

1. INTRODUCTION

Non-Banking Financial Companies (NBFC) is a constituent of the institutional structure of the organized financial system in India. The financial intermediaries in the financial system can broadly be said to comprise of Banks, financial institutions and NBFCs. NBFCs are competitive and complimentary to banks and financial institutions. NBFCs have flourished and have become prominent in a wide range of financing activities. NBFCs play an important and crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector.

NBFCs initially catered to the needs of individual and small savings investors and later developed into financial institutions, providing services similar to those of banks. NBFCs had many tailor made services for their clients with lesser degree of regulation. They offered high rate of interest to their investors and attracted many small size investors.

1.1. WHAT IS AN NBFC?

Legally, a NBFC is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares, securities, leasing, hire-purchase, insurance business and chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

1.2. HISTORICAL BACKGROUND

While NBFCs as an industry has been there for several decades in the Indian financial system, from time to time, with the growth in the number and size of NBFCs, various committees were formed in India to review the existing framework and address the shortcomings in the overall NBFC structure, operations and the degree and depth of the regulations evolved over a period of years to what it is today.

Some of the key committees that played a role in shaping the NBFC regulatory system and the key areas they influenced may be listed as follows:

i. James Raj Committee (1974)

The Committee after extensive research and analysis had suggested

for a ban on Prize chit and other schemes which were causing a great loss to the economy. Based on these suggestions, the Prize Chits and Money Circulation Schemes (Banning) Act, 1978 was enacted.

ii. Chakravarthy Committee (1984)

This Committee made several recommendations for the development of money market.

iii. Vaghul Committee (1987)

As a follow-up to the Chakravarty committee, this committee submitted its Report in 1987 containing number of measures to widen and deepen the money market.

iv. Narasimhan Committee (1991)

This committee was formed to examine all aspects relating to the structure, organization & functioning of the financial system.

v. Dr.A.C.Shah Committee (1992)

This committee made wide ranging recommendations covering, inter-alia entry point norms, compulsory registration of large sized NBFCs, prescription of prudential norms for NBFCs on the lines of banks, stipulation of credit rating for acceptance of public deposits and more statutory powers to Reserve Bank for better regulation of NBFCs.

vi. Khanna Committee (1995)

This Group was set up with the objective of designing a comprehensive and effective supervisory framework for the non-banking companies segment of the financial system.

vii. Vasudev Committee (1998)

This committee emphasised the need for strengthening of the NBFC sector including entry norms and prudential norms and dealt with framework for acceptance of public deposits, issues concerning unincorporated financial intermediaries and addresses issues of supervision of NBFCs.

viii. Usha Thorat Committee (2010-12)

In September 2010, a working group was constituted by the central

bank headed by its former deputy governor, Usha Thorat to close the regulatory gap between banks and NBFCs and to strengthen governance, disclosure and supervision to ensure that the proposed new rules cause minimum damage to NBFCs. RBI released the new draft guidelines for NBFCs based on the Usha Thorat Committee report recommendations on December 12, 2012.

ix. KUB Rao Committee (2012-2013)

The large rise in the gold loan business, rapid expansion of branch network of gold loan NBFCs in a short span of time, quantum jump in bank borrowings by NBFCs raised certain regulatory concerns. Considering this, RBI constituted a working group to study the issues related to gold and gold loan NBFCs in India in April 2012. The working group submitted its draft report to RBI with its recommendations and RBI released the final report on issues related to gold loan and loan NBFCs in India during 2013.

x. Nachiket Mor Committee (2013-2014)

RBI had set up a committee on comprehensive financial services for small businesses and low-income households under the chairmanship of Dr Nachiket Mor. The Committee advocated convergence of certain regulatory aspects between banks and NBFCs based on the principle of neutrality in lines of the Usha Thorat Committee recommendations

1.3. INTERNATIONAL PRACTICES

We observe that in most countries, like in our country the financial system extends beyond traditional banking institutions to include Non-Banking Financial Intermediaries like insurance companies, mutual funds, market makers and other financial service providers. There has been tremendous growth worldwide in the mobilization of financial resources outside traditional banking systems. Channeled mainly through capital markets, such rapid financial diversification also posed new challenges for regulators in many emerging markets.

NBFC as an industry and structure is prevalent in most countries albeit in different forms and different definitions in different countries.

a) United Kingdom

A UK Financial Institution (FI) could be categorized as: 1) non-reporting FI which includes UK Government organizations, Bank of England and

a FI with a "local client base" like credit unions, mutual societies, venture capital companies and 2) reporting FI means any FI that is not a non-reporting FI. A non-reporting FI should not generally need to carry out any due diligence or reporting obligations while the reporting FI will be responsible for ensuring that their relevant due diligence and reporting requirements are satisfied.

Financial Conduct Authority (FCA) regulates the financial services industry in the UK. Their aim is to protect consumers, ensure the industry remains stable, regulates financial firms providing services to consumers and maintains the integrity of the UK's financial markets. Prudential Regulation Authority (PRA), a financial services regulatory body is responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms. It sets standards and supervises financial institutions at the level of the individual firm.

b) Australia

Financial regulation is split mainly between twin regulators: 1. Australian Securities and Investments Commission (ASIC) and 2. Australian Prudential Regulation Authority (APRA). ASIC has the responsibility for market integrity and consumer protection and the regulation of investment banks and finance companies. Finance companies provide loans to households and small and medium-sized businesses. Finance companies raise funds from wholesale markets and using debentures and unsecured notes, from retail investors. ASIC does not conduct prudential supervision of these institutions, but does regulate certain aspects of their operations like compliance with fund raising and securities licensing provisions.

APRA is responsible for the licensing and prudential supervision of Authorised Deposit-taking Institutions (ADIs), life and general insurance companies and superannuation funds. The Reserve Bank of Australia (RBA) retains its central banking functions including responsibility for most payment systems and setting of monetary policy. All these regulators are independent statutory authorities without direct oversight by government departments.

c) Singapore

Monetary Authority of Singapore (MAS) oversees the entire financial system. MAS is the integrated regulator and supervisor of financial

institutions in Singapore. The banking department is responsible for licensing and supervision of banks, merchant banks and finance companies while the insurance department licenses and supervise the insurance companies. A key theme of MAS is that all stakeholders have a shared responsibility to achieve a sound and progressive financial services sector.

Finance Companies focus on providing fixed and saving deposits as well as credit facilities to individuals and corporations. Finance companies are not allowed to deal in any foreign currency, gold or other precious metals or acquire foreign currency denominated stocks, shares or debt securities and are allowed to expand their scope of activities subject to MAS approval.

d) New Zealand

The Non-Bank Lending Institution (NBLI) accounts for a small proportion of total credit extended to the economy. The sector includes deposit taking institutions, such as deposit taking finance companies, building societies and credit unions, which are all regulated by Reserve Bank. Authorised deposit taking institutions licensed and supervised by Reserve Bank are required to meet minimum prudential requirements, credit rating and capital adequacy requirements. NBLI also includes non-deposit taking finance companies, which are not regulated by the Reserve Bank.

e) Malaysia

NBFIs are broadly classified into Development Financial Intermediaries, Saving Institutions, Employees Provident and Pension Funds, Insurance Companies, other financial intermediaries such as factoring companies, leasing companies, unit trusts, credit institutions and credit insurance companies. The Central Bank is the regulator.

2. DEVELOPMENTS ON RBI'S REGULATORY FRAMEWORK

The rapid growth in the business of NBFCs urged for effective regulatory action to protect the interests of investors. With the inputs from the various Committees constituted from time to time, the Reserve Bank of India (RBI) started regulating the activities of NBFCs with the objectives of ensuring that they subserve the financial system efficiently, ensuring healthy growth of the financial companies and do not jeopardise the interest of depositors.

Over the past few decades, with the growth in size of the NBFC industry supported by the key findings of the Committees, progressively the NBFCs have been brought under more regulatory surveillance and supervision in the areas of operations, governance, risk management, provisioning etc. Some of the key milestones in the journey have been the following:

- 1964 -** The Reserve Bank of India Act, 1934 was amended by the Reserve Bank Amendment Act, 1963 to include provisions relating to non-banking institutions receiving deposits and financial institutions.
- 1974 -** Central Government introduced Section 58A in the Companies Act, 1956 which empowered Central Government to regulate acceptance and renewal of deposits and to frame rules in consultation with RBI prescribing (a) the limit (b) the manner and (c) the conditions subject to which deposits may be invited or accepted / renewed by companies.
- 1975 -** The Central Government in consultation with RBI framed Companies (Acceptance of Deposits) Rules, 1975.
- 1977 -** RBI issued the Non-Banking Companies (Reserve Bank) Directions, 1977 to regulate the deposit taking activities of chit fund companies. The other provisions of the directions are similar to those pertaining to NBFCs in general. However, these companies are exempted from the requirements of compulsory registration with RBI.
- 1997 -** In January 1997, several changes were made to the RBI Act 1934 to put in place a comprehensive regulatory framework aimed at protecting the interests of depositors and regulating the functioning of NBFCs. The amended Act authorised RBI to determine policies and issue directions to NBFCs regarding income recognition, accounting standards, NPAs, capital adequacy, etc. The Act *inter-alia* provided for compulsory registration of all NBFCs into three broad categories, viz., (i)

NBFCs accepting public deposit; (ii) NBFCs not accepting/holding public deposit; and (iii) core investment companies.

- 1998 -** RBI implemented a comprehensive regulatory and supervisory framework in January 1998 to safeguard the public deposits and certain measures were taken for ensuring that the NBFCs function on sound and healthy lines. Detailed directions on prudential norms vide Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 were laid down. The directions *inter-alia*, prescribed guidelines on income recognition, asset classification and provisioning requirements applicable to NBFCs, exposure norms, constitution of audit committee, disclosures in the balance sheet, requirement of capital adequacy, restrictions on investments in land and building and unquoted shares. Further, to protect the interest of the depositors, RBI issued detailed guidelines vide Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.
- 2000 -** RBI issued guidelines for entry of NBFCs into insurance sector in June 2000. Accordingly, no NBFC registered with RBI having owned fund of Rs.2 Crores as per the last audited Balance Sheet would be permitted to undertake insurance business as agent of insurance companies on fee basis, without any risk participation.
- 2004-2005 -** RBI issued guidelines on Know Your Customer (KYC) Guidelines and Anti Money Laundering (AML) Standards. NBFCs were advised to adopt the same with suitable modifications depending on the activity undertaken by them and ensure that a proper policy framework on 'KYC' and AML measures is formulated and put in place with the approval of the Board.
- 2005-2008 -** RBI issued guidelines on Obligation of NBFCs to comply with PMLA guidelines and to adopt Fair

Practices Code to protect the interest of the customers and to regulate the credit system of the country. In 2006, in view of the systemic risk arising from access to public funds by NBFCs and their interconnectedness with the financial system, the focus of regulatory concern widened to include non-deposit taking NBFCs also. Accordingly, a regulatory framework was put in place for non-deposit taking NBFCs with an asset size of Rs.100 crores and above which were defined as systemically important NBFCs. The guidelines on corporate governance were framed with intent to adopt best practices and greater transparency in NBFCs operations and to protect the interests of the stakeholders. RBI further prescribed the reporting and monitoring system of frauds.

2010-2011 - RBI introduced a new category of NBFC, "Infrastructure Finance Companies" (IFCs) in view of the critical role played by them in providing credit to the infrastructure sector and introduced its regulatory framework. RBI issued guidelines to all Core Investment Companies (CICs) for registration with RBI and prescribed a differential regulatory treatment for such NBFCs since it was felt that companies which have their assets predominantly as investments in shares for holding stake in group companies but not for trading and also do not carry on any other financial activity. Based on the recommendations of Y.H. Malegam Committee, RBI introduced a new category of NBFC - "Micro Finance Institution" (MFI) and introduced its regulatory framework along with the guidelines on asset classification and provisioning norms that needs to be adhered by MFIs.

2011-2012 - Following concerns over the discrepancy in regulations, RBI had set up a working group under the chairmanship of Ms. Usha Thorat to review the regulatory framework for NBFCs. The draft guidelines were released by RBI in 2012 based on these recommendations to address issues and