Non-Banking Financial Companies

46. In keeping with the spirit of financial sector liberalisation, efforts were made to integrate NBFCs into the mainstream of overall financial sector. The first phase of this process was initiated on the basis of the recommendations of the Shah Committee. Measures relating to registration and prudential norms based on Shah committee's recommendation could not, however, be given statutory backing because the RBI Act 1934 did not confer the RBI with necessary powers in this regard. An ordinance was therefore promulgated by the Govenment in January 1997 effecting comprehensive changes in the provision of the RBI Act, 1934 which was later replaced by the Reserve Bank of India (Amendment) Act, 1997. The Act conferred wide ranging powers on the RBI for registration, regulation/supervision, issue of guidelines and even winding-up of these companies. Under the amendment, compulsory registration, a minimum net owned fund (NOF) of Rs. 25 lakh, maintenance of certain percentage of liquid assets, creation of reserve fund, etc. were prescribed for the NBFCs. In May, 1997, as certain malpractices pertaining to NBFCs came to light, the RBI took prompt corrective steps and the financial sector was also resilient enough to withstand this shock. The percentage of liquid assets to be maintained by NBFCs has been revised upward uniformly for all NBFCs to 12.5% and 15% of their 'public deposits' with effect from 1.4.1998 and 1.4.1999 respectively. The process of registration of 37,478 NBFCs, more than 9000 of which have Net Owned Funds (NOF) of Rs.25 lakh and above, is being attended to on top priority basis.

47. The focus of supervision has now shifted to NBFCs accepting public deposits inasmuch as only such companies will be subjected to deposit regulations and prudential norms in their entirety. Auditors have been entrusted with the task of ensuring compliance with regulations by the NBFCs not accepting public deposits and non-compliance thereof has to be reported by them to the Bank by exception. In the envisaged system, large NBFCs having public deposits of Rs.50 crore and above will be subjected to on-site inspection on an annual basis. Further 10% of NBFCs accepting public deposits will also be put on annual inspection. Other companies will be taken up for inspection depending on the record of compliance of the regulations/complaints. Smaller companies will be mainly subjected to off-site surveillance through periodical returns.

48. With a view to bringing a measure of uniformity and to disclose a true and fair picture of financial health of the companies, a committee with representatives from Reserve Bank of India and the Institute of Chartered Accountants of India has been constituted to decide an appropriate format for drawing balance sheet, Profit and loss account, etc.

49. On January 2, 1998 the RBI issued detailed guidelines regarding norms of deposit acceptance, prudential norms, etc. for various categories of the NBFCs. These were later reconsidered and revised guidelines were issued on January 31, 1998; deposit entitlement limits were raised in certain cases to minimise hardship without endangering the interests of depositors. According to these guidelines an NBFC will have to obtain the minimum prescribed investment rating before accepting public deposits. The limit of acceptance of public deposits has been linked to the NOF of NBFCs and its rating. While equipment leasing companies having NOF of Rs.25.00 lakh and above and having a credit rating of AAA, AA, A and A – can accept public deposits up to 4 times, 2.5 times, 1.5 times and 0.5 time respectively, of their NOF, a loan company having a NOF of Rs.25 lakh and above and having credit rating of AAA, AA and A will be allowed to accept deposits from public up to 2 times, 1 time and 0.5 time, respectively of NOF. Furthermore, NBFCs with NOF of less than Rs. 25 lakhs have been prohibited from accepting public deposits with immediate effect.

BOX 3.3

Major Recommendations by the Narasimham Committee on Banking Sector Reforms

Strengthening Banking System

- Capital adequacy requirements should take into account market risks in addition to the credit risks.
- In the next three years the entire portfolio of government securities should be marked to market and the schedule for the same announced at the earliest (since announced in the monetary and credit policy for the first half of 1998-99); government and other approved securities which are now subject to a zero risk weight, should have a 5 per cent weight for market risk.
- Risk weight on a government guaranteed advance should be the same as for other advances. This should be made prospective from the time the new prescription is put in place.
- Foreign exchange open credit limit risks should be integrated into the calculation of risk weighted assets and should carry a 100 per cent risk weight.
- Minimum capital to risk assets ratio (CRAR) be increased from the existing 8 per cent to 10 per cent; an intermediate minimum target of 9 per cent be adhieved by 2000 and the ratio of 10 per cent by 2002; RBI to be empowered to raise this further for individual banks if the risk profile warrants such an increase. Individual banks' shortfalls in the CRAR be treated on the same line as adopted for reserve requirements, viz. un-formity across weak and strong banks. There should be penal provisions for banks that do not maintain CRAR.
- Public Sector Banks in a position to access the capital market at home or abroad be encouraged, as subscription to bank capital funds cannot be regarded as a priority claim on budgetary resources.

Asset Quality

- An asset be classified as doubtful if it is in the substandard category for 18 months in the first instance and eventually for 12 months and loss if it has been identified but not written off. These norms should be regarded as the minimum and brought into force in a phased manner.
- For evaluating the quality of assets portfolio, advances covered by Government guarantees, which have turned sticky, be treated as NPAs. Exclusion of such advances should be seperately shown to facilitate fuller disclosure and greater transparency of operations.
- For banks with a high NPA portfolio, two alternative approachs could be adopted. One approach can be that, all loan assets in the doubtful and loss categories, should be identified and their realisable value determined. These assets could be transferred to an Assets Reconstruction Company (ARC) which would issue NPA Swap Bonds.
- An alternative approach could be to enable the banks in difficulty to issue bonds which could from part of Tier II capital, backed by government guarantee to make these instruments eligible for SLR investment by banks and approved instruments by LIC, GIC and Provident Funds.
- The interest subsidy element in credit for the priority sector should be totally eliminated and interest rate on loans under Rs. 2 lakhs should be deregulated for scheduled commercial banks as has been done in the case of Regional Rural Banks and cooperative credit institutions.

Prudential Norms and Disclosure Requirements

- In India, income stops accruing when interest or instalment of principal is not paid within 180 days, which should be reduced to 90 days in a phased manner by 2002.
- Introduction of a general provision of 1 per cent on standard assets in a phased manner be considered by RBI.
- As an incentive to make specific provisions, they may be made tax deductible.

Systems and Methods in Banks

- There should be an independent loan review mechanism especially for large borrowal accounts and systems to identify potential NPAs. Banks may evolve a filtering mechanism by stipulating in-house prudential limits beyond which exposures on single/group borrowers are taken keeping inview their risk profile as revealed through credit rating and other relevant factors.
- Banks and FIs should have a system of recuriting skilled manpower from the open market.
- Public sector banks should be given flexibility to determined managerial remuneration levels takeing into account market trends.
- There may be need to redefine the scope of external vigilance and investigation agencies with regard to banking business.
- There is need to develop information and control system in several areas like better tracking of spreads, costs and NPSs for higher profitability, , accurate and teimly information for strategic decision to Idnetify and promote profitable products and customers, risk and asset-liability management; and efficient treasury management.

Structural Issues

- With the conversion of activities between banks and DFIs, the DFIs should, over a period of time convert themselves to bank. A DFI which converts to bank be given time to face in reserve equipment in respect of its liability to bring it on par with requirement relating to commercial bank.
- Mergers of Public Sector Banks should emanate from the management of the banks with the Governemnt as the common shareholder playing a supportive role. Merger should not be seen as a means of bailing out weak banks. Mergers between strong banks/FIs would make for greater economic and commercial sense.
- ‘Weak Banks' may be nurtured into healthy units by slowing down on expansion, eschewing high cost funds/ borrowings etc.
- The minmum share of holding by Government/Reserve Bank in the equity of the nationalised banks and the State Bank should be brought down to 33%. The RBI regulator of the monetary system should not be also the owner of a bank in view of the potential for possible conflict of interest.
- There is a need for a reform of the deposit insurance scheme based on CAMELs ratings awarded by RBI to banks.
- Inter-bank call and notice money market and inter-bank term money market should be strictly restricted to banks; only exception to be made is primary dealers.
- Non-bank parties be provided free access to bill rediscounts, CPs, CDs, Treasury Bills, MMMF.
- RBI should totally withdraw from the primary market in 91 days Treasury Bills.

BOX 3.4

Major Recommendations of the Working Group for Harmonising the Role and Operations of DFIs and Banks

Role, Structure and Operations

- To enable indian financial institutions and commercial banks to compete in a deregulated and increasingly global market place, a progressive move towards universal banking, supported by an enabling regulatory framework, is necessary.
- Pending a full banking licence, DFIs be permitted to have a banking subsidiary (with holdings upto 100 per cent); DFIs themselves to continue to play their existing role.
- The appropriate corporate structure for the universal bank should be an internal management/shareholder decision. The structure can be a single company or a holding company with individually capitalised but wholly owned subsidiaries, a group of entities with cross holdings or a flagship company with subsidiaries which may or may not have independent shareholders.
- Keeping in view the importance of size, expertise and reach for sustained viability and future survival in the financial sector, management and shereholders of banks and DFIs should be permitted to explore and enter into gainful mergers. Such mergers can be between banks or between banks and DFIs. However, restructuring/ consolidation should be brought about in a market-oriented fashion and led solely by considerations of viability and profitability.
- DFIs in India have started moving in the direction of universal banking and increasingly operate on commercial as opposed to develomental considerations. Developmental obligations would require financial support from RBI/Government.

Regulatory and Legal Framework

- Establish a ‘super regulator’ to supervise and coordinate the activities of multiple regulators
- Undertake legal reforms with focus on debt recovery area of Banks and FIs; thorough revamp of the 1993 Act on Recovery of Debts from Banks and DFIs.

Supervisory practices

- Supervisory framework be risk-based with focus on macro-management.
- Consolidated supervison for financial subsidiaries and conglomerates and global consolidated supervison by banking supervisor

Statutory obligations

- CRR should be confined to cash and cash-like instruments; it should be brought down progressively within a time-bound frame to international levels.
- Given the stringent asset classification and provisioning norms and Government borrowing at market determined rates, the need for SLR has declined; SLR may therefore be phased out in line with international practice.
- There is a need to develop an alternative mechanism for financing specific sectors which require concessional funds which can be provided by specifically targeted subsidies rather than via statutory obligation on the entire banking system.
- Definition of priority sector should be modified to reflect the growing importance of infrastructure finance. However, infrastructure ledning may not be included in the definition of "net bank credit" used in computing priority sector obligations.
- To facilitate sound credit planning and efficient disbursal of loans, priority sector obligation should be linked to the net bank credit at the end of the previous financial year.

State Level Institutions (SLIs)

- Eventual merger of SFCs, SIDCs and SSIDCs in each state into a single entity.
- Strong SFCs to go public with state government holdings gradually brought down to below 50 per cent.
- Transfer of present share holdings of IDBI in SLIs to SIDBI
- Ownership of SIDBI to be transferred to RBI/Govt. on the same lines as NABARD.

Harmonising the Role, Operations and Regulatory Framework

- In view of the large amount of funding required, both DFIs and Banks have a role in working capital finance and long-term funding with different levels of emphasis on each segment. Since the basic functional differences will continue (at least for the present), removal of the following restrictions/stipulations be considered :—
  - (i) Prior approval for bond issues by DFIs with either maturity of less than 5 years or maturity of 5 years and above but with interest rate exceeding 200 basis points over the GOI securities of equal residual maturity.
  - (ii) Overall ceiling for DFIs' mobilisation of resources by way of term money bonds, CDs, term deposits and inter-corporate deposits at 100 per cent of net owned funds of DFIs.
  - (iii) Maturity ceiling of five years on deposits from the public and the capping of interest rate on deposits of DFIs at interest rate offered by SBI for similiar maturities.
  - (iv) Minimum size of deposits to be accepted by DFIs.