Policy Response

September 2011

Response to the Report of the Working Group on the Issues and Concerns in the NBFC Sector[1]

1. NBFCs play a critical role in furthering the goal of financial inclusion. It is our view that in order to make access to financial services universal, while ensuring systemic stability, we need to build on the separate natural strengths of banks and NBFCs. While banks need to grow into directly regulated, very transparent, very large institutions, NBFCs must be institutions with deep local understanding that leverage technology and local talent to provide a comprehensive range of financial services and are held accountable for the financial well-being of clients. Financial inclusion requires the proliferation of such NBFCs funded directly by banks and capital markets, which also supervise the NBFCs as counterparties, so that regulatory capacity does not constrain their proliferation.

2. The report has set out to fill the regulatory arbitrage that has been prevailing between banks and NBFCs. It however excludes NBFCs engaged in microfinance activities. This also comes at a time when the draft MFI bill has been released. There are certain inconsistencies between spirit of the report's recommendations and draft bill:

   (a) The draft MFI Bill talks of the need for registered NBFCs that engage in microfinance, to register again under the envisaged Microfinance Act. Which category of NBFCs do the MFIs then come under, in order for them to register? If an NBFC-MFI needs to deregister as it does not comply with the Net owned fund (NOF) and asset requirements, will these entities be allowed to register under the envisaged Microfinance Act and continue microfinance operations?

   (b) The report mentions that there has been a decline in deposit taking by NBFCs and that RBI has stopped issuing fresh licenses to deposit-taking NBFCs. It is in this backdrop that the MFI Bill envisages collection of thrift. Does this imply that the RBI is indeed planning to allow for thrift collection by NBFC-MFIs, thereby making them strikingly similar to banks? This must not be permitted.

3. Exempting NBFCs that do not access public funds and with asset size below 1000 crore from registration is not consistent with the classification of NBFCs with assets over Rs.100 crore as systemically important. The same limit of Rs. 100 crore must be applied to NBFCs not accessing public funds as well.

4. The increase in the threshold percentage level for determining the principal business of an NBFC to 75% of assets and income is a welcome recommendation, which will ensure that a financial company will focus primarily on financial business which will in turn lead to a healthier financial system.

[1] http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/FRWS250811.pdf

5. Introducing liquidity reserve requirements for NBFCs can be seen as a positive move as it will prevent systemic risks from building up in times of liquidity freeze. Liquidity ratios have been introduced to cover liquidity gaps for the first 30 days; tolerance levels can similarly be prescribed for 90 days and 365 days to cover for markets freezing up for longer times.

6. Providing relief for NBFCs with regard to capital adequacy norms is a welcome move in view of the increased liquidity requirements. The stipulated Tier 1 capital of 12% is reasonable and will to lead to a safer financial system by providing a buffer against cyclical downturns. If increased liquidity reserve requirements to provide for longer liquidity freezes are considered for NBFCs, then the CRAR can be adjusted as appropriate.

7. Homogenising asset classification and provisioning norms for NBFCs and Banks is a welcome move which will help in reducing arbitrage. Another positive recommendation made by the Committee is that of making the tax treatment for provision of doubtful/bad debts of NBFC similar to Banks. Being subject to the same norms on provisioning and income recognition as Banks, it is only fair that NBFCs also enjoy these tax benefits.

8. Another significant recommendation which will benefit the NBFC sector is the extension of the coverage of the SARFAESI act to NBFCs as well, which will ensure quicker recovery of their non-performing assets. This will encourage NBFCs to provide access to a wider range of financial products and serve the cause of financial inclusion.

9. While prudential norms have been laid out in the report, one of the gaps in the report lies in the absence of regulation for consumer protection. The issue of consumer protection (for banks as well as non-banks) needs to be dealt in a comprehensive manner and reflected in well-considered regulation.

10. We commend the recommendations for strengthening governance, disclosure and supervision of NBFCs. These will improve transparency in the system, reduce risks and lead to a healthier financial system.