NEW DIRECTIONS FOR NON-BANKING FINANCE COMPANIES: Old wine in old bottle, just a new sticker

Vinod Kothari
[vinod@vinodkothari.com]

The Prudential Regulations applicable to NBFCs, both depository and non-depository, and both big and small, have been replaced by a new set of Directions.

Background
The present regulatory regime for non-banking finance companies (NBFCs) was ushered in 1998 when Non-banking Financial Companies Acceptance of Public Deposits (RBI) Directions 1998 was promulgated. Almost simultaneously, NBFC Prudential Norms (RBI) Directions were also pronounced.

In pursuance of the Governor's Mid Term policy statement for 2006-7, an internal committee was constituted within the RBI. The internal group reviewed the existing regulations and there was a notice of proposed rule making (NPR) issued on Nov 3, 2006.

Basic purpose of the new Directions
The key philosophy of the new Directions was regulatory arbitrage, that is, taking advantage of the disparity on the regulations applicable to banks and NBFCs. As is common knowledge, NBFCs have a much lighter regulation than that applicable to banks. Formation of an NBFC is much easier than forming a bank. Foreign direct investments in NBFCs are also much easier than those in case of banks.

In terms of powers and functions, NBFCs have substantially similar scope of activities. Other than running checking accounts, NBFCs can do virtually the same things that banks can. In fact, their right to leverage capital is almost the same, as the leveraging power is principally controlled by capital adequacy norms which require 9% minimum capital in case of banks, and 10% in case of NBFCs. If one takes into account the impact of the SLR and CRR applicable to banks, the right of NBFCs to generate business assets is, in fact, more than that in case of banks.

A Table showing the regulatory arbitrage in case of banks versus NBFCs is enclosed.

Regulatory arbitrage potential has been frowned upon both at international level and national level. IMF has framed principles for regulation of the financial sector, where it suggests that institutions performing similar functions should be subject to similar regulations.

With this philosophy in mind, the Nov 3, 2006 NPR classified NBFCs in those that are "systemically important" (SI). These are the NBFCs that have assets of Rs 100 crores or above. This is in addition to the present classification of NBFCs into deposit-taking, and non-deposit-taking NBFCs.

Two sets of Directions
The existing Prudential Directions made distinction between depository and non-depository companies, and several of the Directions were not applicable in case of non-depository companies.

Under the new regime, there are two separate sets of Directions, one applicable to Deposit-taking Companies, and the other applicable to Non-Deposit-taking companies.

Deposit-taking companies: what is new and what is not
The rather long name of Directions for depository NBFCs is Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 – given the two pairs of brackets, it would even be difficult to think of an easy call-name but let's call them Depository NBFCs Prudential Directions (DNPD).

First, quickly, a few things where would have expected amendments, but there are none. Basle II norms are being implemented in India soon, but the capital norms in the DNPD norms are still the same as under Basle I. Norms relating to securitisation and the capital requirements in case of securitisation had been brought by RBI in Feb 2006, and these are applicable to NBFCs too. There is nothing in DNPD relating to securitisation – while it is certain that the securitisation norms are applicable to NBFCs, there might, at least, have been a cross reference.

In fact, even the limits on investment in real estate and unquoted equity shares, which have been talked about as the feature change in the Norms, were also there in the earlier regulations. The word "asset finance companies" seems to be a new coinage in place of the old-fashioned "equipment leasing and hire purchase companies" but there is no difference as regards the percentages permitted for Asset Finance companies and Loan & Investment companies – that latter have a limit of 20% while the former have a limit of 10% of net owned fund.

The main new feature of the DNPD norms is disclosure of capital market exposure in case of "systemically important" NBFCs. These NBFCs have to make monthly disclosures of their capital market disclosure within 7 days of the end of the month.

The other new feature is several provisions applicable in case of project loans to infrastructure companies, which will have limited applicability to only a few NBFCs. These norms certainly don't apply to funding of infrastructural assets or leasing of excavators and tillers.

Non-deposit companies: what is new and what is not
The major change here is that exemptions from the Prudential norms are not applicable for a non-depository company which is systemically important. That is to say, if it systemically important, even though non-depository, it has to comply with all of the Directions for Non-depository NBFCs is Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 (we will call

them NNPD). If it non-depository and systemically non-important, it has to comply with all such norms, minus capital adequacy and concentration limits.

There is no significant difference between the two sets of norms – hence, it is quite intriguing as to why the two separate set of norms were needed at all.

The disclosure of capital market is not required in case of non-depository companies, even though they might be systemically important.

Crucial policy questions left unanswered

The basic philosophy of making the so-called "change" (while there is not much of change really) was to curb scope for regulatory arbitrage. Since nothing much has actually changed, the scope for regulatory arbitrage remains almost unaffected.

There some crucial policy questions left completely unanswered: if it is systemically important and has substantial capital market exposure, then, there is no reason why disclosures should be required only in case of depository companies. Since the purpose of the RBI obviously would have been keeping a tab on how much money is flowing from the financial sector into the capital market, there should not have been a difference between depository and non-depository companies.

The biggest question that remains unanswered is - if it is recognised that it is systemically un-important, and is not relevant from viewpoint of public interest since it is non-depository, why do regulators bother at all?

BANKING VERSUS NON-BANKING COMPANIES
REGULATORY ARBITRAGE IN INDIA

	Banks	**NBFCs**
Functional restrictions		
Carrying on checking accounts, remittance functions and typical retail banking	Permitted	Not permitted
Acceptance of term deposits	Permitted, subject to term restrictions (short term deposits are accepted by banks)	Permitted subject to limitations, but the term of deposit is at least 1 year .
Trusteeship function, nominee	Permitted	No express bar is there
Other functional limitations	Banking Regulation Act expressly bars any business other than that permitted by	a. For domestic NBFCs, no bar on non-financial

	the Act [Sec 6 (1)]	business, except that on crossing of a certain barrier (50% of income or assets), the NBFC will lose its character as an NBFC b. For NBFCs having international funding under automatic route, any activity included within the 19 permitted activities is possible. Any other activity is possible only with the express FIPB approval
Leasing and hire purchase	Banks are allowed to a limit of 10% of their assets	No limit
Operating lease	Treated as a non-financial business, not permitted	Permitted, though treated as non-financial business
Securitisation	Permitted subject to capital norms and other limitations	Permitted subject to capital norms and other limitations
Licensing restrictions		
Need for a license	Any new bank needs a license. Licensing norms are tightly controlled and generally, it is perceived to be quite difficult to get a license for a bank	It is comparatively much easier to get registration as an NBFC. Besides, there are some 30000 NBFCs currently registered, many of which may be available for sale.
Ownership structure/ change in ownership		
Indian ownership	Not more than 10% of capital in a bank may be acquired without the approval of the RBI	While prior intimation of a takeover is required in case of NBFCs, there is no need for express permission for a change in voting control. There is no limit as to the percentage holding permitted in case of NBFCs
Foreign ownership	Upto 74% capital in banking companies may be acquired for foreign owners.	100% capital may be held by foreign owners subject ot minimum capitalisation requirements under FDI

		norms
Capital adequacy requirements and provisioning		
Basle norms	Present capital regulations are based on Basle I. Basle II is proposed to be implemented effective 2007. Capital requirement generally 9% of risk-weighted assets	Prudential Regulations which lay down capital adequacy have been substituted in Feb 2007, but they are based on Basle I and not Basle II. Capital requirement generally 10% of risk-weighted assets.
Provisioning	90 days past due leads to NPA characterisation and calls for provisioning as per international standards	As much as 12 months' overdue is permitted in case of lease and hire purchase transactions. 6 months in case of loans and other exposures
Credit control and sectoral asset restrictions		
SLR/ CRR norms	Substantial part of assets of banks is blocked due to statutory liquidity ratio (SLR) and cash reserve ratio (CRR). These are periodically changed to control the expansion of M3 in the economy.	Only 15% of the deposit liabilities of NBFCs is to be held in certain permitted securities.
Sectoral exposures	Periodic regulations place limits on the extent to which banks may invest in capital market and other specific segments. There are certain segments in which banks need to allocate minimum percentage of their assets	Very scanty limitations have been placed on assets of NBFCs. Investment in real estate and unquoted equity shares is controlled. Capital market exposure is only required to be reported.