Bombay Chamber's Presentation before
Dr. D.Subbarao, Governor, Reserve Bank of India
at the
Pre-Policy Consultation Meeting on NBFC issues
October 10, 2011

Suggestions on proposed change in RBI NBFC Prudential Norms

I Background:

(1) The Reserve Bank of India is in the process to introduce new guidelines on asset classification, provisioning, lending and capital for Non Banking Finance Companies (NBFC) which will narrow the gap between NBFCs and banks, further squeeze profits and reduce possible risks to the financial system.

(2) A working group constituted by the RBI and headed by its former deputy governor Ms Usha Thorat has been formed to recommend appropriate regulatory and supervisory measures to address issue of systemic risks with the aim of creating a strong and resilient financial sector which is vital for all round economic growth of the country.

(3) The working group came out with its draft report in August 2011on the issues and concerns in the NBFC Sector along with its recommendations for improving the existing regulatory and supervisory framework in line with best practices around the world.

(4) The RBI has sought comments from NBFCs on the draft report of the working group. In the above backdrop we submit below our suggestions for your kind consideration.

II Suggestions on proposed changes:

(1) **Capital to Risk Weighted Assets Ratio :** Tier I Capital for Capital to Risk Weighted Assets Ratio (CRAR) purposes may be specified at 12% to be achieved in three years for all registered deposit taking and non-deposit taking NBFCs.

Views:

(a) As per the recent directive from the RBI, Systemically Important Non Deposit Taking NBFCs were required to step up their CRAR to 15 % by March 2011. Table-1 below provides the CRAR to be maintained by NBFCs over last 4 years:

Table-1: CRAR requirement for NBFCs over last 4 years

From		April 1	March 31	
CRAR	Limit	2007	2010	2011
Tier I	Minimum	5	6	7.5
Tier II	<=	5	6	7.5

(b) As can be seen from the above table, the CRAR for NBFCs have already been increased by 50% in last 3 years. The working group has now recommended a steep increase the Tier I CRAR from 7.5 to 12% over three year period. Incidentally, this recommendation is more stringent for NBFCs vis-a-vis bank. Even under Basel III proposed framework, the CRAR is less than 15 per cent.

It is recommended that the RBI increases the Tier I CRAR from present 7.5% to 9% in a phase manner over a period of next 3 years as provided in Table-2 below. Even at 9%, Tier I CRAR would still be on the higher side as bank's total CRAR presently stands at 9%.

Table-2: Suggested CRAR requirement for NBFCs years

From		**March 31**	
CRAR	**Limit**	**2013**	**2015**
Tier I	Minimum	8.0	9.0
Tier II	<=	7.0	6.0

(2) **Risk Weight as per Rating**:

(a) Under Basel II Norms, Banks assign Risk Weights in proportion to the credit risk associated with the counter party. In such cases, credit rating awarded by the recognised rating agencies is used to assign risk. The risk assigned is inversely proportional to the rating of the asset i.e, higher the rating, lower the risk weight assigned to the counter party and vice versa.

(b) Under Clause 16 of the NBFC Prudential Norms, the risk weight assigned to assets is fixed at 100% irrespective of the counter party credit risk and nature of lending viz. secured or unsecured. Hence practically there might be a situation where a Bank lending to 'AAA' rated counter party assigns a risk weight of 20% whereas the NBFC lending to the same counter party assigns a risk weight of 100%.

(c) Under clause 20 (13), securitized papers pertaining to Infrastructure facility attracts risk weight of 50% subject to certain conditions. It is suggested that the above provision should be extended to infrastructure facility in normal course of business i.e. term loan, debentures.

(d) The Credit conversion factor for Financial Guarantee is considered as 100% making it equivalent to Credit exposure in term of requirement of Capital adequacy. It is suggested that Credit Conversion factor on the Financial Guarantee should be based on the objective assessment of the Guarantee.

(e) In view of the above, it is recommended that regulatory gap between Banks and NBFC be bridged and risk weight for funded as well as non funded exposures be aligned.

(f) Banks are required to follow the New Capital Adequacy Framework (NCAF). As RBI proposes to align most of the NBFC norms with those of Banks, it is recommended that the benefit of NCAF and any subsequent changes should also be made applicable to NBFCs having an asset base of Rs 1,000 crores and above and subject to protective measures as it deems fit.

(3) **Increase in Risk Weight for certain specified exposure**: As per proposed guidelines risk weights of NBFCs may be raised to 150 per cent for Capital Market Exposures (CME) and 125 per cent for Commercial Real Estate (CRE) exposures.

Views:

(a) As per the master circular on exposure norms issued by the RBI, definition of capital market exposure includes “advances for any other purposes where shares or convertible bonds or convertible debentures or units of equity oriented mutual funds are taken as primary security”. In current scenario there might be a situation where lender provides shares as security to NBFCs but ultimately utilizes these funds for some Infrastructure projects.

(b) The development of infrastructure sector is critical for the sustainable growth of the India and therefore it is imperative that due importance is given to end use of borrowed funds. This would enable categorisation of such exposures as non capital market.

(e) It is further suggested that RBI could consider fixing up prudential limits as percentage of owned funds which would act as a guiding force in restricting exposure to such sector. This limit should be enforced in a phased manner over a period of 3 years which would also provide NBFC to realign their portfolio. An indicative list of exposure to CME and CRE is provided in Table-3 below:

Table-3: Indicative list of Exposure to CME and CRE

(%)

Year ended	CME	CRE	Total
March 2013	300	200	500
March 2014	250	150	400
March 2015	200	100	300

(4) **Principal Business Criteria for determination of NBFC**: As per current norms a company is treated as an NBFC if its financial assets are more than 50 per cent of its total assets and income from these financial assets is more than 50 percent of its gross income. The guidelines propose to increase this threshold limit to 75 percent.

Views:

(a) Most of the large NBFCs in India, owing to their vast and varied experience also undertake fee based business such as Project Debt Syndication, Corporate Advisory Services etc along with their principal activity of lending and investing. Under the extant RBI guidelines, fee based income is considered as Income from non financial business. We suggest that fee based income that supplements the fund based business and are not regulated by other regulators should also be considered as financial income which would enable large NBFCs to meet with the minimum income criteria.

(b) The working group has recommended increasing the threshold limit of principal business criteria to 75% instead of current 50%. We submit that the principal business of an NBFC would not change in a year in which it does not meet the criteria. This may happen due to various circumstances beyond the control of the entity including any non finance income booked by the entity in any financial year. We submit that any one time non financial income received by an NBFC should be excluded while computing the principal business criteria both from the numerator as well as the denominator.

It is therefore recommended that for the classification of an entity as a NBFC to be changed, there must be a predominant shift in the nature of the business represented by gross assets or income as an average for last 3 years.

(c) Entities implementing projects and in start-up mode should not be considered as NBFCs due to that fact that it meets the Principal business criteria during the initial period of operations as the objective of such entity is not carrying on business of NBFC but to implement projects.

(d) We would further request the RBI to define Financial Asset and Income from Financial Asset. An indication definition is provided below.

(i) **Financial Asset** : Indian Accounting Standard Ind AS 32 defines Financial asset as follows :

Any asset that is:

- cash;
- an equity instrument of another entity;
- a contractual right:
  - to receive cash or another financial asset from another entity or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity or
- a contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments or
  - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entities own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments; they also do not include puttable financial instruments.

Based on the above definition, a Financial Asset may include but not limited to the following:

- Equity Shares and instruments convertible into equity;
- Preference Shares and instruments convertible into Preference shares;
- Loans
- Advance for investments pending allotment
- Leases including Operating Lease and Finance Lease
- Advances in the nature of Loan
- Debentures and Bonds both convertible and non convertible
- Surplus monies parked into money market instruments including money market mutual funds
- Surplus monies parked into Bank Deposits
- Investment in Government Securities
- Any amount paid as advance or deposit for earning financial income e.g. Deposit to Stock Exchange, Clearing Corporation, Professional Clearing Members etc.

- Cash and Bank Balance
- Any other asset which meets the definition of the Financial asset under Ind AS 32

(ii) **Financial Income** : Based on the above definition of Financial Asset, Financial income should include the following :

- Interest
- Dividend
- Profit on Sale of Investment
- Premium on Redemption
- Lease Rentals under Operating Lease
- Financial Income for assets under Finance Lease
- Exchange traded derivative transactions
- Commodity derivative transactions
- Currency transactions including currency derivatives
- Fee income from the following activities related to Financial Assets unless the activity is regulated by other regulators :
  - Processing fee on Lending activity
  - Syndication
  - Corporate Advisory Services
  - Merchant Banking Activity
  - Financial Consultancy
  - Money changing business
  - Factoring
  - Credit Card
  - Forex Broking
  - Stock Broking
  - Asset Management
  - Portfolio Management Services
  - Credit Rating

(5) **Dedicated Refinance Window** : The borrowing avenues for NBFC are limited. In order to provide much needed liquidity, it is suggested that the RBI provide a dedicated refinance window to be setup for NBFCs on the lines of National Housing Bank (NHB) and National Bank for Agricultural and Rural Development (NABARD).

(6) **Captive NBFC**:

(a) It is noteworthy that the Report has recognized the model of 'Captive NBFCs'. The Report recommends that Captive NBFCs should focus mainly (90 percent and above) on financing their parent company's products. Considering that Captive NBFCs also undertake integral activities that help augment the business of their parent companies and are essentially and inextricably linked to the business of the Captive NBFCs, the condition of mainly focusing (i.e. 90 percent or above) on financing the parent company's products should also include such activities undertaken by the Captive NBFCs.

(b) Further, considering the above mentioned business model of Captive NBFCs, the concentration of credit norms that are currently applicable should also be relaxed for Captive NBFCs (i.e. the concentration of credit to single borrowers should increase from 15 percent to 25 percent and to group of borrowers from 25 percent to 40 percent).

(7) **Borrowing by NBFCs with Put / Call Options** :

(a) RBI's current regulations do not permit issuance of NCDs of less than one year and with Call/Put of less than 3 months. It is submitted that 3 months is considered as too long for the money market investors.

(b) For access to funds with less than 3 months, NBFCs have to resort to either CPs or ICDs. While ICDs have decreased in popularity, short term CP issuance is very inefficient in view of the stamp duty implications. For instance, if a CP were to be issued on a weekly rolling basis for 3 months, the effective cost goes up by 0.6%p.a. only on account of stamp duty.

(d) In order to provide efficient short term instrument for NBFCs as also to improve monetary transmission of repo rate, it is imperative that a market linkage be established between inter-bank rates and corporate rates. This can be achieved by allowing NCD issuance with call put of not less than one week so as to be in sync with CP regulation.

(8) **Access to External Commercial Borrowings**:

(a) (i) At present, access to ECBs is restricted to operating companies and infrastructure finance companies.

(ii) It is submitted that many project companies and SPVs are unable to attract investors in view of typical project risks, while the companies sponsoring these projects typically command higher credit rating and are able to raise foreign funds for infrastructure. The current regulation however excludes such borrowers from the purview of ECB.

(iii) In order to promote investment in infrastructure projects, it is therefore requested that CICs and NBFCs be allowed to raise ECBs while retaining the end-use requirement viz., deployment in infrastructure projects.

(b) (i) In addition, Indian branch of a foreign bank is allowed to borrow funds from their Head Office. While the total amount of head office borrowing in foreign currency is at the discretion of the foreign bank, the manner in which the same needs to be undertaken is subject to certain terms and conditions laid down by the RBI (i.e. minimum initial maturity of 5 years, rate of interest not to exceed ongoing market rate, etc).

(ii) Given the above, Indian branches of foreign banks are able to leverage on cheaper debt funding from their foreign head offices. However, an Indian NBFCs (except Infrastructure Finance Company) are not an eligible borrower for ECBs, even from its own foreign parent. Consequently, Indian NBFCs are not able to leverage on any cheaper debt funding from abroad. RBI should allow Indian NBFCs to be eligible for external commercial borrowings, while the same could be subjected to conditions similar to those set out for the Indian branches of foreign banks as regards head office borrowings.

(9) **Change in Control**: As per proposed guidelines any transfer of shareholding direct or indirect of 25 per cent and above, change in control, merger or acquisition of any registered NBFC should have prior approval of the Reserve Bank.

Views:

Mergers and acquisitions are used as instruments of momentous growth and are increasingly getting accepted by Indian businesses as critical tool of business strategy. The basic law related to mergers is codified in the Indian Companies Act, 1956 which works in tandem with various regulatory policies. The general law relating to mergers, amalgamations and reconstruction is embodied in sections 391 to 396 of the Companies Act 1956 which jointly deals with the compromise and arrangement with creditors and members of a company needed for a merger and subsequent sanction of the High Court is required for bringing it into effect. In view of the already existing comprehensive regulations with respect to mergers and acquisitions in India, it is suggested to dispense of with the need to again seek approval from the RBI.

(10) **Maintenance of Liquid Assets**: As per the proposed norms all registered NBFCs deposit taking and non-deposit taking should maintain high quality liquid assets in cash, bank deposits maturing within 30 days, government securities, and investment in money market instruments maturing within 30 days equal to the gap between total net cash inflows and outflows over the 1 to 30 days.

Views:

(a) The proposed guidelines will require NBFCs to maintain more funds in liquid assets which otherwise could have been deployed in its core business. Unlike banks which have access to cheaper source of funds in the form of current and savings account (CASA), many NBFCs in India have to majorly rely on banks for their funding needs which eventually results in increased cost of borrowing.

(b) In view of foregoing it is suggested to reconsider proposed liquidity requirements for NBFCs that would be best suited for NBFCs as well as provide liquidity cushion during stress. It is further recommended that RBI retains the current liquidity requirement for NBFCs with such restrictions as it deems fit.

(c) The working group has suggested maintaining investment in specified high quality liquid assets. It is suggested that Liquid Mutual Funds should also be added to high quality liquid assets.

(11) **Asset Classification and Provisioning**: Asset classification and provisioning norms similar to banks to be brought in phased manner for NBFCs. Suitable income tax deduction akin to banks may be allowed for provisions made under the regulations. Accounting norms applicable to banks may be applied to NBFCs.

Views:

(a) As per a CRISIL study, tightening of the Prudential Norms to make them aligned with the norms for Banks as proposed would result in a rise in NPAs in NBFCs by about 4% and would impact the business of NBFCs. This would impair credit creation capacity via restricted exposure norms.

(b) It is recommended that NBFCs should be given suitable time to adjust itself to the new regulatory regime and the RBI should introduce the provisioning norms from financial year 2014-15 subject to such conditions as it deems fit. Further the revised norms should be made applicable in a phase manner only when the income tax deduction for such provisions is allowed.

(c) Under the existing framework, there is a differential provisioning norms for Lease & Hire Purchase as compared to Loans. RBI is requested to retain differential Prudential Norms for Lease & Hire Purchase assets taking in to consideration the difference in legal ownership of financed assets, ease of repossession and of liquidation of the same assets. The NPA provisions for Loans / Credit exposure may be reduced to the one applicable to banks whereas the NPA for Lease and Hire Purchase exposure may be reduced from existing 12 months to 180 days.

(d) In addition, presently restructuring norms are applicable only to Infrastructure Loans. It is suggested that these norms should also be applicable to normal loans as applicable to banks. This would immensely help NBFCs that have lending to entities whose loans are under Corporate Debt Restructuring (CDR).

(12) Deposit Insurance: In line with the thinking on convergence of regulations for banks with that of deposit taking NBFCs, deposit taking NBFCs must also be entitled for deposit insurance.

(13) Non-deposit taking systematically important NBFCs was allowed to raise perpetual bonds, when their capital adequacy was increased from 12% to 15%. However, similar access was not provided to systematically important deposit taking NBFCs, when capital adequacy for them was increased from 12% to 15%.Normally NBFCs have regular instalment receipts from its customers whereas liabilities are bunched up. Accordingly, so far they were allowed 15% tolerance limit in their liquidity management under the present ALM guidelines. This 15% tolerance limit is proposed to be removed which may increase the liquidity management cost by a minimum of Rs. 50 Lakhs per annum.

(14) There is a recommendation for income tax deduction of NPA provisions. The proposal to enhance the NPA provision may be made effective only when income tax deductions for such provisions are allowed.

(15) Asset Finance Companies are mainly engaged in financing moveable assets, which generates cash flow for the borrowers. Hence by and large their repayments are regular and under circumstances when the borrowers are not in a position to fulfil their obligations the NBFCs have recourse to the asset financed. Hence, Asset Finance Companies enjoys relatively lower credit losses. In view of this risk weightage of the Asset Finance Companies, loan portfolio should be reduced to 50%.

(16) **Infrastructure NBFC:**

(a) **Background**:

The RBI had issued guidelines on Infrastructure NBFC dated February 12, 2010 which have laid down following criteria for a Company to be qualified as Infrastructure NBFC:

(i) A minimum of 75% of its total assets should be deployed in infrastructure loans;

(ii) Net owned funds of Rs 300 crores or above

(iii) Capital Risk Adjusted Ratio (CRAR) of 15% with a minimum Tier-I capital of 10%

(iii) Minimum credit rating 'A' or equivalent of CRISIL, FITCH, CARE, ICRA or equivalent rating by any other accrediting rating agencies.

(b) **View**:

The condition of 75% of total assets to be deployed in Infrastructure Loan can be achieved by New NBFCs and certain specific NBFCs catering mainly to Infrastructure Lending. Existing NBFCs with a mix of Infrastructure and Other Lending would find it difficult to migrate to the 75% mark immediately and need a few years to achieve this ratio. Therefore in case of existing NBFCs, the ratio may be kept at 50% and increased to 75% in a phased manner over a period of 3 years say till FY 2015.

III **Suggestions on Regulations applicable to Core Investment Companies** :

(1) During January 2011, the RBI had issued a Framework for CICs.

(a) RBI in April 2011 has issued Frequently Asked Questions (FAQ) applicable to CIC. Certain aspects of FAQ namely 23 and 24 summarized below :

(i) FAQ 23: Exemption from Capital Adequacy / exposure norms during the transition period from NBFCs-ND-SI to CICs-ND-SI.

(ii) FAQ 24: CIC not meeting the principal business criteria i.e. 50% of asset and 50% of income criteria in order to be classified as NBFC.

(b) The CIC framework suggests that a CIC first has to be an NBFC and meet the principal business criteria i.e. a company will be regarded as a NBFC if it satisfies the assets-income test, i.e., 50 percent or more of its assets are financial assets and 50 percent or more of its income is income from such financial assets.

(c) However the FAQ suggests that a holding company does not necessarily have to meet principal business criteria. It further states that if the holding company does not meet the criteria as a CIC, it would be required to be registered as a NBFC.

(d) It may also be mentioned that the RBI does not define a "Holding Company". Further the holding company has been narrowly defined in Companies Act, 1956 as follows:

"holding company" means a holding company within the meaning of section 4"

(e) Most start up's and projects companies initially make investments in Special Purpose Entities based on the Concession granted to it. Lending and rating agencies also prefer SPE Model as a means for funding such projects. These companies may initially meet the asset income criteria till the Commercial Operations Date of the SPE. We are of the view that it was not the intention of the RBI to include such companies as CIC and would request the RBI to take a systemic view on this issue.

(f) Suggestions:

(i) A NBFC in order to become a CIC has to meet the principal business criteria of assets and income and assets.

(ii) The key criteria for Project Companies should be based on its business objectives rather than on asset income criteria which may be a temporary phenomenon.

(2) **Overseas Investments by CICs:**

(i) The main business of CIC is to make Investments in and provide Loans to Group Entities or issue Guarantees on behalf of Group Entities. With the increase in globalization of Indian Inc Companies, CICs have to develop, nurture and grow businesses within India as well as in overseas markets: organically or inorganically. Consequently, CICs would need to invest in JVs/WOS abroad to meet the aforesaid objective.

(ii) In terms of the Regulation No. 7 of the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) (Amendment) Regulations, 2004, dated July 07, 2004, all Indian entities require prior approval of the concerned regulatory authorities both in India and abroad in order, to make an investment in any overseas entity.

(iii) As a consequence of the foregoing and in terms of the RBI Circular, CICs-ND-SI need to obtain an NoC from DNBS, RBI for Direct Investment in JV / WOS abroad.

(iv) The main business of CICs is to make investment in Group Companies which would be in India or overseas. Before the issuance of the CIC framework, Companies that met the criterion of a CIC were not regulated by the RBI and they made investments under the automatic route in any activity other than entity engaged in Financial Services without obtaining RBI approval

(v) The FAQ suggests that as CIC are regulated by the RBI, they will need they would require NOC from Department of Non-Banking Supervision (DNBS) for overseas investments.

(v) We respectfully submit that the RBI considers investment by CICs-ND-SI in overseas JVs / WOS under the Automatic Route as detailed above. For investments in entities engaged in Financial Services, the existing RBI Notification would continue to apply.

(3) **Bank Borrowings by CICs:**

(i) Extant RBI Directions to Banks on lending to NBFCs include a negative list of activities which are not eligible for bank credit, including :

- Investments of both current and long term nature in any Company/ Entity by way of shares, debentures etc.
- All types of Loans and Advances to Subsidiaries, Group Companies/ Entities

(ii) CIC is by definition not permitted to engage in any business other than acquisition of shares and securities of Group Companies, granting of loans to and issuing guarantees on behalf of Group Companies. Consequently, the above restrictions would deny CICs-ND-SI all access to bank credit.

(iii) It is our understanding that the RBI does not contemplate denial of banking resources to CICs as a class. This is borne out in the definition of CIC-ND-SI as Companies availing and holding public funds are permitted to leverage upto 2.5 times of Adjusted Net worth.

(iv) Subsequent to the notification of the CIC Directions, discussions with a number of commercial banks indicate that banks are awaiting clarifications from the RBI in this regard.

(v) All CICs will need to access both Banks and Non-Bank services as a part of their resource raising strategy, within the overall framework of CIC Guidelines. These borrowings could be subject to overall ALM framework that is already stipulated by the RBI.

(vi) We therefore respectfully submit that the RBI permit Banks to lend to CICs within the overall leverage stipulated in the CIC Directions.

(4) **Investment in Government Securities**

(i) CICs are allowed to invest / deal in Government Securities as per guidelines issued on January 5, 2011. Though the definition provides for deduction of Money Market instruments including money market mutual funds from the Total Assets in order to arrive at the Net Assets, the same is not specifically spelt for Government Securities.

(ii) Government Securities are considered efficient in managing liquidity. For a CIC, active management of a liquidity reserve would, in fact be an important management consideration.

(iii) Since Government Securities carries “NIL” risk weight, we recommend that Government Securities should also be excluded while computing Net Assets.

(5) **Increase in Risk Weightage on Capital Market Exposure suggested by the Working Group**:

(a) During January 2011, RBI had issued regulatory framework for Core Investment Companies (CIC). A CIC is exempted from compliance with CRAR as well as Concentration Norms. However they are required to maintain Capital Ratio of at least 30%. The numerator is Adjusted Net Worth, where as the denominator is the Risk Weighted Assets. Under the extant guidelines, the risk weight applied to all CIC assets excluding certain identified assets is 100%.

(b) However by the nature, CIC are required to provide loans and make investment in Group Companies. It further has to maintain Investment of at least 60% of its Net Assets. Under the extant guidelines, all investment exposure would get classified as Capital Market Exposure that would adversely affects its ability to fund its Group Companies.

(c) Given that a CIC has substantial investment that is currently classified as CME, RBI may maintain status quo on application of risk weightage for CIC i.e. the risk weight that is currently applicable to CICs should continue.