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Regulatory Framework of NBFCs in India

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Abstract

Non banking finance companies constitute an important segment of the financial system. Almost all corporate houses have set up their own NBFCs. Big banks also floated NBFCs to tap certain segments on which restriction were imposed by the regulators.NBFCs have been in operation in India in an informal setup since long time. The process of evolution of the regulatory framework for NBFCs has, to a great extent, been the outcome of the recommendations of various committees/ working groups. The regulatory framework for NBFCs is based on three criteria, viz., (a) the acceptance or otherwise of public deposits; (b) the size of NBFCs, and (c) the type of activity performed.

Keywords: NBFC, Regulatory Framework, Committee.

Introduction

The report of the Shah working group on NBFCs (1992) mentioned that NBFCs have been in operation in informal setup since long time in India. Over a period, there had been a lot of complaints from the investors relating to NBFCs dubious functioning and the loss to depositors. This threw up new challenges for policymakers and regulators to integrate them within the overall prudential regulatory framework of the financial system. Accordingly, it was felt in the early 1960s that RBI should be vested with the adequate powers to regulate the NBFCs. The RBI Act was amended by the Banking Laws (Miscellaneous Provisions) Act, 1963 to include Chapter IIIB containing provisions relating to Non-Banking Institutions receiving deposits and financial institutions to regulate the NBFIs (RBI,1992). Initially, the legislative intent was aimed at moderating the deposit mobilization of NBFCs and thereby to provide indirect protection to depositors by linking the quantum of deposit acceptance to Net Owned Fund (NoF). Thus, the directions were restricted to the liability-side of the balance sheet and mainly to deposit acceptance activities. It did not extend to the asset-side of the balance sheets of NBFCs. Subsequently, several experts/working groups, viz., Banking Commission (1972), Bhabatosh Datta Sub-Group (1971) and James Raj Committee (1975) which examined the functioning of NBFCs were unanimous about the inadequacy of the legislative framework and reiterated the need for enhancing the extant framework. The Chakravarty Committee (1985) recommended for the introduction of a system of licensing (based on the level of business) for NBFCs in order to protect the interests of depositors. Thereafter, the Narasimham Committee (1991) outlined a regulatory framework for streamlining the functioning of the NBFCs. Accordingly, the Committee recommended for the introduction of capital adequacy, debt-equity ratio, credit-concentration ratio, adherence to sound accounting practices, uniform disclosure requirements and assets valuation. Further, it also stressed that the supervision of these institutions should come within the purview of an agency to be set up for this purpose under the aegis of Reserve Bank of India.

Objective of the Study

To analyse the regulatory framework and policy perspective.

Regulatory Framework

The process of evolution of the regulatory framework for NBFCs has, to a great extent, been the outcome of the recommendations of various committees/ working groups. Following the recommendations of the Working Group on Financial Companies constituted in April 1992 (Chairman: A C Shah), a system of registration was introduced in April 1993 for NBFCs with Net Owned Funds (NOF) of Rs.50 lakh and above.

Along with recommendations of the Shah Working Group and the observations made by the Joint Parliamentary Committee in 1992, the Reserve Bank constituted an Expert Group in April 1995 for designing a supervisory framework for the NBFCs (Khanna Committee) to suggest the off-site surveillance and the on-site examination system based on their asset size and the nature of business conducted by them. Accordingly, an

Ordinance was promulgated by the Government in January 1997 and subsequently, it was replaced by an Act in March 1997 by effecting comprehensive changes in the provisions contained in Chapter III-B and Chapter V of the Act by vesting more powers with the RBI. The amended Act provided, *inter alia,* for:

1. Compulsory Registration of NBFCs and a minimum NOF of Rs.25 lakh as entry point norm;
2. Maintenance of liquid assets by NBFCs as a percentage of their deposits in unencumbered approved securities (Government securities/guaranteed bonds);
3. Creation of a reserve fund and compulsory transfer of at least 20 per cent of the net profits to aforesaid fund;
4. Authorising Company Law Board (CLB) to direct a defaulting NBFC to repay deposits; and
5. Vesting the Reserve Bank with the powers to:

a. issue directions to NBFCs regarding compliance with the prudential norms;
b. issue directions to NBFCs and their Auditors on matters relating to balance sheet and undertake special audit as also to impose penalty on erring auditors;
c. prohibit NBFCs from accepting deposits for violation of the provisions of the RBI Act and direct NBFCs not to alienate their assets;
d. (d) file winding up petition against NBFCs for violations of the provision of the Act/ directions;
e. impose penalty directly on NBFCs for non-compliance with the provisions of the Act.

Thus, with the amended Act came in to existence since January 1, 1998, the whole gamut of regulatory focus got redefined primarily to focus on NBFCs accepting public deposits. Accordingly, prudential norms pertaining to income recognition, asset classification and provisioning were prescribed in January 1998 and for the first time, assets of NBFCs were put under comprehensive regulatory regime (RBI, 1999).

The regulatory framework for NBFCs is based on three criteria, viz., (a) the acceptance or otherwise of public deposits; (b) the size of NBFCs, and (c) the type of activity performed. To ensure the adherence of the NBFCs to the regulatory guidelines, a four pronged supervisory model which included: (i) on-site inspection based on the CAMELS methodology; (ii) off-site monitoring supported by state-of-the-art technology; (iii) market intelligence; and (iv) exception reports of statutory auditors was put in place by the Reserve Bank (RBI, 2005). The basic tenet of regulation and supervision of NBFCs sector is that, while ensuring the interests of depositors, the functioning of NBFCs should be in consonance with the monetary policy framework so that it does not lead to systemic aberrations.

Over a period, considering the rapid growth in the number of NBFC-ND segment in terms of their size and numbers within the financial system, even these NBFCs not accepting public deposits with assets size of Rs. 100 crore and above (defined as systemically important) were also brought within the fold of RBI's regulatory framework since 2006. Though initially it was intended to regulate in a limited manner, since recent years, there is a visible progress in the convergence of regulatory norms between both the deposit taking and non-deposit taking NBFCs of systemically important category.

It is worth being pointed out that as on March 2010, out of 12630 registered NBFCs with the Reserve Bank, only 311 companies are deposit taking companies as per the returns filed with the regulatory authority. The extant regulations are applicable only to larger NBFCs (with assets size of Rs. 100 crore and above) among the non-deposit taking NBFCs which are systemically important. This means, from the remaining around 12000 companies, those companies whose assets are between Rs. 50 crore and Rs. 100 crore are only required to submit an auditor's certificate to the regulator. Interestingly this is meant to monitor their progress towards the threshold limit of Rs. 100 crore. There is no mechanism to ensure if these NBFCs are indeed not accepting public deposits unless some complaints are received from the public. Therefore, banks' exposures to these institutions are also not clear. In view of this, it is necessary that even among the non-deposit taking companies there should be some mechanism to monitor their activities and their progress.

Pre-Requisites for Carrying on Business of NBFC

The company desiring to be registered as an NBFC is required to submit its application for registration in the prescribed format along with the necessary documents for RBI's consideration. RBI issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied. The following pre-requisites mentioned below are cumulative and not alternative.

Registration Requirement

In terms of Section 45-IA of the RBI Act, 1934, it is mandatory that every NBFC should be registered with RBI to commence or carry on any business of nonbanking financial institution.

The registration is compulsory for all NBFCs, irrespective of their holding of public deposits. The RBI (Amendment) Act, 1997, which introduced comprehensive changes provides for an entry point norm of Rs.25 lakh as the minimum net owned fund (NOF). Subsequently, for new NBFCs seeking registration with the Reserve Bank to commence business on or after April 21, 1999, the requirement of minimum level of NOF was revised upwards to Rs.2 crore. No NBFC can commence or carry on business of a financial institution including acceptance of public deposit without obtaining a Certificate of Registration (CoR) from the Reserve Bank.

The company is required to submit its application for registration in the prescribed format along with the necessary documents for RBI's consideration. The Bank issues a Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied Requirements to be complied with and documents to be submitted to RBI by NBFCs for obtaining certificates and Registration from RBI.

However, to obviate dual regulation, certain categories of NBFCs which are regulated by other

regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock broking companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi companies as notified under Section 620A of the Companies Act, 1956, Chit companies as defined in the Chit Funds Act, 1982 or Housing Finance Companies regulated by National Housing Bank.

General Compliance Requirements

All NBFCs, being companies registered under the Companies Act, have to fulfill compliance relating to the Board of Directors, Share Capital, Management Structure, Audits, Meetings, maintenance as well as the publication of books of accounts and general conduct as per the requirements of the Companies Act 1956.

In addition, they have to fulfill the specific requirements of the Reserve Bank of India (RBI) as set out in the Directions and various notifications and amendments by the RBI. The RBI also prescribes a set of compliance norms for all NBFCs. The Prudential Norms for NBFCs accepting public deposits are more rigorous.

Regulatory Framework for NBFCs in India

The NBFC sector is characterized by its heterogeneity. It is heterogeneous in term of size, business, spread and ownership. It is more than three decades since RBI has started regulating and supervising the functioning of the NBFC sector in India. RBI presently regulates the NBFCs whether undertaking, exclusively or in combination, the activities of asset financing, loaning and investment as their principal business, irrespective of whether they accept public deposits or not.

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

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

Amendments to RBI Act and New Regulatory Framework

Various committees, which went into these aspects, strongly recommended that there should be an appropriate regulatory framework over NBFCs and that more power should be vested with an RBI to regulate NBFCs in a better manner. Chapters III-B, III-C and V of the RBI Act were comprehensively amended in January 1997 for vesting more powers with the RBI and providing, *inter alia*, for minimum entry point norm, compulsory registration with the Reserve Bank of all existing and newly incorporated NBFCs for carrying on and commencement of financial business. RBI put in place in January 1998 a new regulatory framework involving the prescription of prudential norms for NBFCs, regulation of deposit taking action to ensure that the NBFCs function on sound and healthy lines and strengthen the financial system of the country. Regulatory and supervisory attention was focused on NBFCs -D which accept public deposits so as to enable RBI to efficiently discharge its responsibilities to protect the interests of the depositors. The process has helped in ensuring consolidation of the NBFC sector as a whole.

With the amendment, any company seeking to commence/carry on business of NBFI was required to obtain a Certificate of Registration from the Bank under Section 45-IA of the RBI Act, 1934 and also have a minimum Net Owned Funds (NOF) of Rs 25 lakhs. The NOF requirement was increased to Rs 200 lakhs w.e.f. April 21, 1999. While giving registration, an evaluation of the quality of management is undertaken by applying fit and proper norm based on the information furnished by the company in respect of the promoters/directors, bankers‘ report, report from other regulators like SEBI/IRDA etc. (in case the promoters/directors are involved in activities regulated by these institutions).

New Companies are not allowed to raise public deposits for a period of two years from the date of registration. For allowing these companies to raise public deposits after a period of two years, the detailed appraisal / review is undertaken by the Bank. A further two sets of detailed directions on Prudential norms were issued by RBI in 2007. The directions inter alia, prescribe guidelines on income recognition, asset classification and provisioning requirements applicable to NBFCs, exposure norms, constitution of the audit committee, disclosures in the balance sheet, requirement of capital adequacy, restrictions on investments in land and building and unquoted shares.

Anti Money Laundering Standards

The Prevention of Money Laundering Act, 2002 (PMLA) is in force since 1st July 2005. Under PMLA certain exclusive and concurrent powers are conferred on the Director, Financial Intelligence Unit, India (FIU-IND). Financial Intelligence Unit – India (FIU-IND) was set by the Government of India vide order dated 18th November 2004 as the central national agency responsible for receiving, processing, analyzing and disseminating information relating to suspect financial transactions. FIU-IND is an independent body reporting directly to the Economic Intelligence Council (EIC) headed by the Finance Minister.

Section 13(2) of the Prevention of Money Laundering Act, 2002, empowers the Director, FIU-IND to impose fine on any banking company, financial institution or intermediary for failure to comply with the obligations of maintenance of records, furnishing information and verifying the identity of clients. The amount of fine may vary from ten thousand rupees to one lakh rupees for each failure.

Section 12 of the Prevention of Money Laundering Act, 2002 lays down following obligations on banking companies, financial institutions and intermediaries.

Every banking company, financial institution and intermediary shall -

a. maintain a record of all transactions, the nature and value of which may be prescribed, whether such transactions comprise of a single transaction or a series of transactions integrally connected to each other, and where such series of transactions take place within a month;
b. furnish information of transactions referred to in clause (a) to the Director within such time as may be prescribed;
c. verify and maintain the records of the identity of all its clients, in such a manner as may be prescribed.

Provided that where the principal officer of a banking company or financial institution or intermediary, as the case may be, has reason to believe that a single transaction or series of transactions integrally connected to each other have been valued below the prescribed value so as to defeat the provisions of this section, such officer shall furnish information in respect of such transactions to the Director within the prescribed time. The records referred to in sub-section (1) shall be maintained for a period of ten years from the date of cessation of the transactions between the clients and the banking company or financial institution or intermediary, as the case may be.

Conclusion

The regulatory framework of NBFCs is highly comprehensive. It speaks out on all the aspects of functioning of NBFCs. The global financial crisis of 2008 made visible the true magnitude of the shadow banking sector. Accordingly, the RBI, along with various other regulators, has been continuously working towards improving the NBFC Regulatory Framework to curb shadow banking activities that pose a risk to financial stability.

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