Risk Asset Ratio (CRAR), their exposure (both direct and indirect) to the real estate, and the maturity pattern of their assets and liabilities. Additionally, if the NBFC is a listed entity it has to comply with the SEBI Code of Corporate Governance under Clause 49. On the whole though NBFC disclosures have been kept simpler and do not call for much detail because they have been

applied uniformly to a whole range of NBFCs with asset sizes varying from as little as Rs. 0.25 crore to as large as Rs. 90,000 crore.

11.1.2 The IMF's Global Financial Stability Report of April 2008 states that "providing timely and consistent reporting of exposures and valuation methods to the public, particularly for structured credit products and other illiquid assets, will help alleviate uncertainties about regulated financial institutions' positions". It also states "nearly all emerging market countries should review the reliability and depth of detail in financial institutions' public disclosures and the robustness of their accounting frameworks as uncertainty about the health of major financial institutions breeds financial instability".

11.1.3 The provisions of the Companies Act are applicable to all companies, including NBFCs, while SEBI disclosure norms apply to all listed entities. However, these disclosure norms do not differentiate between manufacturing, trading or financial companies. Financial institutions are exposed to risks arising out of counterparty failures, funding and asset concentration, interest rate movements, and risks pertaining to liquidity and solvency. Being highly leveraged as compared to manufacturing or trading entities, the capacity of financial institutions to absorb losses is hence typically lower than their commercial counterparts. It follows that the bar for disclosure should be set higher for financial institutions than for non-financial ones. Given the growing inter linkages between NBFCs and other market participants and the increasing complexity of their product offerings there is now need for greater transparency and rigour in the disclosure norms that apply to NBFCs. Lessons from recent global developments only reinforce this conclusion.

11.1.4 The issue however is not just to mandate more disclosure for NBFCs. The need for greater disclosure must be carefully balanced against the cost of such disclosure and the risk of creating information overload for stake holders. It serves no purpose if relevant disclosures get buried under a sea of less significant information.

11.1.5 The members of the Working Group agree that NBFC disclosure norms could be brought closer to those that apply to banks. Since NBFCs are prone to concentration risk and thereby correlation risk, as they are predominantly into

financing of a particular sector or product, certain disclosures on the sectoral concentration and borrower concentration is required. Being a market regulator SEBI disclosure requirements in Clause 49 do not mandate disclosure of interconnectedness of an NBFC to the financial sector, both on the liabilities side and on the asset side. NBFCs may need to disclose the number of loans and advances made to other NBFCs as well as their interconnectedness with the mutual funds. The aim is to ensure that market participants and investors are provided the relevant information on the risks being undertaken by the company. As provided in Clause 49, the NBFC should disclose transactions with related parties and subsidiaries. The present disclosure requirements for NBFCs do not mandate disclosure of complex derivative and structured products involving leveraged positions, risks involved, corporate governance processes, exposure to sensitive sectors and overseas dealings. NBFCs should also disclose the number of frauds, if committed.

11.1.6 Exhaustive and detailed disclosures on the lines of banks, however, would be onerous and expensive for NBFCs and not commensurate with their size and volume of activities. The Working Group agree that greater disclosure requirements should be restricted to NBFCs with asset size above Rs 50 crore. Such NBFCs should be required to provide uniform information on the health of their assets and their exposure to sensitive sectors. Further, disclosures should be extended to cover their off-balance sheet and non-fund based activities, including guarantees, derivatives, securitization and bilateral assignments of loans. It is expected that the latter would make the calculation of capital adequacy requirements for NBCs more accurate than they are currently.

11.1.7 The Working Group also agrees that all NBFCs must be required to additionally disclose details of movements in NPAs.

## **11.2 The Working Group recommends that**

- i. mandatory disclosures under Clause 49 of the listing agreement should be made applicable to all NBFCs, whether listed or not, with assets of Rs. 100 crore and above;**

- ii. **all registered NBFCs should disclose their registration with another regulator such as SEBI, IRDA, Stock Market and Commodity Exchanges, as well as any credit ratings assigned by rating agencies;**
- iii. **all registered NBFCs should disclose penalties, if any, levied by any regulator;**
- iv. **NBFCs with assets of Rs 100 crore and above should, in addition disclose their provision coverage ratio, liquidity ratio, Asset Liability profile, extent of financing of parent company products, movement of NPAs, details of all off-balance sheet exposures, structured products issued by them as also securitizations/assignments;**
- v. **Information as required in iv. above should be made available on the website of an unlisted NBFC with asset size of Rs. 1000 crore and above.**

## **12. Supervisory Framework for the NBFC Sector**

12.1.1 Across the world, central banks and financial regulators have traditionally used supervisory practices as a tool to periodically ensure the safety and the soundness of financial institutions as also to protect the interest of the depositors, investors and other stakeholders of these institutions. In the aftermath of the recent financial crisis in 2008-09 preservation of the financial stability of institutions and markets has emerged as one of the foremost and key objectives of financial supervision. A study of the financial crisis has revealed that while the regulation of financial institutions may have been robust, less attention had been paid to supervision, supervisory resources and compliance with the regulatory framework. According to expert opinion while there is a need for a micro prudential approach to supervision, the importance of also adopting a macro prudential perspective to supervision cannot be overemphasized. The supervisory authorities must remain continually vigilant by identifying and monitoring large capital inflows and outflows, incipient asset market bubbles, sudden changes in market sentiment and expectations and other factors that may affect the stability of the financial system.

12.1.2 Various international bodies such as the G-20, the Bank for International Settlements (BIS), central banks and other supervisory authorities around the world are now actively engaged in the process of prescribing a wide range of measures to

evaluate and contain local and cross border systemic risks for the purpose of promoting a robust and sound global financial system.

## **12.2 Extant Supervisory Framework**

12.2.1 The supervisory framework for Non-Banking Finance Companies in India was created in 1997 with the objective of protecting the interest of depositors. The emergence of large complex interconnected non deposit taking NBFCs with increased scope and sophistication brought in tighter regulations but supervision did not keep pace with the enhanced regulations.

12.2.2 The existing framework for supervision of NBFCs primarily consists of a system of i) off-site supervision involving scrutiny of periodical returns and statements containing financial and prudentially important data submitted by the NBFCs and ii) on- site supervision of the books of account and other records of the NBFCs.

## **12.3 On-Site Supervision**

12.3.1 Under the current framework effective from January 2005, deposit taking NBFCs are inspected at varying intervals depending on the size of their deposits and supervisory concerns which come to light during on-site assessment or off-site surveillance. With effect from 2006, a separate and distinct class of institutions, viz., systemically important non deposit taking NBFCs (NBFC-ND-SIs)<sup>9</sup>, was identified for the purpose of closer monitoring. However, a detailed assessment of NBFC-ND-SIs commenced from the year 2010.

## **12.4 Off-Site Surveillance**

12.4.1 A comprehensive framework for off-site returns has been put in place for deposit taking NBFCs and for non deposit taking NBFCs with asset size of Rs. 100 crore and above. This comprises of returns of varying periodicity on balance sheet financials, compliance to prudential regulations on NOF, capital adequacy, exposure norms, capital market exposure, adherence to the minimum capitalization norms under the FDI norms besides other requirements. For deposit taking companies there is the mandate to report on their maintenance of statutory liquid assets.

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<sup>9</sup> The threshold for categorization as NBFC-ND-SI was fixed in 2006 at Rs 100 crore.

12.4.2 A watch is kept on companies which are likely to become systemically important in the near future and data requirements have been mandated for companies with asset size between Rs. 50 and Rs. 100 crore.

12.4.3 In addition to the above returns, all NBFCs, are required, at the end of March every year, to submit an annual certificate duly certified by their Statutory Auditors, that the company is engaged in the business of NBFI as required by its original CoR.

12.4.4 The system of offsite reporting by NBFCs-D and NBFCs-ND-SI is currently quite comprehensive. However some rationalisation is being envisaged to make it symmetric across both categories.

## **12.5 Government Owned NBFCs**

12.5.1 Government owned NBFCs, although registered with the RBI, have been exempted from Prudential Norms Directions and also from on site supervision. In 2006, when the new regulatory category of NBFCs viz., NBFC-ND-SI, was created, several Government-owned companies came within the systemically important category. The Bank felt that in view of their size and interconnectedness with the wider financial system, their ability to impact financial markets and their reliance on the public exchequer, such companies should also be brought under the Bank's prudential norms directions. Consequently they were asked to provide a roadmap for adherence to the NBFC prudential norms directions.

12.6.1 The members of the Working Group examined the present framework for supervision of NBFCs. The Group is of the view that for supervision to be meaningful it should be timely, focused on risks as thrown up by offsite returns and by market intelligence. Supervision should be forward looking and identify both current and potential risks, including likely contribution to systemic risk. Inspections should invariably focus on the quality of governance and management. Early warning mechanisms should be in place for timely detection of potential risks.

12.6.2 The Group is of the view that the present system of inspection of deposit taking NBFCs should continue. It was felt that the periodicity based on risk and size was appropriate. However, this should be supplemented with supervision of NBFCs-D selected on a random basis as well, irrespective of the size. The supervision of NBFCs with assets over Rs. 1000 crore should be intensive and continuous. In

addition to the present CAMELS system, supervisory focus for such NBFCs should be expanded to include macro prudential parameters to identify system wide risks for maintaining financial stability. The inspection should, apart from regulatory compliance, also focus on potential risks on account of the business model followed by such NBFCs. Aspects such as single product focus, funding strategy, complex liability products, securitisation and assignment of loans, interconnectedness, counterparty credit risk, substitutability etc. should be examined. The rating criteria for such NBFCs should be suitably modified to incorporate these new elements. Compliance failures should lead to penalties which will have to be placed in the public domain and form part of the public disclosure requirements for the entity concerned. Off-site returns for all registered NBFCs, deposit taking and non deposit taking should be uniform in content and periodicity.

12.6.3 A mechanism should also be evolved to carry out periodical stress testing exercises based on historical as well as hypothetical scenarios to gauge the vulnerabilities of large systemically important institutions to unexpected changes in the macroeconomic environment and to design appropriate action to enhance their resilience.

## **12.7 Supervision of Government owned NBFCs**

12.7.1 The Working Group is of the view that supervision should be ownership neutral. Government owned NBFCs being recipients of budgetary support and public borrowings are deeply interconnected to financial markets through both the liability and the asset sides of their balance sheets. There is also the risk of moral hazard on account of the implicit sovereign guarantees they hold. Their enormous growth in the last fifteen years and lack of substitutability could pose serious systemic risk in the event of a severe financial downturn and hence they must be subjected to active regulation and supervision.

## **12.8 Supervision of Conglomerates**

12.8.1 Due to serious limitations to the stand alone approach to supervision in addressing the risks associated with NBFCs there is a need for introducing conglomerate-wide supervision. A large number of NBFCs are part of groups comprising stock brokerages, merchant banking institutions, and insurance firms,

sharing a common brand, logo or name. The financial inspection of NBFCs presently being carried out by RBI does not provide for the review of the overall activities of NBFCs on a group basis. The regulation and monitoring of the financial operations of such large, complex financial conglomerates have been brought under the Financial Conglomerate regulations for banks, provided they hold a banking arm as well. The NBFC sector comprises of many such groups which together can impact the financial system. They have not all been identified as Financial Conglomerates as they do not have significant presence in a given sector.

## **12.9 Supervisory Resources**

12.9.1 The members observed that the expanded mandate for the scope of supervision may require enhanced levels of supervisory resources, both in terms of numbers and skills which the current structure does not support.

### **12.10 The Working Group recommends that**

- i. the existing supervisory framework has to be enhanced to reflect the ongoing changes in perception of risk due to existence of regulatory arbitrage, rapid asset growth, extent of interconnectedness with the financial sector, speed of innovations and technological advancement in the NBFC sector;**
- ii a system of comprehensive supervision based on a forward looking CAMELS plus approach should be introduced for all NBFCs with asset size of above Rs. 1000 crore. The rating model should be revised and made more granular taking into account the contribution to systemic risk by way of assessment of various risks pertaining to concentration, funding models, asset liability mismatches, liquidity, counterparty credit, complex structured off-balance sheet exposures, securitization and credit transfer, leverage, cross border transactions, etc. As the identification and quantification of systemic risks is still evolving, the model adopted has to keep pace with the developments in the field;**
- iii. NBFCs with assets of Rs 1000 crore and above should be inspected comprehensively on an annual basis. Such NBFCs should also be subject to stress testing on an annual basis;**

- iv. NBFCs with less than Rs. 1000 crore should be inspected at intervals depending on size, risk perception based on offsite returns and market intelligence. Also a few inspections and scrutinies may be carried out at random to ensure an element of surprise;
- v. the existing supervisory approach adopted for deposit taking NBFCs which is more on lines of those for banks may be continued;
- vi. off-site returns should be uniform in content and periodicity for all registered NBFCs (including deposit taking and non deposit taking); Monthly data on sectoral flow of credit should be collected from all NBFCs with assets of over Rs 1000 crore;
- vii. All Government entities meeting the principal business criteria for NBFCs should, without exception, be subject to supervisory oversight by the RBI;
- viii. NBFCs which are part of financial groups that do not include a banking company may be subject to conglomerate supervision. For this purpose, guidelines may be evolved in consultation with other regulators;
- ix. NBFCs that have stock brokers and merchant bankers as part of the group may be inspected from the view point of assessing the spill-over risk to the NBFC on account of the own account lending and investment activities of such stock brokers and merchant bankers;
- x. supervisory resources in terms of numbers and skills should be enhanced to meet the demands of supervision.

### 13. Summary of Recommendations

Section	Particulars
3.2	<p><b>Definition and Classification of NBFCs</b></p> <ul style="list-style-type: none"> <li>i. The Reserve Bank should, under Section 45NC, exempt all non deposit taking NBFCs from the requirement of registration if their individual asset sizes are below Rs. 50 crore.</li> </ul>

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|  | <ul style="list-style-type: none"><li>ii. <b>The Reserve Bank should, under Section 45NC, exempt from registration all NBFCs with asset size below Rs. 1000 crore that are not accessing public funds (public funds are raised either directly or indirectly through public deposits, commercial papers, debentures, inter-corporate deposits, guarantees and bank finance or any other debt instrument, but exclude funds raised by issue of share capital and/ or instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue from registration with RBI. However, an annual certificate of their Statutory Auditors certifying the NOF, total asset size and whether they have accessed any public funds in the financial year should be submitted to Reserve Bank. NBFCs with asset size more than Rs. 1000 crore should be registered and regulated even if they are carrying on the business of an NBFC with their own funds.</b></li><li>iii. <b>Existing NBFCs-ND with asset size of less than Rs. 50 crore may be encouraged to deregister with the RBI.</b></li><li>iv. <b>NBFCs-ND which do not get themselves deregistered will have to apply afresh under section 45IA for obtaining a CoR if their asset size exceeds Rs. 50 crore after two years (from the date on which RBI issues suitable Notification under section 45NC).</b></li><li>v. <b>The minimum NOF requirement for all new NBFCs wanting to register with the Bank could be retained as at present viz., Rs. 2 crore (till the RBI Act is amended), but a minimum asset size of more than Rs. 50 crore should be insisted upon by the RBI.</b></li><li>vi. <b>All registered NBFCs, both deposit taking and non-deposit taking, should take prior approval from the Reserve Bank, where there is a change in control or transfer of shareholding directly or indirectly in excess of 25 percent of the paid up capital of the company.</b></li></ul> |
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	<p>vii. <b>Prior approval of RBI should also be required for any mergers of NBFCs under Section 391-394 of the Companies Act, 1956 or acquisitions by or of an NBFC, which are governed by the SEBI Regulations for Substantial Acquisitions of Shares and Takeover.</b></p>
<p><b>4.2</b></p>	<p><b>Principal Business – A Relook at the Definition</b></p> <p>i. <b>The twin criteria of assets and income for determining the principal business of a company need not be changed. However, the minimum percentage threshold of assets and income should be increased to 75 per cent. Accordingly, the financial assets of an NBFC should be 75 per cent or more (as against more than 50 per cent) of total assets and income from these financial assets should be 75 per cent or more (as against more than 50 percent) of total income.</b></p> <p>ii. <b>Existing non deposit taking NBFCs should be given a period of three years to comply with the revised definition of principal business. An incremental approach may be adopted to graduate to the revised criteria and milestones may be specified for NBFCs so that they do not slip back in fulfilling the criteria within the 3 year period. If they are unable to reach the asset and income thresholds respectively within the three year period, they should be deregistered by RBI as an NBFC through a public notification. Existing deposit taking NBFCs failing to achieve deposit taking the 75:75 criteria in three years time should not be allowed to accept fresh deposits or renew fresh deposits thereafter. They should prepay deposits within a timeframe and convert to non banking non financial companies.</b></p> <p>iii. <b>For the purpose of computing total financial assets, cash and bank deposits maturing within 30 days, government securities, treasury bills eligible for repos, investments in</b></p>

	<p>money market mutual funds or investments in money market instruments maturing within 30 days which are kept for liquidity purposes and advance payment of taxes and deferred tax payments, may be deducted from the numerator and denominator. For the purpose of computing income, the three year moving average may be used.</p> <p>iv. The financial activities as given in the Act may be suitably amended to exclude insurance business, management of chits and kuries and collection of monies for awarding prizes or gifts.</p>
<p>5.2</p>	<p><b>Categories of NBFCs and the Practicality of Differentiated Regulations by Type of Activity</b></p> <p>i. In view of the fact that there is no difference in the regulatory framework for loan companies and Investment companies and since most of the NBFCs-ND-SI are a mixture of loan and investment companies, a single category of loan/investment company should be made.</p> <p>ii. Asset Finance Companies should be retained as a separate category of NBFC provided however such companies are predominantly engaged in the asset finance business.</p> <p>iii. Principal business for AFCs may be redefined: a minimum of 75 per cent of the assets of AFCs (as against 60 per cent presently) should be in asset financing activities and at least 75 per cent of total income should be from these asset financing activities. Existing AFCs may be given a period of three years to conform to the revised principal business criteria without any slip back as and when it reaches a higher percent of asset financing.</p> <p>iv. For the purpose of calculating if a company meets the 75 per cent asset and income thresholds, the revised definition of financial assets as given in footnote 5 on page 26 may be adopted for all NBFCs including Asset Finance and Infrastructure Finance Companies.</p>

	<p>v. Limit for acceptance of deposits for rated AFCs should be reduced from 4 times NOF to 2.5 times NOF. AFCs presently exceeding this limit may not renew or accept fresh deposits till such time as they reach the revised limit.</p>
<p>6.2</p>	<p><b>Regulatory Arbitrage and Convergence in Regulation</b></p> <p>i. The Tier I capital for CRAR purposes should be specified as 12 per cent to be achieved in three years for all registered deposit taking and non-deposit taking NBFCs.</p> <p>ii. The Board approved limits for bank's exposure to real estate should be applicable for the bank group as a whole, where there is an NBFC in the group.</p> <p>iii. The risk weights for NBFCs that are not sponsored by banks or that do not have any bank as part of the Group may be raised to 150 per cent for capital market exposures and 125 per cent for CRE exposures. In case of bank sponsored NBFCs, the risk weights for CME and CRE should be the same as specified for banks.</p> <p>iv. The Liquidity Ratio should be introduced for all registered NBFCs such that cash bank balances and holdings of government securities fully cover the gaps, if any, between cumulative outflows and cumulative inflows for the first 30 days.</p> <p>v. The asset classification and provisioning norms (including standard asset provisioning norms) should, in a phased manner, be made similar to that of banks for all registered NBFCs irrespective of size.</p> <p>vi. The tax treatment for provisions made by NBFCs for regulatory purposes should be similar to that for banks.</p> <p>vii. Whenever RBI implements any macro prudential measures to address systemic risk, such measures should be made applicable to NBFCs as well.</p> <p>viii. NBFCs may be given the benefit under SARFAESI Act, 2002.</p>

	<p>ix. The RBI may review the accounting norms prescribed for NBFCs and apply the same norms for them as laid down for banks and further encourage NBFCs to follow the principles enunciated in AS 30.</p>
6.6	<p><b>Gaps in Regulation between Stock Broking firms, Investment/Merchant Banks and NBFCs</b></p> <p>i. NBFCs should be subject to similar regulations as banks while lending to stock brokers and merchant banks. Further they could be subject to similar regulation as stipulated by SEBI for stock brokers while undertaking margin financing.</p> <p>ii. The supervisory framework for NBFCs that have brokers and merchant bankers in the group, where the total assets in the group exceeds Rs 1000 crore, should adopt a financial conglomerate approach and examine the implications of the spill-over of risk of such entities on the parent NBFC or group NBFC arm and issue appropriate directions for cushioning such risk.</p> <p>iii. In general, all Government owned entities that qualify as NBFCs under the prescribed principal business criteria should be required to comply with the regulatory framework applicable to NBFCs at the earliest.</p>
6.8	<p><b>Regulatory Convergence between Banks and Deposit taking NBFCs</b></p> <p>i. The present policy stance of RBI not to allow registration of any new deposit taking company should continue.</p> <p>ii. All existing NBFCs-D should be credit rated. Unrated AFCs should not be permitted to accept deposits.</p> <p>iii. Existing unrated NBFCs-D should be given a period of one year to get themselves rated if they wished to continue to accept deposits. Thereafter, they should not be allowed to accept any fresh deposits or renew existing deposits till they get themselves rated.</p>

<p>7.2</p>	<p><b>Multiple NBFCs</b></p> <ul style="list-style-type: none"> <li>i. For the purpose of applicability of registration and supervision, the total assets of all NBFCs in a group should be taken together to determine the cut off limit of Rs. 100 crore. Capital adequacy, exposure and other prudential regulatory norms in such cases would be applicable to each entity in the group as applicable to NBFCs with assets of over Rs. 100 crore.</li> <li>ii. Their respective Statutory Auditors may certify the asset sizes of all the NBFCs within the group for this purpose.</li> <li>iii. The concept of 'group' should be the same as applicable for CICs.</li> </ul>
<p>8.2</p>	<p><b>Captive NBFCs</b></p> <ul style="list-style-type: none"> <li>i. As a model, captive NBFCs are commercial business decisions and hence should be permitted to exist.</li> <li>ii. Captive NBFCs, the business models of which focus mainly (90 per cent and above) on financing parent company's products, should be asked to maintain Tier I capital at 12 per cent from the time of registration.</li> <li>iii. The supervisory risk assessment should take into account the risk of the parent company on the captive NBFC.</li> </ul>
<p>9.4</p>	<p><b>Liquidity Management of NBFCs</b></p> <ul style="list-style-type: none"> <li>i. All registered NBFCs – deposit taking and non deposit taking - should maintain high quality liquid assets in cash, bank deposits maturing within 30 days, government securities, treasury bills eligible for repos, investment in money market instruments maturing within 30 days equal to the gap between total net cash inflows and outflows over the 1 to 30 day time bucket as a liquidity coverage requirement.</li> </ul>

<p><b>10.2</b></p>	<p><b>Issues in Corporate Governance</b></p> <ul style="list-style-type: none"> <li><b>i. In regulating NBFCs, RBI should have the power relating to management similar to those available under BR Act for banks. This may be considered at the time of comprehensive legislation change for the financial sector.</b></li> <li><b>ii. All registered NBFCs with assets of Rs. 1000 crore and more whether listed or not, should be required to comply with Clause 49 of SEBI listing Agreements, including induction of Independent Directors and disclosures pertaining to connected lending. NBFCs with assets of Rs. 100 crore and more but less than Rs. 1000 crore may be encouraged to adopt Clause 49 principles in their governance practices.</b></li> <li><b>iii. Compensation guidelines when finalised for banks may also be issued to NBFCs.</b></li> <li><b>iv. All Boards of NBFCs with assets of Rs. 1000 crore and above should have in place a Remuneration Committee to decide on the compensation to be paid to the Management of NBFCs. Broad principles must be laid down to ensure that remuneration practices do not lend themselves to excessive risk taking by managers of NBFCs.</b></li> <li><b>v. NBFCs below the Rs. 1000 crore asset size threshold may consider adopting these best practices, though the Working Group is not mandating their adoption.</b></li> <li><b>vi. Continuing due diligence on directors may be ensured.</b></li> <li><b>vii. There should be disclosures on connected lending and other exposures to connected parties in the published annual report.</b></li> </ul>
<p><b>11.2</b></p>	<p><b>Disclosures for NBFCs</b></p> <ul style="list-style-type: none"> <li><b>i. Mandatory disclosures under Clause 49 of the listing agreement should be made applicable to all NBFCs, whether listed or not, with assets of Rs. 100 crore and above.</b></li> </ul>

	<ul style="list-style-type: none"> <li>ii. All registered NBFCs should disclose their registration with another regulator such as SEBI, IRDA, Stock Market and Commodity Exchanges, as well as any credit ratings assigned by rating agencies.</li> <li>iii. All registered NBFCs should disclose penalties, if any, levied by any regulator.</li> <li>iv. NBFCs with assets of Rs 100 crore and above should, in addition disclose their provision coverage ratio, liquidity ratio, Asset Liability profile, extent of financing of parent company products, movement of NPAs, details of all off-balance sheet exposures, structured products issued by them as also securitizations/assignments.</li> <li>v. Information as required in iv. above should be made available on the website of an unlisted NBFC with asset size of Rs. 1000 crore and above.</li> </ul>
12.10	<p><b>Supervisory Framework for the NBFC Sector</b></p> <ul style="list-style-type: none"> <li>i. The existing supervisory framework has to be enhanced to reflect the ongoing changes in perception of risk due to existence of regulatory arbitrage, rapid asset growth, extent of interconnectedness with the financial sector, speed of innovations and technological advancement in the NBFC sector.</li> <li>ii A system of comprehensive supervision based on a forward looking CAMELS plus approach should be introduced for all NBFCs with asset size of above Rs. 1000 crore. The rating model should be revised and made more granular taking into account the contribution to systemic risk by way of assessment of various risks pertaining to concentration, funding models, asset liability mismatches, liquidity, counterparty credit, complex structured off-balance sheet exposures, securitization and credit transfer, leverage, cross</li> </ul>

border transactions, etc. As the identification and quantification of systemic risks is still evolving, the model adopted has to keep pace with the developments in the field.

- iii. NBFCs with assets of Rs. 1000 crore and above should be inspected comprehensively on an annual basis. Such NBFCs should also be subject to stress testing on an annual basis.
- iv. NBFCs with assets less than Rs. 1000 crore should be inspected at intervals depending on size, risk perception based on offsite returns and market intelligence. Also a few inspections and scrutinies may be carried out at random to ensure an element of surprise.
- v. The existing supervisory approach adopted for deposit taking NBFCs which is more on lines of those for banks may be continued.
- vi. Off-site returns should be uniform in content and periodicity for all registered NBFCs (including deposit taking and non deposit taking). Monthly data on sectoral flow of credit should be collected from all NBFCs with assets of over Rs 1000 crore.
- vii. All Government entities meeting the principal business criteria for NBFCs should, without exception, be subject to supervisory oversight by the RBI.
- viii. NBFCs which are part of financial groups that do not include a banking company may be subject to conglomerate supervision. For this purpose, guidelines may be evolved in consultation with other regulators.
- ix. NBFCs that have stock brokers and merchant bankers as part of the group may be inspected from the view point of assessing the spill-over risk to the NBFC on account of the own account lending and investment activities of such stock brokers and merchant bankers.
- x. The supervisory resources in terms of numbers and skills should be enhanced to meet the demands of supervision.

**Recommended Legislative Changes:**

1. Section 45I (c) of RBI Act lists out six activities namely financing, acquisition of shares and securities, hire purchase, insurance, managing chit funds, and collecting money under any scheme etc., as financial business. Companies which carry on such business are NBFCs unless their principal business is carrying on agricultural operations, industrial activities, trading in goods and services or construction and allied activities. There have been many changes in the financial landscape in the recent past. The setting up of IRDA in 1999 to regulate the insurance sector and regulation of Chits by the State Governments calls for revising the list of activities specified in Section 45 I(c). The Working Group is of the view that insurance business and chit fund business should be omitted from Section 45I(c) whenever the amendments are taken up. New forms of business which may require to be regulated by RBI may be separately identified for inclusion in Section 45 I(c) at that time, or flexibility may be given to RBI to include in the said list of businesses, any other business from time to time.
2. Over the years the entry point norms for registering as an NBFC has remained capped at Rs. 2 crore as specified under the Act. In contrast, the entry point norms to start an insurance business is Rs. 100 crore and it is Rs. 10 crore for stock brokers who desire currency exchange memberships (type clearing member). Thus the entry point capital limit presently for NBFCs has not kept pace with the changing times. As discussed in Section 3 of the Report, the present limit of Rs. 2 crore is too small to enable a financial entity to carry on business in such a manner that there are economies of scale and scope. A higher entry barrier in the form of a higher NOF requirement is necessary so that only serious players enter the sector. Hence, a minimum requirement of Rs. 2 crore in start up NOF is grossly inadequate from the perspective of financial soundness and solvency. The Working Group feels as and when the RBI Act amendments are taken up, Section 45IA (1) (b) of

the RBI Act 1934 should be amended to prescribe entry level criteria as a floor without a cap on the power of RBI to specify a higher requirement of NOF.

3. Banks and NBFCs are in similar businesses of lending and investing. Since the assets of the two financial entities are similar, it is necessary that they be subject to similar prudential norms for asset classification, income recognition and provisioning. However, the tax treatments for provisions are not similar. It is therefore proposed that the tax treatment for provisions made by NBFCs for regulatory purposes should be similar to that for banks.
4. Unlike banks and PFI, most NBFCs (except those which are PFIs under Section 4A of the Companies Act) do not enjoy the benefits deriving from the SARFAESI Act even though their clients/borrowers may be exactly the same. The Working Group is of the view that there is a good case for considering NBFCs to be notified by Central Government under Section 2(1) (m) (iv) of SARFAESI Act.
5. In regulating NBFCs, RBI should have the power to legally prescribe fit and proper conditions and have the powers to remove the directors in the event they are not found fit or proper and even appoint directors where it is necessary to do so in public interest and in the interest of financial stability. There should also be powers to supersede the Board in the interest of financial stability and constitute a fresh Board. Also provisions similar to those in banks for obtaining prior approval of RBI for any significant acquisition of ownership and control in any NBFC could be made part of the legislation. This may be considered at the time of comprehensive legislation change for the financial sector.
6. Suitable amendments may be carried out in the RBI Act, 1934, making it obligatory for NBFCs to obtain prior approval of the RBI for any merger, acquisitions or change in management or control.

### Definition of Principal Business for Various Existing Categories of NBFCs

SI No	Category	Eligibility
1.	Loan Company	Principal business should be that of making loans (defined as more than fifty percent of assets deployed in lending and more than fifty percent of income arising from such assets)
2.	Investment Company	Principal business should be that of investments (defined as more than fifty percent of assets deployed in Investment activity and more than fifty percent of income arising from such assets)
3.	Asset Finance Companies	Sixty percent of assets deployed in financing real/physical assets for productive / economic activity, and sixty percent of income arises from such assets
4.	Infrastructure Finance Companies	<p>Minimum 75 per cent of assets deployed in infrastructure loans ;</p> <p>NOF of Rs. 300 crore or above;</p> <p>minimum credit rating 'A' or equivalent</p> <p>CRAR of 15 percent (with a minimum Tier I capital of 10 percent).</p> <p>Has to be a non deposit taking company</p>
5.	Systemically Important Core Investment Companies	<p>Not less than 90% of net assets are in the form of investment in group companies;</p> <p>Not less than 60% of net assets are held as equity stake in group companies</p> <p>The CIC does not trade in its investments except through block sale for the purpose of dilution or disinvestment;</p> <p>The CIC does not carry on any other financial activity referred to in Section 45I(c) and 45I(f) of the Reserve Bank of India Act, 1934 except limited investments for the purpose of liquidity management apart from deployment for group companies.</p>

## Matrix on Recommendations for Registration

	Asset size	Principal business (Asset/Income)	Recommendations
New Companies	> Rs. 50 crore	< 75/75	Can be registered and a transition time of 3 years will be given to achieve the principal business criteria
Existing companies (D and ND)	< Rs. 50 crore	<75/75	<p>NBFC–ND can seek deregistration or transition time of 2 years can be given to achieve the asset size and principal business criteria</p> <p>NBFC-D will be given as period of 2 years to achieve the asset size and principal business criteria.</p> <p>If the required levels have not been achieved for both D and ND after the specified transition period deposit acceptance will be limited to 50 percent of NOF</p>
Existing companies(D and ND)	<Rs. 50 crore	>75/75	<p>Non-deposit taking NBFCs can seek deregistration.</p> <p>Deposit taking NBFCs will be given a period of 2 years to achieve the asset size while continuing to fulfil principal business criteria.</p> <p>If the required levels are not achieved after the specified transition period by Deposit taking NBFCs, deposit acceptance should be limited to 50 percent of NOF</p>
Existing companies (D and ND)	>Rs. 50 crore	<75/75	Transition time of 3 years can be given to achieve the revised principal business criteria, failing which, such companies should

			not be regarded as NBFCs and the deposits collected should be repaid.
Multiple NBFC-non-deposit taking in the same group	>Rs.100 crore	>75/75	Will be required to register
Existing Companies	>Rs.1000 crore	>75/75	Not accepting public funds Will be required to register #

***# In case of multiple NBFCs in the same group, (group being defined as in the case of core investment companies), the aggregate asset sizes of all NBFCs in a group will be taken together for the purpose of registration and supervision***

## Regulation of NBFCs Historical Evolution

1. **February 01, 1964**
  - Chapter III B was inserted in the Reserve Bank of India Act, 1934
  - Gave only limited powers to Reserve Bank i.e. on regulation of deposit acceptance by NBFCs.
2. **1974** - Chapter V (on Penalties) was inserted in RBI Act, 1934.
3. **February 15, 1984** - Chapter III C (to regulate deposit taking activities of UIBs) was inserted in RBI Act, 1934.
4. **1992 - Working Group on Financial Companies by RBI (Chairman: Dr. A.C. Shah).** Reserve Bank of India Act, 1934, did not confer RBI with adequate powers to make the recommendations mandatory.
5. **April 1993** – System of registration for NBFCs with NoF Rs. 50 lakh and above was introduced.
6. **June 1994-** RBI prescribed prudential norms as an attempt to regulate the assets of the companies.
7. **1995**
  - Khanna Committee (Expert Group on Designing a Supervisory framework for **NBFCs**) -.Recommendations laid foundation to the supervisory framework of NBFCs.
  - The supervision of the NBFC sector was brought under the jurisdiction of the Board for Financial Supervision (BFS) (July 01).
8. **1997** - Department of Non-Banking Supervision (DNBS), was formed by segregating FCW from DoS, for focused attention to the supervision of NBFCs by 16 Regional Offices.
9. **March 1997** - the Reserve Bank of India (Amendment) Act was passed amending Chapter III B, III C and V of RBI Act, 1934.
10. **April 30, 1997** - Reserve Bank of India (Non-Banking Financial Companies) Returns Specifications 1997 was issued.
11. **January 02, 1998** - New Regulatory Framework for NBFCs
  - NBFCs were classified into 3 categories for purposes of regulation, viz, (i) those accepting public deposits; (ii) those which do not accept public deposits but are engaged in the financial business, and (iii) core investment companies which hold at least 90 per cent of their assets as investments in the securities of their group/holding/subsidiary companies.
  - New entry point norm of Rs. 25 lakh.
  - While NBFCs accepting public deposits were to be subjected to the entire gamut of regulations, those not accepting public deposits would be regulated in a limited manner.

- In respect of new NBFCs (which are incorporated on or after April 20, 1999 and which seek registration with the Reserve Bank), the minimum NOF was raised to Rs. 2 crore.
12. **January 31, 1998** - Directions were issued as under:
    - Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998
    - Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998
    - Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1998.
  13. **August 1998**- Task Force on Non-Banking Finance Companies under the Chairmanship of Shri C M Vasudev, Special Secretary (Banking), Ministry of Finance to examine the adequacy of then legislative framework was set up.
  14. **October 1998** - The Task Force submitted its Report to the Government. Recommendations included:
    - higher CRAR for NBFCs than banks,
    - statutory powers to RBI to appoint depositors' grievance redressal authorities,
    - review of prudential norms etc.
  15. **April 08, 1999** – Press Release issued by RBI defining principal business. A company will be treated as an NBFC
    - if its financial assets are more than 50 per cent of total assets (netted off against intangible assets) and
    - income from financial assets is more than 50 per cent of the gross income.
    - both these criteria are required to be fulfilled as the determinant factor for principal business of a company.
  16. **January 13, 2000** – On the lines of scheduled commercial banks, all NBFCs having asset size of Rs. 50 crore or above were advised to have compulsory internal audit system and also constitute an Audit Committee from among the members of their Board of Directors.
  17. **January 13, 2000** – Exemptions were granted to NBFCs (Section 25 Companies) engaged in micro financing activities, MBCs (Potential Nidhis) and Government companies (registration applicable) from Core provisions of RBI Act, 1934 and Directions, subject to eligibility criteria.
  18. **June 09, 2000** - Guidelines for entry of NBFCs into insurance business was issued.
  19. **December 13, 2000** - Financial Companies Regulation Bill, FCRB was introduced in the Lok Sabha. The Standing Committee on Finance submitted its report in July 2003, making 21 recommendations for amendments in the FCRB. The Committee recommended that only deposit taking companies should be covered under the new legislation.
  20. **June 27, 2001** – The concept of asset liability management was introduced in 2001 for all NBFCs with asset base of Rs. 100 crore or holding public deposits of Rs. 20 crore or more.
  21. **November 28, 2002** - Venture Capital Fund Companies registered with SEBI and not holding public deposits were exempted from core provisions of RBI Act and Directions.

22. **January 08, 2003** - Stock broking companies, registered with SEBI and not holding public deposit were exempted from core provisions of RBI Act and Directions.
23. **March 29, 2003** - As part of implementation of the recommendation of the Working Group on Redesigning of Financial Statements of NBFCs, additional schedule to Balance Sheet of NBFCs was stipulated for all NBFCs.
24. **June 18, 2003** - In terms of amended FEMA Notification No. 94 dated June 18, 2003, Foreign Direct Investments (FDI) was permitted under automatic route for 18 specified NBFC activities subject to minimum capitalisation norms.
25. **2004** - Several all India associations and State level associations formed a Self Regulatory Organisation named Finance Industry Development Council (FIDC).
26. **June 2004** – Discussions were held with NBFCs regarding their plan of action for voluntarily phasing out of their acceptance of public in line with international practices. NBFCs-ND were advised that they would require Rs. 2 crore NoF before applying for permission to accept public deposits.
27. **February 2005** - the Government of India (GOI) was advised by RBI that a separate legislation, viz., FCRB 2000, for financial companies was not necessary since the initiatives taken by RBI and the change in the composition of the sector, had addressed the issues to a great extent.
28. **September 06, 2005** - A system of monitoring the capital market exposure of NBFCs-ND-SI through monthly returns was brought in.
29. **December 2005** - The concept of Corporate Governance was introduced in 2005 with directions to rotate partners of statutory auditors after three years and further elaborated in August 2007.
30. **September 28, 2006** - Guidelines on Fair Practices Code was issued to NBFCs.
31. **December 06, 2006** - A new category of NBFCs formed as Asset Finance Companies by combining the classes of Equipment Leasing and Hire Purchase Companies.
32. **December 12, 2006**
  - Systemic significance of the sector was recognized and
  - NBFCs with asset size of Rs. 100 crore and above classified as systemically important companies
  - Capital adequacy requirements and credit concentration norms introduced.
  - NBFCs allowed to issue co-branded credit cards with scheduled commercial banks without risk sharing and with prior approval of RBI subject to certain eligibility criteria.
33. **February 22, 2007** - The need for differential regulation was recognized for deposit taking and non deposit taking companies and separate prudential norms were issued for them in February 2007.
34. **April 27, 2007** - submission of **an annual statement** of capital funds, risk asset ratio etc., as at end of March every year in form NBS-7 was stipulated for NBFCs-ND-SI.
35. **August 01, 2008** - Guidelines for NBFC-ND-SI as regards capital adequacy, liquidity and disclosure norms was issued

- Increase in Capital adequacy to 12% w.e.f March 31, 2010 and 15% w.e.f March 31, 2011
  - introduction of ALM reporting and
  - disclosure norms for NBFC-ND-SI
36. **September 24, 2008** – NBFCs with asset size of Rs. 50 crore and above but less than Rs. 100 crore were advised to submit online, a quarterly return on important financial parameters.
  37. **October 29, 2008** - NBFCs-ND-SI were permitted to issue Perpetual Debt Instruments (PDI) in accordance with the guidelines issued.
  38. **September 17, 2009** – Instructions on takeover / acquisition of a deposit taking NBFC, would require prior permission of RBI were issued.
  39. **September 18, 2009** -NBFCs were allowed to participate in Interest Rate Futures market subject to prescribed conditions.
  40. **February 12, 2010** - New class of NBFCs viz; IFCs introduced and eligibility criteria stipulated.
  41. **July 09, 2010** - Issue of guarantees by NBFCs-ND-SI treated as akin to access to public funds for considering applications for special dispensation from exposure norms.
  42. **August 09, 2010** – NBFCs permitted to participate in currency futures only for hedging.
  43. **August 11, 2010** – NBFCs-ND-SI permitted to participate in repo of corporate debt securities.
  44. **August 12, 2010 and January 05, 2011** – Guidelines and Notification on Core Investment Companies (CICs) issued.
  45. **September 16, 2010** – NBFCs permitted to participate in currency options for hedging.
  46. **January 17, 2011** - Provisioning requirement for standard assets - a general provision at 0.25 per cent of the outstanding standard assets introduced.
  47. **Feb 02, 2011** - Gold loans not to be treated as agricultural loans and the priority sector status for such bank lending was removed (RPCD circular).
  48. **Feb 17, 2011** - CRAR requirement of NBFCs-D raised to 15% from the extant 12% w.e.f March 31, 2012.
  49. **March 30, 2011** - NBFCs were prohibited from contributing capital to any partnership firm or to be partners in partnership firms.
  50. **May 27, 2011** - contribution made by the group entities in an insurance JV along with the NBFC brought within the ceiling of 'not more than 50% of the paid up equity capital of the insurance JV'. Group concept in this case has been revised on the lines of CICs.