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and NBFCs in India: Issues
and Policy Implications

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Abstract

The recent global financial crisis (2007-09) has clearly highlighted the gravity of high financial inter-connectedness within the financial system. In the Indian context, this brief study attempts to explore the financial inter-connectedness between NBFCs (both deposit taking and non-deposit taking) with banking system. The study found that both NBFCs-D and NBFCs-ND-SI are highly dependent on the banking system for their funding, though there are regulatory limits at the individual bank's level to lend to NBFCs. NBFCs' exposures to banks in the form of deposits are however, very limited. The discouragement of NBFCs from raising public deposits has resulted in substitution of public deposits with borrowings from the banking system. The high dependency of NBFCs on banks as a whole makes the financial system vulnerable in a stressful situation.

JEL Classification: G21, G23, G24, G28.

Key words: Depository Institutions; Private Financial Institutions; Investment Banking; Policy and Regulation; NBFCs India.

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Section I: Introduction

An essential feature of the evolution of financial system has been the emergence of non-banking financial institutions, outside the traditional banking system including finance companies, leasing companies, merchant banks and trust and investment companies. The deep and broad-based financial system has invariably enhanced access to finance at a reasonable cost, and reduced volatility thereby reducing risk by improving transparency, inducing competition and diversifying products and services and also efficient delivery of them. Diversification of the financial sector has been one of the principal features of economic growth in both advanced and emerging economies. It has been well established that improvements in financial architecture quite often precede and contribute to economic performance in most countries (World Bank, 2003). Tremendous progress of financial system, especially during the 1980s and 1990s, was mainly due to the rigorous efforts of the non-banking financial institutions (NBFIs) world over. Therefore, Non-banking financial companies (NBFCs) have been the subject of special focus during the eighties and nineties including in India. In particular, the rapid growth of NBFCs, especially in the nineties, has led to a gradual blurring of dividing lines between banks and NBFCs, with the exception of certain exclusive privileges for the commercial banks. Over a period, both banks and non-bank financial institutions have become key elements of broad-based and sound financial system in India. The growing importance of NBFCs was recognised by series of committees and working groups since early 1970s including Banking Commission till the second Narasimham Committee (1998). Further, the Reserve Bank of India in its Discussion Paper on Harmonisation of the Role and Operations of DFIs and Banks(1999) and the Report of the Working Group on Money Supply (1998) (Chairman: Dr. Y.V. Reddy) had also discussed their importance.

In the recent global crisis, however, the role of non-bank financial intermediaries (NBFIs)¹ had been widely reproached. NBFIs, in general, were known

¹ NBFIs and NBFCs are used interchangeably. However, due to non-availability of specific data relating to NBFCs in the international context, the former is used in the international context.

for taking higher risks than the banking system. The nexus between the banking system and the NBFIs during the global crisis (2007-2009) put the entire financial system in distress. Traditionally, the debate regarding the banks expansion into non-banking activities veered around certain activities, viz., insurance, investment banking, etc. However, the recent global crisis has extended the debate to the interconnectedness of the banking system with the NBFIs, as excessive inter-institutional exposure put the entire financial system into vulnerability.

In this backdrop, the objective of this study is to examine 'the issue of Bank-NBFC financial inter-connectedness and their policy implications'. The rest of this study is structured as follows: importance of the role of the NBFIs, the structure of this sector and growth of NBFCs over a period in India, are presented in Section II. In Section III, besides tracing the evolution of regulatory and supervisory framework in India, in brief, the regulatory norms relating to raising of resources by NBFCs and banks' exposure to NBFCs is presented. In Section IV, attempt is made to address 'the core issue of 'banks-NBFCs inter-connectedness' by analyzing banks exposures to NBFCs of both deposit taking and non-deposit taking systemically important institutions'. Besides, a snapshot of select countries' experiences of banks' exposures to NBFCs/ NBFIs is also presented in the same section. Conclusion and policy implications are presented in the section V.

Section II: Importance of the Role of NBFIs

By now it is well established, with the experience, that the robust growth and effective functioning of a financial system is vital for economic development. There is universal agreement that a well functioning financial system is necessary for a thriving modern economy (Kroszner, 2010). In all advanced economies, for example, sophisticated financial systems efficiently deliver a broad range of financial services and act as a critical pillar in contributing to macroeconomic stability and sustained economic growth and prosperity (World Bank, 2003). Moreover, the well developed financial markets facilitate mobilization of savings, by offering savers and investors wider choice of instruments. Further, with NBFCs coming up on the financial system, investors could place their funds at more attractive returns in comparison to the bank deposits. This is the single most important reason to explain as to why the NBFCs are popular among lower and middle class population including India. This

development paradigm is increasingly recognized around the world, especially in the aftermath of repeated emerging market crises in countries with bank-dominated financial systems. According to a report from the World Bank (2003), developed financial markets also have enhanced access to finance for more firms and individuals at reasonable cost, reduced volatility and distortions, by operating in an environment that is transparent, competitive, and characterised by the presence of a diverse array of products and services, including instruments for effective risk management. All these were made possible because of widening the financial system with effective participation of NBFIs.

Referring to NBFIs, Greenspan (1999) had stated: "...enhance the resilience of the financial system to economic shocks by providing it with an effective 'spare tyre' in times of need..." Moreover, while short term loans required by the industry and agriculture are provided by the banking system, the other types of services required by industry as well as other segments of economy are provided by NBFCs and other similar financial institutions, such as factoring, venture finance, and so on. A common feature in all the advanced economies is their financial systems are well developed to deliver a wide range of financial services and sophisticated products at competitive price that are demanded by the sophisticated clientele. This was possible because of institutions such as NBFIs that were found to be more aggressive and innovative. More importantly, it resulted in improving the efficiency by inciting competition between NBFIs and banking system and ultimately stated to have contributed to macroeconomic stability and sustained economic growth.

Indeed it is evident in India that with the development of NBFCs segment within the overall financial system, it challenged the other segments, viz., banks to innovate, to improve quality and efficiency, and deliver at flexible timings and at competitive prices. In fact, in a number of un-treaded paths, NBFCs were the ones to enter first to try the market and develop before banks entered the field. In India, for instance, the loans against gold jewellerys were introduced by the NBFCs² much before the nationalised banks entered this market. Similarly, lending to small traders and small transport operators, used-commercial vehicle financing, in particular, were initiated by the NBFCs. Practically, many specialised financial services, such as the factoring, lease finance, venture capital finance, financing road transport, etc., were

² Some of the present day NBFCs were operating as informal financiers at that point of time.

pioneered by the NBFCs. NBFCs have also played a leading role in the business of securities-based lending such as Loan against Shares (LAS), Margin Funding, Initial Public Offering (IPO) Financing, Promoter Funding, etc. These customized credit products have added liquidity and encouraged retail participation in public issues in particular and equity markets in general, resulting in better price discovery according to a report by the Task Force appointed by FICCI. Even housing finance was taken to newer heights by the NBFCs. In the recent years, NBFCs also played important role in wider reach of microfinance. Moreover, development of such alternative financing vehicles adds to the liquidity and diversity of the financial system, thereby increasing its effectiveness as an engine for economic growth and enhancing the financial system's capacity to absorb shocks (Carmichael *et al*, 2002).

In view of the above, both banks and non-bank financial intermediaries are key prerequisites of sound and stable financial system and development of both sectors offer important synergies. It is interesting to note that the growth in the non-bank financial services industry in many countries has been more rapid than the deposit / lending activities of commercial banks. As a result, banking institutions have sought to diversify away from the traditional commercial banking business i.e., accepting deposits and providing loans to non-traditional banking activities, viz., investment banking, IPO financing and other capital market related activities besides the lease finance etc. NBFIs thus, in general '...tend to offer enhanced equity and risk-based products...' (RBI, 2005).

With the rise of middle class in India which has reached a certain stage of discernible economic development, there is a growing demand for property ownership, small-scale investment, and saving for retirement and a growing need for housing finance, contractual savings, insurance services, pension plans management and asset management. These varied requirements cannot be met by the banking system alone as commercial banks in India are not functioning as a full-fledged 'universal banking'. This is being met by opening non-banking financial subsidiaries by practically all the major banks in India³. These subsidiaries are in the form of merchant banks, mutual funds, insurance companies, primary dealers and other NBFCs. Thus, NBFIs play a crucial role in broadening access to financial

³ At the end of March 2010, 18 NBFCs were owned by foreign banks operating in India and 10 NBFCs were owned by Indian banks and are regulated by the RBI.

services, enhancing competition and diversification of the financial sector (RBI, 2005).

It is therefore, necessary to view NBFIs segment of financial system as a catalyst for economic growth and to provide proactive regulatory policy support for their contribution towards economic development.

Structure of NBFIs in India

Indian financial system is predominantly institution oriented unlike many developed economies such as the US where the financial system is predominated by capital market. The institutions include both banks and non-bank financial institutions⁴, though banking system takes dominant position as it is the main conveyor of core financial services. Over the years, the non-bank financial entities came into existence with multiplicity as well as importance in mobilizing the public savings and channelising the same to industry and other economic activities since the country's independence.

The NBFCs⁵ form the major sub-sector of NBFIs in India and is widely recognized for its heterogeneous character. Presently⁶, for the purpose of regulatory convenience, the NBFCs are broadly being classified into two categories based on whether they accept public deposits, viz., (i) NBFC-Deposit taking (NBFC-D) and (ii) NBFCs-Non-Deposit taking (NBFC-ND). Besides, there are only two residuary non-banking finance companies (RNBCs)⁷ which are also deposit taking companies of different character. Among the NBFCs-ND, companies with asset size of Rs. 100 crore and more have been categorized as systemically important (NBFC-ND-SI). Further, since 2006, both of deposit taking and non-deposit taking NBFCs were reclassified based on whether they were involved in the creation of productive assets. Under this new classification, the companies creating productive assets were divided into three major categories, i.e., asset finance companies (AFCs), loan companies (LCs) and investment companies (ICs) (Exhibit 1).

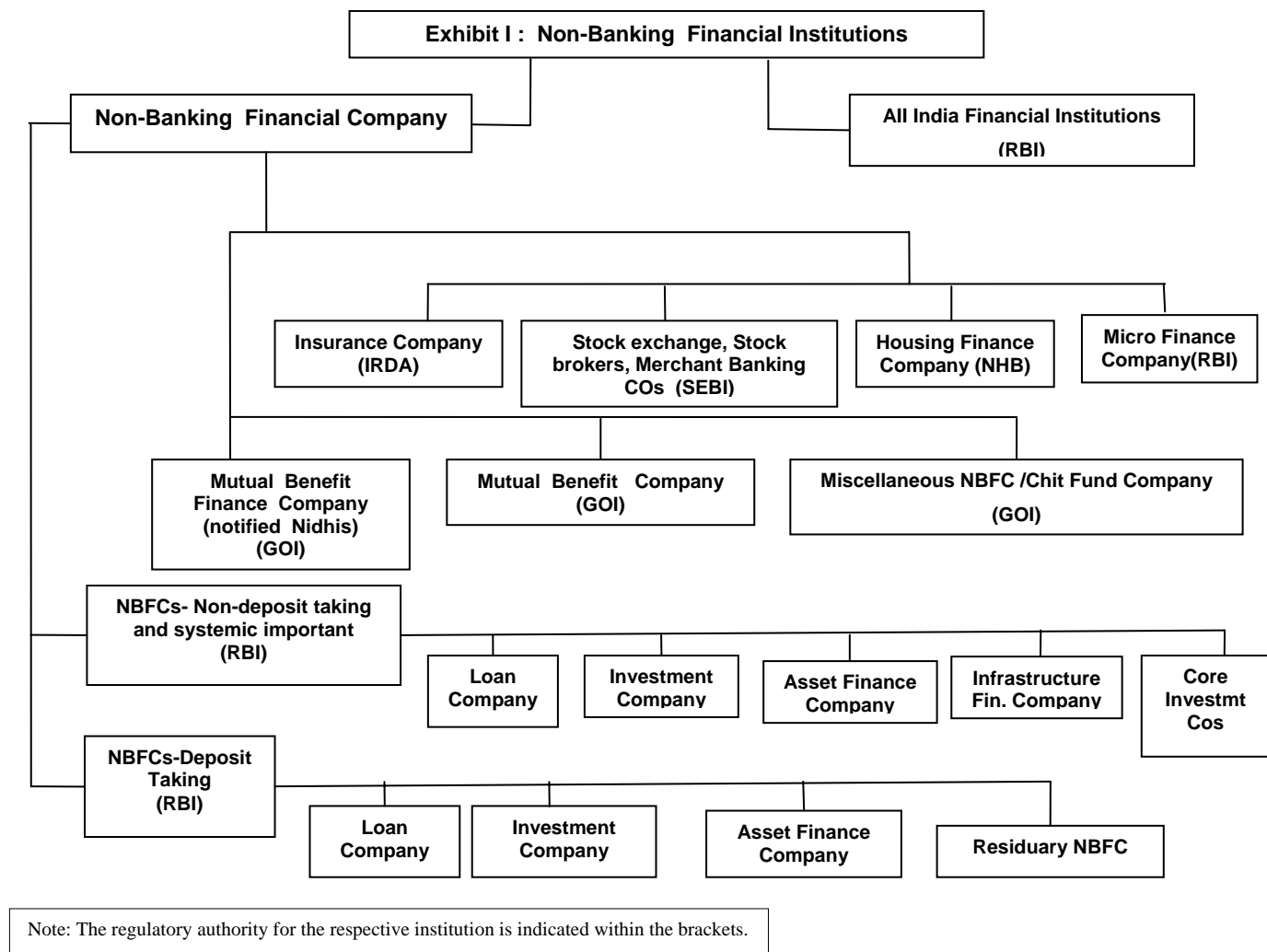
⁴ Non-Bank Financial Institution is a broad category of financial institution and its principal activities are financial services other than commercial banking.

⁵ Non-banking Financial Company means only the non-banking institution which is a loan company or an investment company or as asset finance company or a mutual benefit financial company according to RBI guidelines.

⁶ Earlier, used to be classified as loan companies, investment companies, hire-purchase finance companies, equipment and leasing companies.

⁷ RNBCs have been instructed not to raise deposits and also been ordered to wind up their business by end -2015 in the present form.

In the recent years, infrastructure finance gained greater importance, and considering this; a fourth category of NBFC involved in 'infrastructural finance' was introduced in February 2010. These companies are called as 'infrastructure finance companies' (Annex I). In a nutshell, all deposit taking companies are classified under three categories, viz., AFCs, ICs, and LCs. The non-deposit taking systemically important NBFCs (NBFCs-ND-SI) are also classified along the similar line as AFCs, ICs, and LCs. Besides, new set of companies, viz., infrastructure finance company (IFC) called as core investment companies (CIC) are also included recently.



Size of NBFCs Sector and their Growth

In line with the global trend, NBFCs in India too emerged primarily to fill in the gaps in the supply of financial services which were not generally provided by the banking sector, and also to complement the banking sector in meeting the financing requirements of the evolving economy. Over the years NBFCs have grown sizably

both in terms of their numbers as well as the volume of business transactions (RBI, 2009). The number of such financial companies grew more than seven-fold from 7,063 in 1981 to 51,929 in 1996.⁸ Thus, the growth of NBFCs has been rapid, especially in the 1990s owing to the high degree of their orientation towards customers and simplification of loan sanction requirements (RBI, 2000). Further, the activities of NBFCs in India have undergone qualitative changes over the years through functional specialisation. NBFCs are perceived to have inherent ability and flexibility to take quicker decisions, assume greater risks, and customise their services and charges according to the needs of the clients. These features, as compared to the banks, have tremendously contributed to the proliferation of NBFCs in the eighties and nineties. Their flexible structures allowed them to unbundle services provided by banks and market the components on a competitive basis. Banks on the other hand, had all along been known for their rigid structure, especially the public sector banks. This compelled them carry out such services by establishing 'banking subsidiaries' in the form of NBFCs. The willingness of NBFCs to engage in varied forms of financial intermediation, *hitherto* unavailable to the banking system, has provided the valuable flexibility in financing new areas of business. Though the NBFCs are different species and smaller in size as a segment when compared with the banking system, their relevance to the overall economic development and to certain specified areas cannot be undermined.

Over a period as the regulatory requirements were made progressively stringent, the total number of NBFCs registered with the Reserve Bank stood at 12,409 by end-March 2011. The number of NBFCs-D declined considerably with conversion into non-deposit taking companies, besides closure and mergers of weaker companies. Incidentally, the regulatory regime also seems to be in favour of reducing the number of deposit taking NBFCs and consequent migration of depositors towards the banking system which is better regulated and supervised in line with the global standards.

It may be underlined that the public deposits of NBFCs, after showing a steady increase till 2007, declined thereafter and sharply by end-March 2011. However, the size of total assets, have grown more than double from Rs. 53,878 crore as at end-March 2001 to Rs. 1,16,897 crore by end-March 2011, clearly

⁸ NBFCs have been made mandatory to get registered with the Reserve Bank under Section 45 IA of the RBI Act, 1934 since January 1997.

indicating greater demand for the services provided by these companies in a fast growing economy (Table 1). The net owned fund (NoF) of NBFCs has also increased sharply between end-March 2001 and end-March 2011 by more than three times to Rs. 17,975 crore, showing the strength of the NBFCs segment.

Item	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
No of COs registered with RBI@	13815	14077	13849	13764	13261	13014	12968	12809	12740	12630	12409
No of reporting companies*	981	910	875	981	573	466	362	364	336	308	297
Total Assets*	53,878	58,290	58,071 (20,362)	53,878 (17,955)	52,900 (19,056)	57,453 (21,891)	71,171 (23,172)	94,744 (24,452)	97,408 (20,280)	1,12,131 (17,919)	1,16,897 (11,466)
Public Deposits*	18,085	18,822	20,100 (15,065)	18,085 (15,327)	20,246 (16,600)	22,842 (20,175)	24,665 (22,622)	24,395 (22,358)	21,548 (19,595)	17,352 (14,521)	11,964 (7,902)
Net Owned Fund*	4,943	4,383	4,950 (809)	4,943 (1,002)	5,510 (1,065)	6,663 (1,183)	8,601 (1,366)	12,261 (1,718)	13,458 (1,870)	16,424 (2,921)	17,975 (2,988)

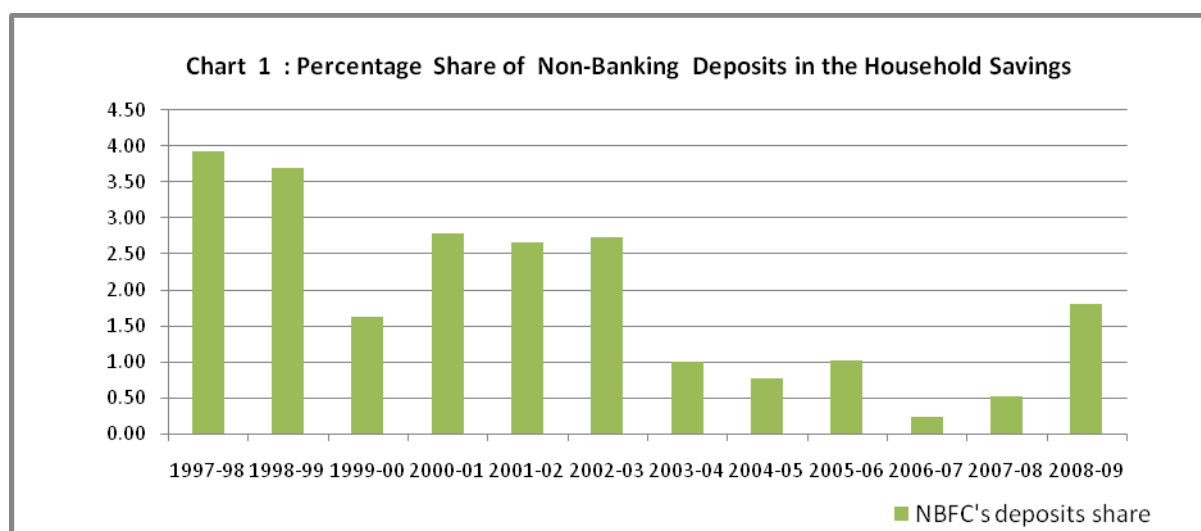
@ This includes all NBFCs (both deposit taking and non-deposit taking).

* NBFCs include Deposit taking NBFCs (NBFCs-D), Mutual Benefit Financial Companies (MBFCs) (Notified Nidhis), Mutual Benefit Companies (MBCs) (Potential Nidhis) etc, till 2004-05 and only NBFCs-D thereafter.

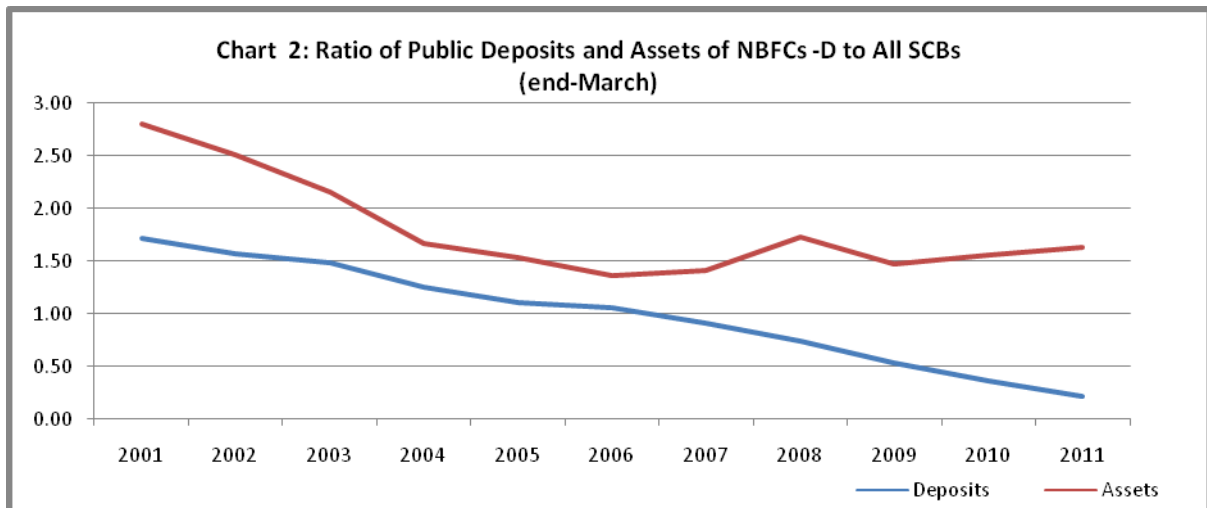
Note: Figures in brackets relates to RNBFCs.

Source: Report on Trend and Progress of Banking in India various issues.

Over the years, especially with the Reserve Bank's regulation becoming progressively more broad-based and stringent, the size of the NBFCs (in terms of numbers) as a segment has been reduced drastically as most of the unviable and substandard companies disappeared from the scene. It is also clear from the percentage share of non-banking deposits of household sector saving in gross financial assets, which decreased from around 4.0 per cent in 1997-98 to 1.8 per cent in 2008-09 (chart 1).



Further, the ratio of deposits of NBFCs to aggregate deposits of scheduled commercial banks (SCBs) showed a consistent decline revealing the regulatory focus of the Reserve Bank which emphasised on the discouragement of deposit taking NBFCs.



Thus, in comparison with the banking system in India the size of deposits in respect of NBFC-D showed a constant decline over a period and reduced to very small in size (Chart 2). Interestingly, the ratio of NBFC-D assets to banking sector since 2006 seems to have reversed from the declining trend as their asset size began swelling, though when compared with the banking system it is very small. As the size of deposits is not growing in tandem with the growth of their assets, obviously it becomes inquisitive to ascertain the source of funding the asset growth of NBFCs. In this context, analysis of sources and application of funds in respect of NBFCs-D revealed that among the sources, there is consistent increase in the borrowings and it emerged as the major source of finance to the tune of more than 72 per cent of the total liabilities at the end of March 2009. However, it slowed down to 66.7 per cent by end-March 2011. Even in the case of deposit taking NBFCs, public deposit as a share in the total liabilities have been drastically reduced to a meagre 3.85 per cent at the end-March 2011 from as high as 21 per cent in end-March 2001, while the borrowings shot up. It is of particular significance to note that funding by banks and FIs have been on the increase to reach more than 50 per cent in the total borrowings (Table 2).

On the deployment of funds, the major chunk is in the form of loans and advances and hire purchase assets together accounted for more than 73 per cent as at the end of March 2011. It needs to be underlined that they, by and large, are medium to long term assets, while major part of the funding of these assets are not of long term sources.

Table 2 : Sources and Application of Funds by the NBFCs-D								
(Percentage Share in the Total Assets/ Liabilities)								
	2001	2005	2006	2007	2008	2009	2010	2011p
Sources								
Paid up Capital	4.18	6.13	4.83	4.67	4.38	4.95	4.13	3.46
Reserves & Surplus	11.79	12.62	14.87	12.07	11.66	12.20	12.92	12.81
Public Deposit	20.90	10.90	6.47	4.28	2.74	2.56	3.00	3.85
Borrowings	31.86	64.01	65.94	66.84	67.83	72.47	68.01	66.22
<i>of which</i>								
from Banks & FIs*	NA	30.18	39.21	45.99	37.56	44.45	49.71	50.59
Other Liabilities	31.27	6.34	7.90	12.14	13.39	7.82	11.92	13.66
Application								
1. Investments	11.26	10.99	11.44	15.27	15.03	20.34	19.63	20.01
i) SLR Securities @	8.57	6.21	0.77	8.83	9.58	12.20	10.23	12.79
ii) Other Investments	2.68	4.78	10.66	6.44	5.45	8.13	9.41	7.22
2. Loan & Advances**	31.60	35.41	28.25	22.78	25.24	27.98	75.29	73.89
3. Hire Purchase Assets	32.58	40.00	52.89	54.01	44.96	46.44	-	-
4. Equipment Leasing Assets	12.45	5.62	3.97	2.81	1.41	0.79	-	-
5. Bill business	1.95	1.31	0.12	0.01	0.02	0.03	0.05	0.08
6. Other Assets	8.04	6.67	3.33	5.12	13.34	4.42	4.83	6.01
7. Accumulated balance of loss	2.13	0.00	0.00	0.00	0.00	0.00	0.00	0.00

NA = Not available

P : Provisional @ : SLR Asset comprises 'approved securities' and 'unencumbered term deposits' in Scheduled Commercial Banks.

* : percentage share to total borrowings. ** : Break-up into hire purchase and equipment leasing for 2010 and 2011 not available.

Source: worked out based on the absolute figures available from the Report on Trend and Progress in Banking in India, various volumes, RBI.

Section III

Evolution of Regulatory and Supervisory Framework of NBFCs in India

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)⁹. 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

⁹ Net Owned Fund (NoF) for this purpose is as defined under Section 45-IA of the RBI Act, 1934.

should come within the purview of an agency to be set up for this purpose under the aegis of Reserve Bank of India.

Thus, 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:

- (i) Compulsory Registration of NBFCs and a minimum NOF of Rs.25 lakh as entry point norm;
- (ii) Maintenance of liquid assets by NBFCs as a percentage of their deposits in unencumbered approved securities (Government securities/guaranteed bonds);
- (iii) Creation of a reserve fund and compulsory transfer of at least 20 per cent of the net profits to aforesaid fund;
- (iv) Authorising Company Law Board (CLB) to direct a defaulting NBFC to repay deposits; and
- (v) 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) 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. The extant key regulatory and supervisory norms are presented in the Annex II.

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.

Regulatory Focus relating to Raising of Resources by NBFCs

Consequent upon the amendments to the Reserve Bank of India Act in 1997, the Reserve Bank has narrowed down its focus by confining its regulatory focus only in relation to public deposits from the originally defined broader concept of 'regulated deposits'. Hence, it needs to be underlined that the concept of 'public deposits'¹⁰, mobilised by NBFCs as on March 31, 1998 and after, is different from the earlier concept of regulated deposits. NBFCs are not permitted to accept deposits payable on demand, as these companies are not part of payment system. The accepted global practice is that only banks by virtue of being part of payment system and well regulated and supervised should be the main institutions that are permitted to seek such deposits. Therefore NBFCs are discouraged to raise public deposits; however, because of legacy of the past, still a number of NBFCs are being allowed to raise public deposit¹¹. At the same time, the public deposit taking activities of NBFCs would need to be regulated in the same manner as banks. This is the underlying principle of the regulatory regime presently being put in place in respect of NBFCs in India.

Only those NBFCs that are registered with and specifically authorized by the Reserve Bank are entitled to accept public deposits. The quantum of deposits accepted by a company is linked to its net owned funds (NoF) and credit ratings by

¹⁰ The term deposit is defined under Section 45 I (bb) of RBI Act, 1934.

¹¹ What does not constitute as public deposit is defined under paragraph 2(1)(xii) of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.

the approved rating agencies. Borrowings by way of inter-corporate deposits, issue of secured debentures/ bonds, deposits from shareholders by a private limited company and deposits from directors by both public as well as private limited companies have been excluded from the purview of public deposits.

Effective June 17, 2008, the minimum NoF of Rs. 25 lakh for a new NBFC-D to be registered with the Reserve Bank has been hiked to Rs. 200 lakh. Accordingly, a snap shot of the present provisions relating to raising of resources by NBFCs are as under:

NBFCs with a Net Owned Fund (NoF) of Rs. 200 lakh and more :	
Type of NBFCs	Ceiling on public deposits
AFC with CRAR of 15% (without credit rating)	1.5 times of NOF or Rs. 10 crore whichever less
AFC with CRAR of 12% (With investment grade credit rating)	4 times of NoF
Loan Cos/ Invest Cos with CRAR of 15% (With investment grade credit rating)	1.5 times of NoF
In case the NBFC having a NoF of Rs. 25 lakh but less than Rs. 200 lakh, the ceiling on raising Public Deposits are as under :	
AFC with CRAR of 15% (without credit rating)	Equal to NoF
AFC with CRAR of 12% (With investment grade credit rating)	1.5 times of NoF
Loan Cos/ Invest Cos with CRAR of 15 % (With investment grade credit rating)	Equal to NoF
Source: summarised based on RBI Circulars issued to NBFCs accessible at www.rbi.org.in	

On October 10, 2000, the Reserve Bank exempted money received by NBFCs by issue of commercial paper (CP) from the purview of public deposits. These apart, NBFCs are also permitted to borrow from the banking system directly by way of loans and advances. And till recently many of the categories of such loans and advances by commercial banks to NBFCs were permitted to be treated as priority sector advances. Further, NBFCs borrow indirectly, by banks subscribing to debentures and CPs issued by these companies. It needs to be underscored that presently, there are no regulatory limits prescribed for NBFCs to borrow from the banking system. However, at the banks' level, there are exposure norms with respect to NBFCs prescribed by the banking regulator.

Prudential Limit on Banks' Exposures to NBFCs

The banking sector regulator (RBI) has put in place prudential norms with respect to the exposure of banks to NBFCs (both lending and investment, including off-balance sheet exposures). Exposure of a bank to a single NBFC / NBFC-AFC should not exceed 10 per cent / 15 per cent, respectively, of the bank's capital funds as per its last audited balance sheet. Banks may, however, be permitted to exceed their exposures on a single NBFC / NBFC-AFC(asset finance company) up to 15 per cent / 20 per cent, respectively, of their capital funds provided the exposure in excess of 10 per cent / 15 per cent, respectively, is meant for funds on-lent by the NBFC / NBFC-AFC to the infrastructure sector. Further, exposure of a bank to the NBFCs-IFCs (Infrastructure Finance Companies) should not exceed 15 per cent of its capital funds as per its last audited balance sheet, with a provision to increase it to 20 per cent if the same is on account of funds on-lent by the IFCs to the infrastructure sector. Further, the regulator has advised the banks to consider fixing 'internal limits' for their aggregate exposure to all NBFCs put together. Infusion of capital funds after the published balance sheet date may also be taken into account for the purpose of computing exposure ceiling. Even registered residuary NBFCs are permitted to raise resources by way of borrowings from the banking system limited to 'one time equivalent of net owned fund (NoF)'.

Even if the NBFCs are not raising resources directly by way of public deposits, from the regulator's perspective, there is a strong rationale to regulate and supervise them in the contemporary globalised financial system. The rationale emanates principally from their systemic inter-connectedness. For, the losses, if any, in whatever the form for any set of institutions would affect the system as a whole and eventually the general public. In fact, it was with this consideration, during the recent global financial crisis, the Reserve Bank provided temporary liquidity support to even the non-deposit taking NBFCs that are systemically important through a special purpose vehicle (SPV), i.e., by way of purchasing of government guaranteed bonds.

Section IV

Analysis of NBFCs and Banks Financial Inter-Connectedness¹²

Against the above setting, an attempt is made, in this section, to analyse the extent that NBFCs (both deposit taking and non-deposit taking systemically important) and the banking system are financially inter-linked. The financial institutions have become increasingly and intricately inter-connected among each other world over. From the financial stability point of view, the inter-connectedness would also mean that anything happening in a particular segment of the financial system will have its consequence over the entire financial system. Kroszner *et al*, (2010) pointed out that many layers of intermediation create chains of inter-linkages that can make the entire system more vulnerable to shocks in any one market or at any single institution.

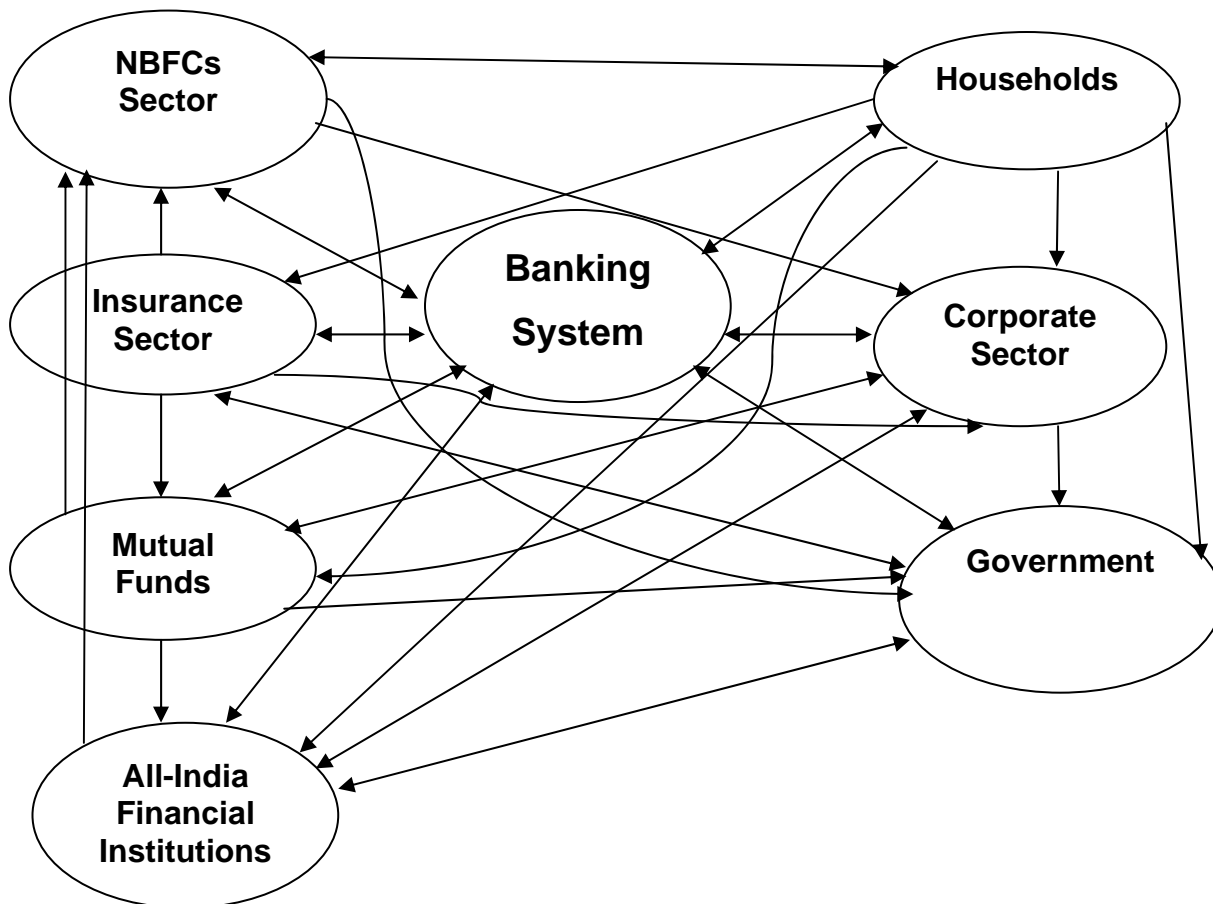
The inter-connectedness can be explained in two forms i.e., organizational (structural) and financial. The former refers to a situation where NBFCs are either subsidiaries of the banks or the holding companies with banks and other type of financial institutions as their subsidiaries. In India as of now, barring HDFC Bank, being a subsidiary of an NBFC (Housing Development Finance Company Ltd), there seems no other bank a subsidiary of an NBFC, whereas the reverse is common. In fact, there has been increasing interest in the recent past in setting up NBFCs in general by banks (RBI, 2006). Some of the NBFCs are subsidiaries/ associates/ joint ventures of banks – including foreign banks, which may or may not have a physical operational presence in the country. For instance, all major banks and financial Institutions both in private and public sector (domestic and foreign) have some form of subsidiary or an NBFC. Even this type of inter-connected NBFCs are less in number when compared with NBFCs that are standalone entities, or mostly owned by the industrial houses. However, practically all major banks in India have subsidiaries which undertake some or the other form of financial services activities such as mutual funds, merchant banking, insurance business, venture capital etc¹³. Although this kind of organizational interconnectedness is worthwhile to explore in a

¹² This section also includes a small paragraph on mutual funds' exposures to NBFCs.

¹³ These subsidiaries are regulated by different regulatory bodies such as Securities Exchange Board of India, Insurance Regulatory and Development Authority and the RBI depending upon their principal areas of business.

more comprehensive manner, due to paucity of relevant data, this study is delimited to only the financial inter-connectedness between banking system and the NBFCs (Exhibit II).

Exhibit II: Financial Inter-connectedness of Indian Financial System



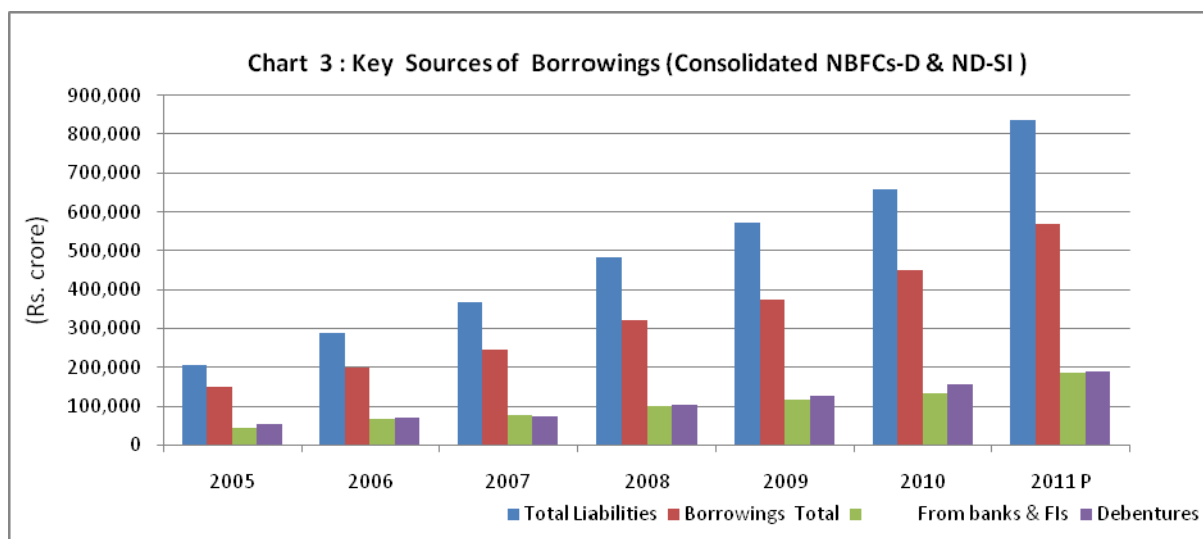
Banks' Exposure to NBFCs

In the context of the recent global crisis, it was observed that undue reliance on borrowed funds can be a source of risk and a more stable retail base of deposits are good for both the bottom line and resilience of the financial institutions. In that context, analysis of liabilities side of the balance sheets of NBFCs¹⁴ revealed that the major sources of finance are public deposits, debentures, borrowings, commercial papers and inter-corporate loans. Liabilities of the consolidated balance sheets of NBFCs revealed that borrowings constitute the largest size of liabilities,

¹⁴ NBFC-NDs do not raise public deposits.

even for the deposit taking NBFCs; corresponding to this, the size of public deposits are very miniscule as pointed out earlier.

The consolidated balance sheets of NBFCs (both the categories i.e., deposit taking and non-deposit taking and systemically important companies) revealed that more than 68 per cent of the consolidated balance sheet constitutes borrowings. Out of which, 30 per cent resources are borrowed from banks and financial institutions as at the end of March 2011. These borrowings are in the forms of direct advances and loans (both secured and unsecured). These apart, borrowings by way of debentures issued by the NBFCs constituted around 33 per cent and of which a sizable portion is subscribed by the banking system. Both of these are on the rise over a period (Chart 3).



Banks Exposure to Deposit taking NBFCs-D

For the deposit taking NBFCs, it is significant to note that, the proportion of public deposits outstanding is reduced to just around 3.8 per cent of their total liabilities as at the end of March 2011 from 20.9 per cent as at the end-March 2001. With tightening of the prudential regulatory norms in respect of deposit taking companies, NBFCs' zest to raise public deposits seems to be fading, and the public deposit is increasingly being substituted with their reliance on other forms of sources, viz., mainly borrowings. A closer analysis of the sources of funds revealed that their total borrowings as at the end of March 2009 constituted as much as 72.5 per cent of their total liabilities (which increased from 31.8 per cent as at the end of March

2001), which came down to 66.2 per cent by end-March 2011. Understandably, borrowings are mainly from within the financial system, viz., banks and financial institutions (nearly half of the total borrowings), which besides showing the close financial inter-connectedness within the financial system, also underscores higher systemic risks of the financial system in certain extreme circumstances (Table 3 and Chart 4).

Table 3 : Key Liabilities of Deposit taking NBFCs@ (end-March)											
	(per cent to total)										
Liabilities	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011p
Paid up Capital	4.18	5.46	7.58	7.11	6.22	4.83	4.67	4.38	4.95	4.13	3.46
Reserves & Surplus	11.79	10.48	12.58	13.48	11.39	14.87	12.07	11.66	12.20	12.93	12.81
Public Deposit	20.90	15.06	13.35	13.18	10.77	6.47	4.28	2.74	2.56	3.00	3.90
Borrowings	31.85	45.23	58.54	63.66	64.01	65.94	66.84	67.83	72.47	68.00	66.22
Other Liabilities	31.27	23.76	1.56	2.58	7.07	7.90	12.14	13.39	7.82	11.92	13.70
Total Liabilities (Rs.crore)	25,604	29,895	26,355	32,754	36,003	37,828	48,554	74,562	77,128	94,212	1,05,431

P: Provisional @: Excluding Residuary Non-Banking Financial Companies (RNBCs)

Source: Author's calculation based on Data from Report on Trend and Progress of Banking in India, various volumes, RBI

It is clear that the banking system is the major source of funding for NBFCs, both directly and indirectly, though banks have been prescribed with prudential ceiling on their exposures to the NBFCs. Till recently, banks had the incentive for lending to NBFCs as such loans were permitted to be classified as 'priority sector' lending by the banks¹⁵. Incidentally, NBFCs are the major issuers in CPs segment which was as high as 62 per cent of the market size of Rs. 44,171 crore at end-March 2009 this share, however, came down to around 48 per cent in a market size of Rs. 1,23,400 crore by end-June 2011¹⁶.

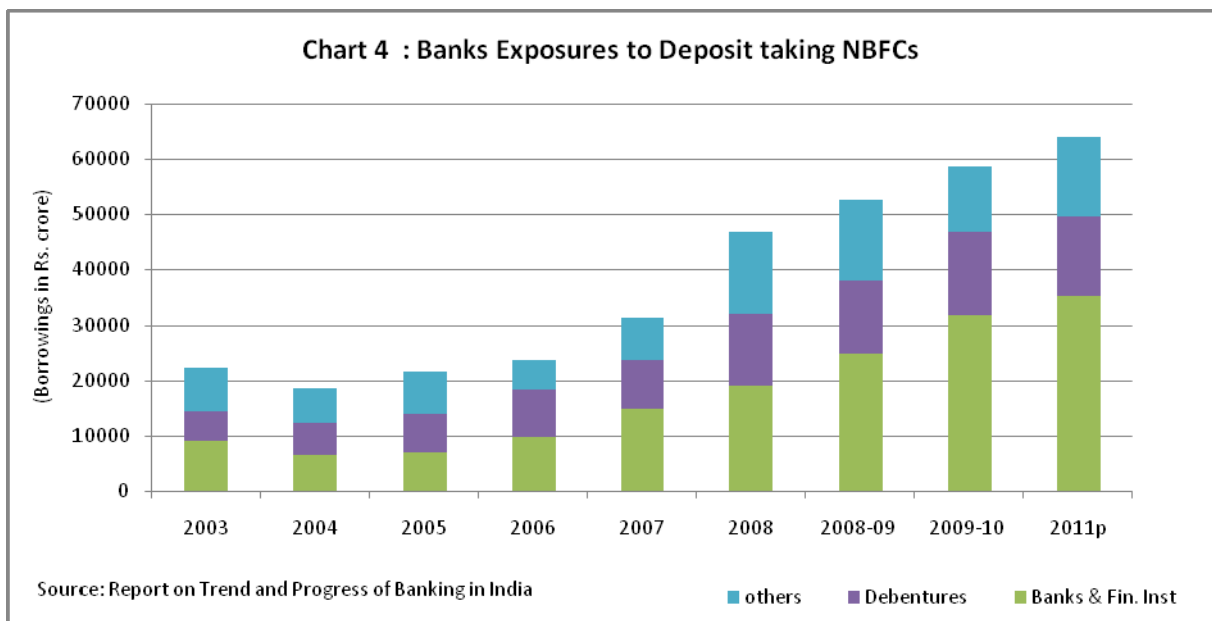
This kind of high dependability of NBFCs on the banking system would mean systemic vulnerability in the context that NBFCs are involved in higher risk activities vis-à-vis the banking system. For instance, NBFCs do not have any exposure limit on their capital market related activities unlike the banking system. Moreover compared with regulation of banking sector, NBFCs in general, are less stringently regulated as pointed out by various Committees and Working Groups. However, it

¹⁵ Recently, the regulator had clarified that bank loans to NBFCs, other than to such MFIs which fulfilled certain recently introduced eligibility conditions, would not be eligible to be classified as priority sector loans.

¹⁶ Relates to the outstanding position by mid-June 2011.

needs to be underlined that there has been substantial progress over the period towards bringing the regulatory norms relating to NBFCs on par with the banking system. Nevertheless, it needs to be underlined that, the protective cover available for the depositors of banks through the Deposit Insurance and Credit Guarantee Corporation (DICGC) are also absent for the depositors of NBFCs-D.

The seriousness of high financial interconnectedness/ interdependencies was also highlighted by the Financial Stability Report of RBI (2010). The report stated that immediately after the Lehman Brothers collapse, NBFCs faced with the pressure of withdrawal from the mutual funds which subscribed to the short term NBFC debt were unable to either rollover or extend further credit and this created a liquidity crisis. This type of situation would have thrown the system out of gear had not the Reserve Bank of India, being the lender of last resort, and the Government taken appropriate liquidity support measures.



The higher borrowings of NBFCs, especially from the banking system raise some concerns about their liquidity position. More so, if such reliance happens to increase further. Incidentally, as can be seen from the Chart 4, the banking system's exposure to NBFCs-D has considerably increased over the years. These concerns will be further accentuated in case the banks' own liquidity position becomes tight at the time of crisis or even at crisis like situation.

Analysing the sectoral deployment of credit by the banking system also revealed the fact that their lending to NBFCs have been on the consistent increase from 2007 to 2011 from around 2.75 per cent in May 2007 to 4.80 per cent by March 2011 confirming NBFCs' reliance on the banking system for their major chunk of funds. Though this percentage is apparently smaller, any failure or crisis at few NBFCs can still have its implications.

Incidentally, it may be worth being pointed out that the mutual funds also have a sizable exposures to NBFCs by subscribing to instruments, viz., debentures, CPs and securitised debts issued by the NBFCs. Accordingly, at the end of October 2010 mutual funds exposure accounted around 16.6 per cent of the total exposures to debt related instruments and it came down to 11.8 per cent by end-March 2011.

Non-Deposit taking Systemically Important NBFCs (NBFCs-ND-SI)

In India, as pointed out earlier, among the non-deposit taking NBFCs, the large NBFCs with Rs. 100 crore and above assets size¹⁷ have been classified as systemically important financial institutions (NBFC-ND-SI). As these NBFCs are not raising resources by way of public deposits, they are regulated with fewer rigors compared with NBFCs-D. Even this type of reclassification of NBFC-ND-SI came into existence since mid-2006 although, the Reserve Bank has initiated measures effective 2000 to reduce the scope of 'regulatory arbitrage' between banks, NBFCs-D and NBFCs-ND (RBI, 2008) recognising their importance, essentially from the systemic stability point of view.

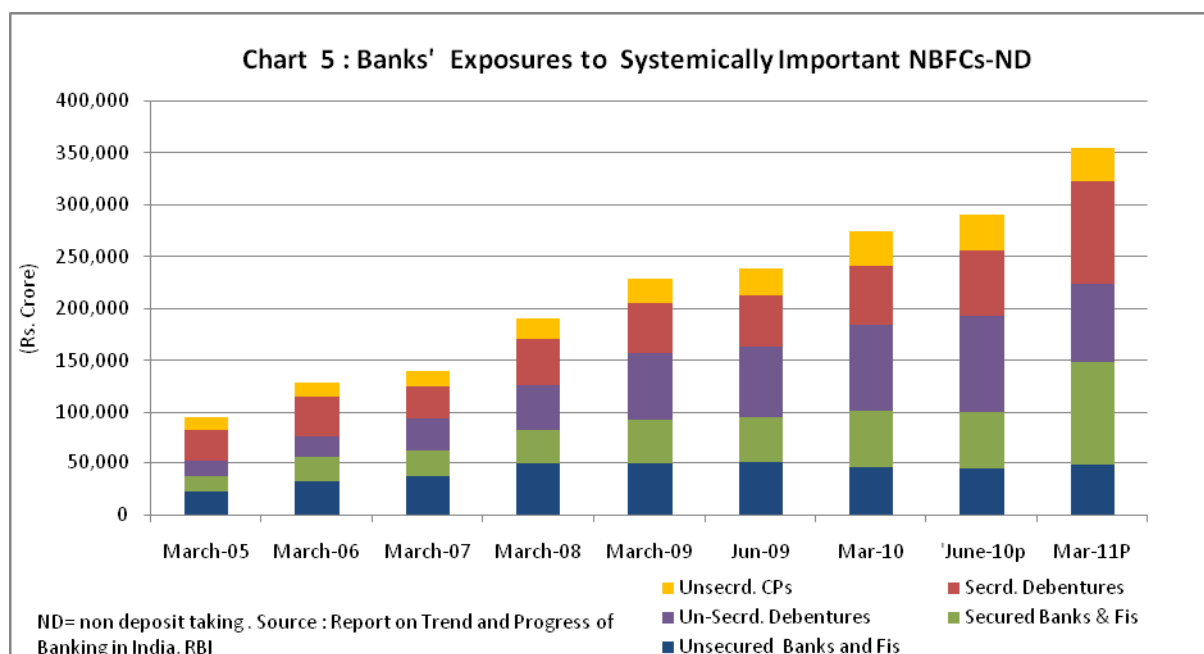
With the recent happening of global financial crisis and aftermath, the regulators' attention world over has received increased attention towards the systemically important financial institutions (SIFIs). Even in the case of India, the extant prudential regulation of NBFCs-ND-SI are endeavoured to bring convergence with that of the deposit taking NBFCs. Accordingly, it is advisable to introduce the return relating to balance sheets on a monthly basis and a more detailed returns encompassing the whole operations of the companies on completion of their annual accounts, as against the quarterly, half yearly annual returns to be filed by the deposit taking NBFCs.

¹⁷ Till September 2005 these NBFCs were classified with an asset size of Rs.500 crore and above.

It is also worth being pointed out that there are also NBFCs-ND with assets size of less than Rs. 100 crore which are further classified into NBFCs-ND with asset size of Rs 50 crore and above but less than Rs. 100 crore, in respect of which monitoring is done only with respect to their assets size. The other smaller NBFCs are outside the purview of the Reserve Bank's regulatory and supervisory ambit.

It is intriguing to note that the total size of the balance sheet of NBFCs-ND-SI reached to Rs. 7,30,366 crore as at the end of March 2011, from Rs.1,70,957 crore as at the end of March 2005 growing more than four fold. It is even more interesting to note that the NBFCs-D which is a better regulated segment *vis-à-vis* NBFC-ND-SI makes up to just around 14 per cent of the latter. In other words, the systemically important non-deposit taking NBFCs have grown faster by nearly 7 fold as at the end of March 2011 when compared with the size of deposit taking NBFCs. As NBFC-ND-SI companies are not permitted to raise public deposits, borrowings constitute the major component of their liabilities at around 74 per cent by end of March 2005. This proportion got mellowed down to around 65 per cent by end-March 2009 reflecting subtle effect of the global crisis and the aftermath, as there was no direct impact on the Indian financial system. However, this proportion gone up to 69 per cent by end of March 2011. From the point of view of systemic interconnectedness, it is important to examine the proportion of loans and advances from the banks and financial institutions to total borrowings, accordingly it constituted 25 per cent of the total borrowings (both secured and unsecured) of NBFCs-ND-SI by end-June 2010 (Chart 5) which increased to 30 per cent by end-March 2011. These are direct borrowings in the form of loans and advances from the banks and FIs. Besides, indirectly, even assuming that major portion of the debentures, securitised debts and CPs issued by NBFCs are subscribed by the banking system, this portion alone forms another 30 to 35 per cent of the total borrowings. Thus in any case, the large chunks of resources are coming from the banking system to NBFCs. The argument therefore, is to put more checks and balances on the banking system's exposures to NBFCs. To be precise, this is aimed to avoid any serious systemic consequences if either side of the institutions show some symptoms of trouble. To put more specific question; is there a corrective mechanism before it builds up a system level crisis. If there are any trouble among the NBFCs-ND-SI, there is a possibility to spill over to the banking system and also the mutual funds and thereby to the rest of the financial system, especially as the banks are largely based with the short term deposits, while

the NBFCs, in general, are known for the medium to long term financing and high risk taking activities. *Ceteris Paribus*, it has the implications for mis-matches in the assets-liabilities of NBFCs, though this is subject to more detailed analysis of the maturity pattern of the assets and liabilities buckets¹⁸. Further, it may be cited that ‘...it is possible for an NBFC to conduct some other non financial activity by deploying funds in non-financial assets...’ (RBI, 2011). Similar views have also been expressed by the Report of the recent Working Group on Issues and Concerns in the NBFCs Sector (Chairperson: Usha Thorat, 2011). Therefore, it calls for introspection for the regulators whether it is sufficient to fix a ceiling from the banks’ level. As a long term remedy, efforts need to be in the development of private bond market as that would serve better for diversifying the sources of funds for NBFCs.



It needs to be underlined that higher dependency of NBFCs on the banking system for their resources will not only strain banks at the time of crisis but also place NBFCs themselves into vulnerable situation. For, there are possibilities that banks can become over sensitive to a liquidity crisis or imminent crisis and they can either become too reluctant to lend to NBFCs or at the extreme case, they may completely refrain from lending to NBFCs which would further precipitate the situation, especially when NBFCs are in dire need of funds. The recent global crisis is a pointer in this direction. Further, this type of situation would compel NBFCs to

¹⁸ The detailed analysis of ALM statement is beyond the scope of this study due to paucity of disaggregated data.

turn to money market with higher costs to wade over the tight liquidity conditions impacting the money market as well. It may also be pointed out that a significant portion of their funds are also being funded by the mutual funds (RBI, 2010A). Even here similar situations are possible: NBFCs were stressed as bank loans to them had dried up and interest rates had increased in money markets, leading to higher costs of borrowing (RBI, 2010).

It may be pointed out that NBFCs are also having exposures to banking system as they keep their funds in the form of fixed deposits, *albeit* it constitutes relatively a smaller proportion of say 11 to 12 per cent of their total assets.

Even if NBFCs are not deposit taking and therefore, the question of repayment commitment of the depositors' money does not arise, any failure of even such institutions will result in the losses that will ultimately have a cascading effect on the entire system, therefore all the institutions should come under closer scrutiny. The underlying principle to regulate these NBFCs are 'to regulate similar risks in a similar manner' irrespective of whether they take public deposits or otherwise.

Presently, the definition of 'systemically important' is based only on the size of assets of NBFCs and this seems to be inadequate and highly simplistic. The size of liabilities/assets alone is not a sufficient condition for the systemic importance. This requires refinement by taking into account the intricate inter-connectedness (both organically and financially) with the rest of the institutions within the financial system and also abroad, since intricate connectedness increases the systemic risk. For instance, a recent report from Financial Stability Board pointed out that besides the size, the degree of inter-connectedness, the degree of substitutability of the activities undertaken by the institution are to be taken into account to benchmark an institution as 'systemically important'. The types of business activity as well as the complexity of the activity of the institutions are also necessary for redefining the 'systemic importance'.

Thomson (2009) suggested for regulatory attention to deal with the four 'C's (Contagion, Concentration, Correlation and Context or Condition) to identify the institutions which are systemically important. According to him, 'contagion' refers to failure of institution which has the potential of transmitting to other institutions/ market. 'Concentration' refers to the size and substitutability aspects of a particular institution in the system. 'Correlation' refers to (i) institution take on risks that are highly correlated with other institutions and (ii) potential for largely uncorrelated risk

exposures to become highly correlated in periods of financial stress. It is also known as the 'too many to fail' problem. Condition/ context, of course, refer to the judgment of a particular context or situation in which an institution becomes systemically important. It also refers to the probability that economic or financial conditions if materialise that produce the state of nature where a firm becomes systemically important.

Although banks and NBFCs compete for similar kinds of business on the assets side, NBFCs distinguish themselves by offering wide range of products/ services such as leasing and hire-purchase, financing of used commercial vehicles, corporate loans, investment in non-convertible debentures, IPO funding, margin funding, small ticket loans, venture capital, equity and debt investments, etc. In most of these areas either banks are reluctant to finance or finance to a very limited extent. Since the regulatory and cost-incentive structures are not identical for banks and NBFCs and that NBFCs borrow funds from banks to on-lend, it is necessary to establish adequate checks and balances to ensure that the banks' depositors are not indirectly exposed to the risks of a different cost-incentive structure. Moreover, as NBFCs are well known to venture into the areas not permitted for the banks and in such cases, large scale exposures to NBFCs tantamount to banks entering into those areas in an indirect route.

There was a substantial change in the risk perception in 1990s, world over, about the non-banking financial activities. This was one of the strong reasons for the passage of Graham Leach Bliley (GLB) Act in the US which till then separated the traditional banking from the modern day financial activities under the erstwhile Glass Steagall Act. With the passage of GLB Act, banks were permitted to pursue financial activities in the form of universal banking framework. Accordingly, the non-banking financial activities also amplified multi-fold in the US during the post GLB Act. However, the global financial crisis has proved the fact that greater risks to banks particularly came in newer forms of non-banking activities such as sponsoring of securitisation SPVs and private pools of capitals (RBI, 2011). In that context, the banking sector will be affected with growing interconnectedness with non-banking business, in case NBFCs continued to have less than par regulation and supervision with that of banks. This is not to advocate that NBFCs borrowings from banks *per se* will result in crisis, it is only intended to caution that excess dependency on banking sector will only exasperate if a crisis like situation arises.

In view of the above, the work is also underway on structural methodologies to identify systemic importance at the IMF, the BIS and the national central banks and academia based on inputs capturing size, probabilities of failure, similarities in exposures and interconnectedness (FSB, 2011).

Experiences of Select Countries: Banks Exposures to NBFCs

It is significant to note that the practice of NBFCs borrowing from banking system is not un-common in many countries. A survey of select countries experience revealed that the NBFCs in general are relying on the banking system for their source of funds to a great extent. In Bangladesh, for instance, NBFCs collect funds from a wide range of sources including borrowings from banks, financial institutions, insurance companies and international agencies as well as deposits from other institutions and the public. Incidentally, line of credit from banks constitutes the major portion of total funds for NBFCs in that country. Deposit from public is another important source of fund for NBFIs, which is stated to be increasing over the years. NBFIs are allowed to take deposits directly from the public as well as institutions. Just as the case of India, there are regulatory restrictions for the NBFIs to collect public deposits with less than one year.

In Bangladesh, a study by Ahmed *et al.* (2007) pointed out that there is evident that loan from bank and deposit base are the key sources for NBFIs' fund and account for nearly 75 per cent of the total. At the same time over the period bank loans as the main source of funds is decreasing, while the importance deposit base is gaining momentum. NBFIs have to offer higher rates on deposits due to competition from banks to attract deposits and such high cost of fund for NBFIs compel them to operate on a relatively low profit margin.

Similarly it was observed from the analysis that in several other countries such as Indonesia, Thailand etc. similar kind of interconnectivity between banks and NBFCs were found with higher exposures to NBFCs.

Section V: Conclusion and Policy Implications

It is thus clear from the analysis that NBFCs are highly reliant on the banking system for their large chunk of funds. As a policy when the NBFCs are discouraged from raising public deposits, these companies are becoming non-deposit taking, while increasingly substituting public deposits with borrowings from the banking system. Some NBFCs, being deposit taking companies, rely heavily on borrowings from banks. Thus there seems to be strong growing systemic inter-connectedness between banks and NBFCs with high dependency of the latter on the former. This has even more systemic concerns than NBFCs directly raising resources by way of public deposits. NBFCs' high dependency on the banks for their funding means short term funding of longer term assets of NBFCs.

There is a possibility that chains of inter-connectedness can make the system more vulnerable to shocks in any one market or at any single larger institution. This kind of high dependency of NBFCs on banking system would mean systemic vulnerability in the context that NBFCs are involved in higher risk activities vis-à-vis the banking system. In other words, banks are indirectly exposed to a different cost incentive structure. Even the slightest symptoms of crisis or crisis like situations, NBFCs can face pressure of withdrawal from the banks similar to the one encountered from mutual funds immediately after the Lehman Brothers episode. The banking system's exposure to NBFCs has considerably increased over the years and the concerns will be further accentuated in case the banks face tight liquidity conditions. If there are any troubles in the NBFCs segment, it can spill over to the banking system and the financial system, especially as they have high exposures to capital market and high risk business. The spill over can also be possible from the banking system and NBFCs could be placed in a vulnerable situation when banks become over sensitive to a liquidity crisis or imminent crisis like situation. Banks may either become too reluctant to lend to NBFCs or at the extreme case, they may completely refrain from lending to NBFCs which would further precipitate the situation. Any strain in the normal chain would compel NBFCs to turn to money market with higher costs to wade over the tight liquidity conditions disturbing the money market as well. As NBFCs lend medium to long term when compared with the

banks, while borrowing short from the banking system, there is possibility of asset-liability mismatch.

Policy Implications

As the assets of NBFCs are expanding considerably, there is a clear need for the services of both deposit taking and non-deposit taking NBFCs in India. There is even more strong case when the economy is on the fast growth track requiring strong support of the well developed and diversified financial system. Therefore, the correct policy choices should include promoting an appropriate degree of diversity in channels for financing, along with a balanced set of incentives for complementary development of banking and NBFCs and markets in promoting economic growth. Given a regulated approach rather than restrictive policy approach, NBFCs will be able to play a more positive role for the promotion of economic activities that are not served by the banking system. Further, NBFCs may be encouraged with proactive policy measures to create a healthy competition for the banking system, while also provide wider choice to investors for savings.

NBFCs should give serious thought to broad base the sources of funding by raising resources through the issue of bonds/ debentures. This requires a strong policy stimulus for the development of corporate bond /debentures market. Such development would provide an alternate avenue for the savers and also compete directly with the banking system to promote efficiency. NBFCs' future growth depends to a large extent on the success they achieve in diversification of sources of funds. When it comes to the prudential regulation of banks' exposures to NBFCs, there is no distinction between NBFC-D and NBFC-ND and all are permitted to borrow from the banking system equally. It is possible that those companies which are non-deposit taking with less than Rs. 100 crore assets would indulge in even higher risk activities as they are 'not regulated'. Hence, there seems to be a scope to fix separate ceiling for NBFC-ND companies to borrow from the banking system. In the fast changing scenario, supervisory efforts require a shift in balance from a focus on the 'traditional system oriented mainly to compliance' to 'risk prevention' measures. Perhaps the policy can encourage more consolidation among the NBFCs and reduce the total number of registered companies from existing 12400 companies to a smaller number of strong companies by weeding out the unviable and weaker

companies. This would ensure the feasibility of bringing the entire NBFCs segment under the regulatory framework on par with banking system. Going forward, there is a requirement for redefinition of 'systematically important NBFCs-ND' as against the present definition based only on the size of assets. In line with the Basel Committee on Banking Supervisors (BCBS)'s recommendations, besides the size, it needs to take into account the degree of inter-connectedness with other financial institutions within the domestic financial system, and the degree of specialized services they provide for which there are few substitutes. In fact the definition can go a step ahead of BCBS's definition by taking into account the 'complexity of business' undertaken by them. Progressive movement towards Basel norms is expected to help mitigate the systemic risks as there are relevant provisions in Basel III to address systemic risks and inter-connectedness among systemically important institutions by mitigating the risks arising from firm-level exposures. Higher liquidity requirements against the excessive reliance on wholesale short-term funding and higher capital requirements for inter-financial sector and intra-financial sector exposures are some of the key prudential requirements need consideration. Prudential norms relating to NBFCs' exposures to capital markets also need a relook. Last but not least, presently the system-wide inter-institutional exposure related data is not available at a single point. This is essential, particularly for the regulators to take a wholesome view.

Annex I

Types of NBFCs and their Principal Business	
Companies	Principal Business
Non-Banking Financial Company	In terms of the Section 45-I(f) of the RBI Act, 1934 as amended in 1997, their principal business is that of a financial institution as defined in Section 45 I(c) or that of receiving deposits under any scheme or lending in any manner.
Equipment leasing company (EL)	Equipment leasing or financing of such activity.
Hire purchase finance company (HP)	Hire purchase transaction or financing of such transactions.
Investment company (IC)	Acquisition of securities and trading in such securities to earn a profit.
Loan company (LC)	Providing finance by making loans or advances, or otherwise for any activity other than its own; excludes EL/HP/HFCs.
Mutual benefit financial company (MBFC) i.e. <i>Nidhi Company</i>	Means any company which is notified by the Central Government under Section 620A of the Companies Act 1956 (1 of 1956).
Miscellaneous non-banking company (MNBC) i.e. <i>Chit Fund Company</i>	Managing, conducting or supervising as a promoter, foreman or agent of any transaction or arrangement by which the company enters into an agreement with a specified number of subscribers that every one of them shall subscribe a certain sum in instalments over a definite period and that every one of such subscribers shall in turn, as determined by lot or by auction or by tender or in such manner as may be provided for in the agreement, be entitled to the prize amount.
Residuary non-banking company (RNBC)	Company which receives deposits under any scheme or arrangement, by whatever name called, in one lump-sum or in instalments by way of contributions or subscriptions or by sale of units or certificates or other instruments, or in any manner. These companies are NBFCs but do not belong to any of the categories as stated above.
Non-banking non-financial company (NBNFC)	Means an industrial concern as defined in the Industrial Development Bank of India Act, 1964, or a company whose principal activity is agricultural operations or trading in goods and services or construction/sale of real estate and which is not classified as financial or miscellaneous or residuary non-banking company.
Housing finance company (HFC)	The financing of the acquisition or construction of houses including the acquisition or development of plots of land. These companies are supervised by the National Housing Bank.

Asset Finance Company (AFC)	This is a new classification of company brought out by combining the Equipment Leasing company and Hire Purchase company. Companies which finance the purchase of physical assets are grouped under this category.
Core Investment Company (CIC)	A CIC is a NBFC carrying on the business of acquisition of shares and securities. And it holds not less than 90% of its net assets in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies and subject to other conditions prescribed by RBI under the RBI Act.

The Extant Key Regulatory Norms relating to NBFCs

In respect of 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. It was made clear that 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.

NBFCs accepting public deposits are required to comply with all the directions on acceptance of public deposits, prudential norms and liquid assets, and should submit periodic returns to the Reserve Bank. In fact, the Reserve Bank progressively implemented nearly all key prudential norms, such as exposure norms, income recognition, prudential asset classification and provisioning, corporate governance, investment norms, etc. While NBFCs which are not holding or accepting public deposits are also regulated and supervised in a limited manner. They are required to comply with prudential norms relating to income recognition, accounting standards, asset classification and provisioning against bad and doubtful debts. Market intelligence and auditors' exception reports constitute the core supervisory tools in respect of these companies. The deposit taking companies are subject to file returns with different frequencies, while the NBFC-ND-SI, since 2006 are also required to submit monthly returns on some key parameters and more detailed returns at the close of annual accounts. Both NBFC-D and NBFC-ND-SI are subject to on-site inspection (based on CAMELS) and off-site surveillance with different intensity.

Liquidity Reserves of NBFCs

To improve the liquidity of NBFCs, the percentage of liquid assets required to be maintained by them has been enhanced to 12.5 per cent and further to 15 per cent with effect from April 1, 1998, and April 1, 1999, respectively. With a view to ensuring that NBFCs can have recourse to such liquid assets in times of emergency,

the custody of these assets with designated commercial banks has also been prescribed. The liquid assets requirement has been enhanced to 25 per cent. Further, effective October 1, 2002, government securities are to be necessarily held by NBFCs in a demat form. These securities can be disposed only for the purpose of repayment of depositors.

Creation of Reserve Fund

Every NBFC is required to create a reserve fund and credit 20 per cent of its net profits to that fund before declaration of dividend every year. No appropriation is permitted from the fund without prior permission of the Reserve Bank.

Capital Adequacy

The prudential norms relating to capital adequacy has been enhanced from 8 per cent to 10 per cent effective April 1, 1998, and further to 12 per cent with effect from April 1, 1999. Presently all NBFCs-D has been prescribed with 15 per cent CRAR. Similarly, NBFCs-ND-SI that are required to maintain an enhanced CRAR of 12 per cent effective March 2010, has been further enhanced to 15 per cent effective March 2011.

Miscellaneous Aspects of Regulation and Supervision

NBFCs have also been directed to constitute Audit Committees, consisting of not less than three members of their Boards of Directors, if they have assets of more than Rs.50 crore, as per the last audited balance sheet. NBFCs would be required to follow a uniform accounting year of March 31 every year with effect from the accounting year ending March 31, 2001.

The Reserve Bank announced ALM guidelines for NBFCs for effective risk management. All NBFCs with asset size of Rs.100 crore or above or with public deposits of Rs. 20 crore or above, as per their balance sheet as on March 31, 2001, were instructed to have ALM systems in place.

NBFCs registered with Reserve Bank of India have been permitted to take up insurance agency business on fee basis and without risk participation, without the approval of Reserve Bank of India subject to the certain conditions; NBFCs which satisfy the eligibility criteria are permitted to set up a joint venture company for undertaking insurance business with risk participation, subject to safeguards. The maximum equity contribution such an NBFC can hold in a joint venture (JV) company is 50 per cent of the paid-up capital of the insurance company. A

subsidiary or company in the same group of an NBFC or of another NBFC engaged in the business of a non-banking financial institution or banking business shall not be allowed to join the insurance company on risk participation basis. In case more than one company in the same group of the NBFC wishes to take a stake in the insurance company, the contribution by all companies in the same group shall be restricted to the limit of 50 per cent prescribed for the NBFC in an insurance JV.

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