REPORT of
the WORKING GROUP
on
DEVELOPMENT FINANCIAL INSTITUTIONS

Reserve Bank of India

Department of Banking Supervision
Financial Institutions Division

May 2004

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Preface

The emerging economies in post colonial era faced the difficult choice of appropriate mechanism for channelising resources into the development effort. Many of them had inherited capital starved primitive financial systems. Such system could not be relied upon to allocate resources among competing demands in the economy. The task of institution building was too important to be left at the mercy of the market forces at the nascent stage of development. In such a situation several governments in Continental Europe and East Asian economies decided to take matters into their hands and established institutions specifically to cater to the requirements of financial resources for developmental effort. Such institutions were called Development Financial Institutions. Development financing is a risky business. It involves financing of industrial and infrastructure projects which usually have long gestation period. The long tenor of such loans has associated with it uncertainty as to performance of the loan asset. The repayment of the long term project loans is dependent on the performance of the project and cash flows arising from it rather than the realisability of the collaterals. The project could go wrong for a variety of reasons, such as, technological obsolescence, market competition, change of Government policies, natural calamities, poor management skills, poor infrastructure etc. The markets and banking institutions were highly averse to such uncertain outcome, besides not possessing enough information and skills to predict with any certainty the outcome. There were also the cost considerations associated with such risky ventures. The long term loan comes with a higher price tag due to the term premium loaded into the pricing. In such a situation the long term financing would be scarce as well as costly so as to render the project financially unviable. DFIs were established with the Government support for underwriting their losses as also the commitment for making available low cost resources for lending at a lower rate of interest than that demanded by the market for risky projects. This arrangement worked well in the initial years of development. As the infrastructure building and industrialisation got underway the financial system moved higher on the learning curve and acquired information and skills necessary for appraisal of long term projects. It also developed appetite for risk associated with such projects. The intermediaries like banks and bond markets became sophisticated in risk management techniques and wanted a piece of the pie in the long term project financing. These intermediaries also had certain distinct advantages over the traditional DFIs such as low cost of funds and benefit of diversification of loan portfolios. The Government support to DFIs, in the meanwhile, was also waning either for fiscal reasons or in favour of building market efficiency. Therefore, towards the end of twentieth century the heydays of DFIs were over and they started moving into oblivion. In several economies, having attained their developmental goals, the DFIs were either restructured and repositioned or they just faded away from scene. The Indian experience has also more or less traversed the same path. Although India cannot said to have achieved the developmental goals yet, the Government's fiscal imperatives and market dynamics has forced a reappraisal of the policies and strategy with regard to the role of DFIs in the system.

Following the recommendations of the Narasimham Committee II, and the RBI Discussion Paper on "Harmonising the Role and Operations of Development Financial Institutions and Banks" released in January 1999 for wider public debate, the regulatory approach to Development Finance Institutions was spelt out in the Reserve Bank's annual policy statement of April, 2000. The approach so finalised, suggested that any DFI intending to transform into a bank, could approach RBI or convert itself into an NBFC. Since then, ICICI has completed the process of transition to a bank and IDBI is in the process of doing so. In order to address the regulatory and supervisory issues relating to the remaining term lending and refinancing institutions and for improving the flow of resources to them, RBI in terms of the Mid Term Review of Monetary and Credit Policy for the year 2003-04 set up a Working Group (WG) for examining, within the broader framework of NBFCs, various regulatory and supervisory aspects including access to short term resources for the DFIs as a separate category. The constitution and terms of reference of the Working Group are as under:

<u>Composition of the Group:</u>

Sh. N. Sadasivan, Banking Ombudsman for Maharashtra and Goa, Chairman Sh. S.S. Gangopadhyay, Chief General Manager, RBI, Member
Sh. O.P. Aggarwal, Chief General Manager, RBI, Member
Sh. Deepak Mohanty, Adviser, RBI, Member

Sh. Amarendra Mohan, General Manager, RBI, Member
Sh. M.K. Samantaray, General manager, RBI, Member

Terms of Reference:

a) to review the experience of DFIs, which have transformed as banks;

b) to indicate the status and prospects of those DFIs, which are moving in a similar direction and which are likely to move in a similar direction;

c) to assess the financial position and the regulatory framework in regard to all the existing Financial Institutions;

d) to identify the common characteristics of DFIs, as a category and explore the appropriate framework for regulation of such DFIs keeping in view the fact that they are not banks but still accept public deposits;

e) to recommend a regulatory framework for DFIs in the above light after assessing the current status and keeping in view the need to bring them under the overall regulatory framework of Non-Banking Finance Companies (NBFCs), but treating the DFIs as a separate category;

f) to advise whether NBFCs of large sized liabilities should automatically be brought under the separate category of NBFCs, as applicable to DFIs; and

g) to review the status of Residuary Non-Banking Companies (RNBCs) and identify where they have characteristics of DFIs and suggest mechanisms, by which the companies under this category could move into one of the definable categories of NBFCs, including that of the DFIs.

However, while covering the terms of reference, certain amount of reordering has been done in the chapters, for the sake of convenience.

The Group examined in depth the issues flagged by the terms of reference, by consulting several experts in the field of DFIs and NBFCs and perusing the available literature on the subject. The Group studied the evolution of DFIs in India in the post independence period as well as elsewhere in the world and the effects of the developments in financial sector on these institutions during the same period. The experience gained in conversion of one of the DFIs into a bank and the useful lessons learnt from such conversion have been captured for future reference. The Group has attempted to delve into the debate raging for and against the sustainability of DFI model and has endeavored to suggest a way forward, according to the need and imperatives of the current situation and the unfolding scenario. The Group has scanned the existing regulatory framework for DFIs and has suggested an appropriate framework for DFIs, under the changed circumstances. The Working Group has also analysed some issues, relating to large NBFCs and RNBCs and studied various options, for mitigating the concerns arising from this sector.

The Working Group wishes to acknowledge the secretarial assistance rendered by the Financial Institutions Division, RBI. The major task of arranging the meetings and minuting all the deliberations was handled by Shri A.M. Tiwari, AGM. The drafting of the report was shared between Shri Rajesh Verma, General Manager and Shri A. M. Tiwari, AGM with useful inputs from Dr. K. Jayanthi Anand, Director and Shri Mohinder Kumar, AGM. The assistance in stenographic work was rendered by Shri C. Ramachandran and Shri S.G. Pradhan.

Chapter I

Evolution, objectives and financial position of Financial Institutions in India

1.1 Introduction

A typical structure of financial system in any economy consists of financial institutions, financial markets, financial instruments and financial services. The functional, geographic and sectoral scope of activity or the type of ownership are some of the criteria which are often used to classify the large number and variety of financial institutions which exist in the economy. In its broadest sense the term ‘financial institution’ would include banking institutions and non-banking financial institutions[1]. The banking institutions may have quite a few things in common with the non-banking ones. However, the distinction between the two has been highlighted by Sayers, by characterising the former as ‘creators’ of credit, and the latter as mere ‘purveyors’ of credit[2]. This distinction arises from the fact that banks, which are part of payment system, can create deposits and credit but the non-banking institutions, which are not part of payment system, can lend only out of the resources put at their disposal by the savers.

1.2 Development Finance Institutions

An efficient and robust financial system acts as a powerful engine of economic development by mobilising resources and allocating the same to their productive uses. It reduces the transaction cost of the economy through provision of an efficient payment mechanism, helps in pooling of risks and making available long-term capital through maturity transformation. By making funds available for entrepreneurial activity and through its impact on economic efficiency and growth, a well-functioning financial sector also helps alleviate poverty both directly and indirectly.

In a developing country, however, financial sectors are usually incomplete in as much as they lack a full range of markets and institutions that meet all the financing needs of the economy. For example, there is generally a lack of availability of long-term finance for infrastructure and industry, finance for agriculture and small and medium enterprises (SME) development and financial products for certain sections of the people. The role of development finance is to identify the gaps in institutions and markets in a country’s financial sector and act as a ‘gap-filler’. The principal motivation for developmental finance is, therefore, to make up for the failure of financial markets and institutions to provide certain kinds of finance to certain kinds of economic agents. The failure may arise because the expected return to the provider of finance is lower than the market-related return (notwithstanding the higher social return) or the credit risk involved cannot be covered by high risk premium as economic activity to be financed becomes unviable at such risk-based price. Development finance is, thus, targeted at economic activities or agents, which are rationed out of market.

The vehicle for extending development finance is called development financial institution (DFI) or development bank. A DFI is defined as "an institution promoted or assisted by Government mainly to provide development finance to one or more sectors or sub-sectors of the economy. The institution distinguishes itself by a judicious balance as between commercial norms of operation, as adopted by any private financial institution, and developmental obligations; it emphasizes the "project approach" - meaning the viability of the project to be financed – against the "collateral approach"; apart from provision of long-term loans, equity capital, guarantees and underwriting functions, a development bank normally is also expected to upgrade the managerial and the other operational pre-requisites of the assisted projects. Its insurance against default is the integrity, competence and resourcefulness of the management, the commercial and technical viability of the project and above all the speed of implementation and efficiency of operations of the assisted projects. Its relationship with its clients is of a continuing nature and of being a "partner" in the project than that of a mere "financier” " (Scharf and Shetty, 1972)[3].

Thus, the basic emphasis of a DFI is on long-term finance and on assistance for activities or sectors of the economy where the risks may be higher than that the ordinary financial system is willing to bear. DFIs may also play a large role in stimulating equity and debt markets by (i) selling their own stocks and bonds; (ii) helping the assisted enterprises float or place their securities and (iii) selling from their own portfolio of investments.

1.3 DFIs in India

The Group notes that there is no specific use of the term ‘DFI’ in either the RBI Act, 1934 or the Companies Act, 1956 or various statutes establishing DFIs. While the RBI Act defines the term ‘Financial Institution’ (FI), the Companies Act has

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1 Bhole, L.M, ‘Financial Institutions and Markets: Structure, Growth and Innovation’ 2nd Edition, Tata McGraw Publishing Company Ltd, New Delhi, 1992.

2 Sayers, R.S., ‘Modern Banking’, Oxford University Press, Oxford, 1964

3. Scharf and Shetty [1972, Dictionary of Development Banking, Elsevier Publishing Company, New York).

categorised certain institutions as Public Financial Institutions (PFIs). While the various FIs including PFIs vary from each other in terms of their business specifications, some of them perform the role of DFIs in the broadest sense of the term as described in para 1.2 above.

1.4 Emergence of Financial Institutions in India

1.4.1 As mentioned earlier, DFIs are created in developing countries to resolve market failures, especially in regard to financing of long-term investments. The DFIs played a very significant role in rapid industrialisation of the Continental Europe. Many of the DFIs were sponsored by national governments and international agencies. The first government sponsored DFI was created in Netherlands in 1822. In France, significant developments in long-term financing took place after establishment of DFIs such as Credit Foncier and Credit Mobiliser, over the period 1848-1852. In Asia, establishment of Japan Development Bank and other term-lending institution fostered rapid industrialisation of Japan. The success of these institutions, provided strong impetus for creation of DFIs in India after independence, in the context of the felt need for raising the investment rate. RBI was entrusted with the task of developing an appropriate financial architecture through institution building so as to mobilise and direct resources to preferred sectors as per the plan priorities. While the reach of the banking system was expanded to mobilise resources and extend working capital finance on an ever-increasing scale, to different sectors of the economy, the DFIs were established mainly to cater to the demand for long-term finance by the industrial sector. The first DFI established in India in 1948 was Industrial Finance Corporation of India (IFCI) followed by setting up of State Financial Corporations (SFCs) at the State level after passing of the SFCs Act, 1951.

1.4.2 Financial Institutions set up between 1948 and 1974

Besides IFCI and SFCs, in the early phase of planned economic development in India, a number of other financial institutions were set up, which included the following. ICICI Ltd.[4] was set up in 1955, LIC in 1956, Refinance Corporation for Industries Ltd. in 1958 (later taken over by IDBI), Agriculture Refinance Corporation (precursor of ARDC and NABARD) in 1963, UTI and IDBI in 1964, Rural Electrification Corporation Ltd. and HUDCO Ltd. in 1969-70, Industrial Reconstruction Corporation of India Ltd. (precursor of IIBI Ltd.) in 1971 and GIC in 1972. It may be noted here that although the powers to regulate financial institutions had been made available to RBI in 1964 under the newly inserted Chapter IIIB of RBI Act, the definition of term 'financial institution' was made precise and comprehensive by amendment to the RBI Act Section 45-I (c) in 1974[5].

1.4.3 DFIs set up after 1974 and Notification of certain institutions as Public Financial Institutions

Another important change that took place in 1974 was the insertion of Section 4A to the Companies Act, 1956 whereunder certain existing institutions were categorised as 'Public Financial Institutions' (PFI) and the powers of Central Government to notify any other institution as PFI were laid down. In exercise of these powers GOI has been notifying from time to time certain institutions as PFIs. As on date, under the Section 4A, six specified institutions are

regarded as PFI and it has been provided that the Securitisation Company or Reconstruction Company which has obtained a certificate of registration under sub-section (4) of Section 3 the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 shall also be regarded as a PFI. Besides these institutions, GOI has been notifying, from time to time, certain other FIs as PFIs and as on date *additional* 46 institutions have been so notified. Thus, in all 52 institutions have been categorised as PFIs.

The FIs set up after 1974 have been as follows. NABARD was set up in 1981, EXIM Bank (functions carved out of IDBI) in 1982, SCICI Ltd. in 1986 (set up by ICICI Ltd. in 1986 and later merged into ICICI Ltd. in 1997), PFC Ltd. and IRFC Ltd. in 1986, IREDA Ltd. in 1987, RCTC Ltd. and TDICI Ltd. (later known as IFCI Venture Capital Funds Ltd. and ICICI Venture Funds Management Ltd.) in 1988, NHB in 1988, TFCI Ltd. (set up by IFCI) in 1989, SIDBI (functions carved out of IDBI) in 1989, NEDFi Ltd. in 1995 and IDFC Ltd. in 1997.

As may be observed from the foregoing, over the years, a wide variety of DFIs have come into existence and they perform the developmental role in their respective sectors. Apart from the fact that they cater to the financial needs of different sectors, there are some significant differences among them. While most of them extend direct finance, some extend indirect finance and are mainly refinancing institutions viz., SIDBI, NABARD and NHB which also have a regulatory / supervisory role.

DFIs can be broadly categorised as all-India or state / regional level institutions depending on their geographical coverage of operation. Functionally, all-India institutions can be classified as (i) term-lending institutions (IFCI Ltd., IDBI, IDFC Ltd., IIBI Ltd.) extending long-term finance to different industrial sectors, (ii) refinancing institutions (NABARD, SIDBI, NHB)

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[4] For full names of DFIs please see Annexure II

[5] 'Reserve Bank of India: Functions and Working' 4th Edition, 1983

extending refinance to banking as well as non-banking intermediaries for finance to agriculture, SSIs and housing sectors, (iii) sector-specific / specialised institutions (EXIM Bank, TFCI Ltd., REC Ltd., HUDCO Ltd., IREDA Ltd., PFC Ltd., IRFC Ltd.), and (iv) investment institutions (LIC, UTI, GIC, IFCI Venture Capital Funds Ltd., ICICI Venture Funds Management Co Ltd.). State / regional level institutions are a distinct group and comprise various SFCs, SIDCs and NEDFi Ltd. A brief description of evolution of and objective behind setting up of various financial institutions is furnished in Annexure I.

1.5 Operating environment of DFIs: before and after Financial Sector Reforms

Historically, low-cost funds were made available to DFIs to ensure that the spread on their lending operations did not come under pressure. DFIs had access to soft window of Long Term Operation (LTO) funds from RBI at concessional rates. They also had access to cheap funds from multilateral and bilateral agencies duly guaranteed by the Government. They were also allowed to issue bonds, which qualified for SLR investment by banks. For deployment of funds, they faced little competition as the banking system mainly concentrated on working capital finance. With initiation of financial sector reforms, the operating environment for DFIs changed substantially. The supply of low-cost funds was withdrawn forcing DFIs to raise resources at market-related rates. On the other hand, they had to face competition in the areas of term-finance from banks offering lower rates. The change in operating environment coupled with high accumulation of non-performing assets due to a combination of factors caused serious financial stress to the term-lending institutions.

1.6. Review of current financial position of various FIs

A brief summary of financial position of various financial institutions and large Non-Banking Financial Companies (NBFCs) including Residuary Non-Banking Companies (RNBCs) (which were also studied by the Working Group (WG) as per the terms of reference) is furnished in the Table-1.

Table -1

Financial position of FIs and large NBFCs and RNBCs as on 31.3.2003

(Amounts in Rupees crore)

Sr. No.	Institution	Owned Funds	Total assets /financial Assets	Net Profit
I	**All India Institutions notified as PFIs**			
	A. PFIs regulated and supervised by RBI (1 to 9)	**39,379**	**1,83,332**	**1,493**
1	IDBI	6,978	# 62,361	* 401
2	IFCI Ltd.	1,538	# 22,481	* (-)260
3	IIBI Ltd.	476	# 4,526	(-)527
4	TFCI Ltd.	* 160	* 837	* 10
5	IDFC Ltd.	1,553	# 3,845	* 180
6	EXIM Bank	1,967	# 12,011	* 207
7	NHB (balance sheet data as on 30.06.2003)	1,538	10,290	128
8	SIDBI	4,431	# 17,427	* 207
9	NABARD	20,738	49,554	* 1,147
	B. All India PFIs not regulated / supervised by RBI (10 to 24)	**71,093**	**4,58,734**	**13,622**
10	PFC Ltd.	5,332	20,825	1,172
11	REC Ltd.	2,862	15,759	579
12	IRFC Ltd.	2,324	17,263	335
13	IREDA Ltd. (as on 31.3.2002)	** 437	** 2,228	** 16
14	NEDFi Ltd.	* 224	* 266	* 16

15	HUDCO Ltd.	2,767	*P* 22,834	267
16	UTI *	* 38,513	* 57,947	* 568
17	LIC *	* 2,516	* 2,77,301	* 9,768
18	GIC * (excluding its undernoted erstwhile subsidiaries)	* 9,320	* 10,545	** *P* 260
19	NIC *	* 1,072	* 6,533	136
20	NIA *	* 3,404	* 12,985	256
21	OIC *	* 834	* 6,480	64
22	UII *	* 1,446	* 7,723	171
23	IFCI Venture Capital Funds Ltd.	* 10	* 10	* 1
24	ICICI Venture Funds Management Co. Ltd.	32	* 35	* 13
II	**State level Institutions notified as PFIs**	**-**	**25,012**	**-**
25	17 SFCs & Tamilnadu IIC Ltd.	1,662	# 12,712	NA
26	SIDCs (5 of the SIDCs have been notified as PFIs)	NA	# @ 12,300	NA
III	**Major categories not notified as PFIs**	**-**	**70,621**	**-**
27	NBFCs having assets of more than Rs.500 crore (including the large two RNBCs)	NA	70,621	NA
	TOTAL	**1,12,134**	**7,37,699**	**15,115**

@ Last year's figure repeated. *p- provisional* # Source : Report on Trend & Progress of Banking, 2002-03; * Source IDBI's report on Development Banking In India 2002-03 ; **Source - Website

1.6.1 Financial position of DFIs regulated by RBI

It is observed that nine select all India financial institutions are being regulated and supervised by RBI at present. Out of these, three institutions viz., NABARD, NHB and SIDBI extend indirect financial assistance by way of refinance. The financial health of these three institutions is sound as their exposure is to other financial intermediaries, which in certain cases is also supported by State Government guarantees. Of the remaining six institutions, two niche players viz. EXIM Bank and IDFC Ltd. are also quite healthy. The former operates in the area of international trade financing and the latter is a new generation FI with a mandate of leading private capital into the infrastructure sector, rather than itself being a direct lender. The remaining four institutions that have been operating as providers of direct assistance, are all in poor financial health. It was observed that while the total financial assets and capital and reserves of the refinancing institutions had increased during the year ended March 31, 2003, the same of term lending institutions had decreased. In terms of some select indicators the financial position of the nine FIs as on March 31, 2003 is summarised below:

CRAR

The prescribed minimum CRAR for the FIs was 9%. The CRAR of two FIs, viz., IFCI Ltd. and IIBI Ltd. was below the prescribed minimum at (-) 0.95% and (-) 11.04% respectively. Remaining 7 FIs were maintaining CRAR above 15% - with EXIM Bank, IDFC Ltd., NHB, NABARD and SIDBI having it above 25%.

Net NPAs

Net NPAs of 5 FIs viz., EXIM, IDFC Ltd., NABARD, NHB and SIDBI were below 5%. Net NPAs of IDBI were 14.20% and the rest of the FIs viz., IFCI Ltd., IIBI Ltd. and TFCI Ltd. had the same above 20% at 29.50%, 34.72% and 20.47%, respectively.

Return on Average Assets

The Return on Average Assets was negative for both IFCI Ltd. and IIBI Ltd.; it was between 0% to 1% for IDBI and NHB; between 1% to 2% in case of SIDBI and TFCI Ltd.; between 2% to 3% in case of EXIM Bank and above 3% in case of NABARD and IDFC Ltd.

1.6.2 Financial position of DFIs not regulated by RBI

In regard to the DFIs not regulated by RBI it is observed from the information available in the public domain that, as on March 31, 2003, the position is as follows. The institutions like PFC Ltd., REC Ltd., and IRFC Ltd. are making profits. Same is the case with LIC and GIC (and its erstwhile subsidiaries that have since been delinked), and UTI. However, UTI had to undergo a massive restructuring in 2001-02 as it faced severe liquidity problems. While IREDA Ltd. and NEDFi Ltd. are somewhat profitable, the two venture capital companies seem to be too small to be systemically significant. HUDCO Ltd., being a housing finance company is within the regulatory and supervisory domain of National Housing Bank, and it had declared profits. The financial position of state level institutions in general, and of SFCs in particular, is very poor.

Chapter II

DFIs: Recent experiences and future outlook

2.1. International Experience[1,2]

2.1.1 Two distinct models of development financing have been followed internationally at different times. At one end of the spectrum is the Anglo-American model, which is purely market based, financial markets playing an important role in allocating resources for competing uses, including the industry and long term projects. At the other end is the model adopted by Continental Europe and South East Asian Economies, in which financial savings were channelised and allocated through financial intermediaries like banks and DFIs. In Germany and Japan, development banks have successfully contributed to the reconstruction and industrialisation after the World War II. Their initial mission could be said to have ended by the 1980s and their focus and role have been since redefined. Most drastic changes have been observed in Japan in the area of Development Banking, where the Government owned Japan Development Bank (JDB) and three private long term lending banks had successfully helped the industrialisation in the 1950s and 1960s. JDB, which existed for almost fifty years and played an important role in supplying long term finance for investment was dissolved in 1999 and in its place, a new institution called Development Bank of Japan was established with a new mandate, focussing on regional development, improvement of living standards (such as environment protection and disaster prevention) and strategically important industries. The other three term lending institutions, namely, Industrial Bank of Japan (IBJ), the Long Term Credit Bank of Japan (LTCB) and Nippon Credit Bank Ltd. (NCB) went bankrupt under the onslaught of competition from other banks and development of capital market since 1980s and were restructured in 1998-99 by putting LTCB and NCB under Government control and merging IBJ with two private sector banks (Fuji Bank and Daichi Kangyo Bank). Thus, the long term credit banks, which partly, but eloquently characterised Japan's financial system during the period of industrialisation and high economic growth, have come to an end and disappeared from the scene.

2.1.2 In Korea also, the policy based loans through DFIs, namely, Korean Development Bank (KDB) and Korea Exim Bank (KEXIM), have been used as principal means of industrialisation. KDB was established in 1953 by a special law and its main task was to lend equipment capital for postwar recovery. Since 1960s, KDB has functioned as a body for implementing Government's development plans, which were aimed to encourage strategic industries like steel, electronics and petro chemicals. It played a nuclear role in developing heavy and chemical industry in 1970s. Its focus has been constantly shifting, with the change in priorities as enumerated by the policies of the Government and currently it has been repositioned by amendment to the KDB Act, separating it from its role as a public interest corporation and it is now pursuing profit more aggressively.

2.1.3 Development Bank of Singapore (DBS) was established in 1968, succeeding some of the development finance functions of Economic Development Board (EDB), such as industrial park construction (Jurong Town Corporation) and export promotion. DBS was listed as a public company with foreign capital participation. Since the demand for development finance in the city state was very limited, it went into commercial banking very early and has become a full-fledged commercial bank and accordingly has deposits as its main source of funds. At the initial stage, however, DBS primarily utilised Government borrowing to provide medium and long term loans to priority areas, such as, manufacturing, marine transport and real estate. The Government's holding in DBS has dropped to a lower level.

2.2. Emerging Indian Scenario

2.2.1 India has, historically, followed a financial intermediation-based system where banks, DFIs and other intermediaries have played a dominant role. However, in recent years resources are increasingly being mobilised through capital markets (both debt and equity). The information available in regard to the resources mobilised by the real sector and summarised in

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[1] Finance for Industrial Growth by Dr. Rakesh Mohan, DG, RBI, Mohan Kumarmangalam Lecture at ASCI, Hyderabad, October 9, 2003.

[2] Development Banking in the New Millenium, An Evaluation of Development Banking in Selected Countries & Lessons for the Future, Koichiro Fukui et al, October 1999.

Table – 2, clearly indicates a conspicuous enhancement of the role of capital markets (debt and equity) in allocation of resources to the real sector during the 1990s, as compared to the earlier two decades.

Table – 2 : Sources of Resource Mobilization

(Per cent of GDP)

		Period	
		1971 to 1992	1992 to 2000
A.	Credit by banks and DFIs	3.9	4.3
B.	Resources mobilized from Capital Market (Debt and Equity)*	0.6	1.7

* Excluding Private Placement ; Source : Report on Currency & Fnance-2000-01

2.2.2 As it generally happens in the evolution of all dynamic systems, the Indian financial system has also come of age. The capital market, both equity and debt taken together, is providing significantly larger resources to the corporate sector in the 1990s. The banking system is well diversified with public, private and foreign banks of varying sizes operating efficiently and has acquired the skills of managing risks involved in extending finance to different sectors of the economy including long term finance. Thus the need for DFIs as the exclusive providers of development finance has diminished. The banks may be encouraged to extend high risk project finance, with suitable Central Government support, with a view to distributing risk and funding sources as also developing appropriate credit appraisal and monitoring skills across the financial system. Banks may also be permitted to raise long term resources through issuance of development bonds, for the purpose of long term project finance, so that problems of asset liability management can also be taken care of.

2.2.3 Banks enjoy the natural advantage of low cost funds and are, therefore, capable of providing long term finance at lower rates despite higher intermediation cost and can derive at the same time the benefit of risk diversification across a wide spectrum of assets of varying maturities, subject, of course, to the limitations imposed by their ALM considerations. With the change in the operating environment, the supply of low cost funds has dried up for the DFIs forcing them to raise resources at market related rates. The DFIs are unable to withstand the competition from banks due to their higher cost of their funds. A suggestion has been made that banks may share with DFIs, the benefits of their lower cost funds by earmarking their funds for lending at lower rates to DFIs, for on lending by the DFIs to the infrastructure sector, either on the lines of priority sector lending mandated for the banks or by way of placement of deposits by banks with DFIs. The WG is of the view that such sharing is not workable because firstly, the banks would like to load term premium and risk premium, besides reasonable margin on the rates at which funds will be lent to the FIs, thus resulting in cost of funds increasing to a level not attractive to the FIs. Further, this arrangement would lead to two layers of intermediation and with additional margin loaded by the FIs for second level of intermediation the perceived cost advantage on the funds sourced from the banks would be neutralised for the ultimate user of funds.

2.2.4 Besides higher cost of funds, DFIs are also burdened with large NPAs due to exposure to certain sectors, which have not performed well due to downturn in the business cycle, further adding to their cost of doing business. Further, their portfolio is almost entirely composed of long-term high risk project finance and consequently the viability of their business model has come under strain. In a purely market-driven situation, the business model of any DFI which raises long-term resources from the market, at rates governed by the market forces and extends only very long-term credit to fund capital formation of long gestation, is unlikely to succeed on account of threat to its spread from higher cost of funds and higher propensity to accumulate non-performing assets, owing to exposure to very high credit risks, notwithstanding lower operating expenses vis-a-vis banks. DFIs are, therefore, crucially dependent for their continued existence on government commitment for continued support. As support from the government has a social cost, Central Government need to decide, after a detailed social cost-benefit analysis, on the areas of activities which require developmental financing and only those DFIs, which the Central Government decide to support for the time being may continue as DFIs. The rest of the DFIs must convert to either a bank or a regular NBFC, as recommended by the Narasimham Committee and should be subject to full rigor of RBI regulations as applicable to the respective category. Further, no DFI should be established in future without the Central Government support.

2.3. Need for PFIs

2.3.1 Section 4(A), which was inserted in the Companies Act in 1974, defines the term Public Finance Institution (PFI). Besides certain FIs regarded in terms of the said Section as PFIs, Central Government by notification in the official Gazette may notify other institutions as PFIs. As on date there are 46 PFIs which have been so notified by the Central Government. A list of PFIs is enclosed in Chapter IV of the report.

2.3.2 The rationale for insertion of the above Section 4(A) as well as the criteria for notification of an FI as PFI by the Central Government could not be discerned by the WG, as no information on this subject was available from the sources accessible to the WG.

2.3.3 The PFIs enjoy certain advantages under the Companies Act, 1956, Recovery of Debts due to Banks and FIs Act, 1993, Income Tax Act etc. However, the foremost advantage that accrues to the PFIs is that the bonds issued and certain other liabilities of PFIs are treated as eligible investments for insurance companies, Provident Funds (PFs), Mutual Funds (MFs) and RNBCs. Such exposures to certain PFIs also qualify for concessional risk weight of 20% for banks, FIs and NBFCs including RNBCs under RBI guidelines. Such dispensation is fraught with risks for the entities having exposure to the PFIs, as the PFIs are disparate entities without being subject to adequate and robust regulatory regime, in the case of majority of PFIs. Besides the financial position of some of the PFIs has become extremely weak without any assurance of Government support thus exposing the counterpart entities to undue risks. A committee appointed by Govt. of India in 2002 had recommended the abolition of Section 4A of the Companies Act, 1956. However, this WG is of the view that the eligibility of resources raised by these entities as approved investment and concessional risk weight of 20% allowed for exposure, to some of them, by banks, FIs, NBFCs and RNBCs regulated by RBI are based on perception of safety, merely on account of the PFI status being conferred upon them and the same should be done away with.

2.4. Future of SFCs

State Financial Corporations (SFCs) had been established as state level institutions for meeting the financial requirements of small and medium scale industries under State Financial Corporations Act, 1951. SFCs have, however, even after their long existence have remained largely "single product" provider extending term loans assistance to SSIs. They have not been able to diversify products and services to ward off the competition from banks. One of the experts consulted by the WG has succinctly put it that in the present day context SFCs have lost their relevance and banks are today in a position to perform all those functions being done by the SFCs. Further, there are a host of governance issues like lack of corporate culture and excessive centralisation of decision making process, which have remained unaddressed. SFCs are highly bureaucratic organisations having high transaction costs and very poor appraisal skills. The regulation of SFCs is another area which leaves much to be desired. The State Governments are the majority owners and have exclusive powers under Section 39 of the SFCs Act to give policy directions to the SFCs. Such combination of policy making and regulatory function results in creation of monolithic organisations leading to undesirable consequences. Due to combination of several factors, the SFCs' financial position has irretrievably deteriorated. Barring four, the remaining 14 SFCs in different states have hugely negative CRAR and very high NPAs averaging 64%, with the highest being at 99% and the lowest at 38%. The issue of restructuring of SFCs has been defying any solution, despite recommendations of an expert committee[3] advocating infusion of a considerable amount of funds. Also, it is uncertain whether these SFCs would turn around even after such infusion of funds. In the final analysis the SFCs have outlived their utility in the present context and should be phased out within a definite timeframe. The credit gap, if any, created by the exit of the SFCs from the market can be filled by banks and also by suitably repositioning SIDBI.

CHAPTER III

Transformation of DFIs into banks

3.1 Current Policy Stance towards the DFIs

3.1.1 Pursuant to the recommendations of the Khan Working Group on Harmonizing the Role and Operations of the Development Financial Institutions and banks, a Discussion Paper was prepared outlining the issues arising out of the recommendations of the Narasimham Committee II and the Khan Working Group. Extensive discussions were held on the issues brought out in the paper and a broad policy framework was outlined in the Mid-Term Review of Monetary and Credit Policy of 1999-2000 of RBI as under:

3.1.2 The principle of Universal Banking was a desirable goal and some progress had already been made by permitting banks to diversify into investments and long-term financing and the DFIs to lend for working capital. However, it was emphasized that banks had certain special characteristics and any dilution of RBI's prudential and supervisory norms for conduct of banking business would be inadvisable and any conglomerate in which banks were present should be subject to a consolidated approach to supervision and regulation. It was recognized that though the DFIs would continue to have a special role in Indian financial system, until the debt market demonstrated substantial improvement in terms of liquidity and depth, any DFI which wished to transform into a bank should have the option, provided the prudential norms applicable to the banks were fully satisfied. To this end, a DFI would need to prepare a transition path, in order to fully comply with the

[3] Committee on restructuring of SFCs, Chairman, Shri G.P.Gupta

regulatory requirements of a bank and, therefore, the DFIs were advised to consult RBI for such transition arrangements, which the RBI would consider on a case-to-case basis. The need for strengthening the regulatory framework of RBI in respect of DFIs, if they were to be given greater access to short-term resources for meeting their financing requirements, was recognized. It was expected that in the light of the evolution of the financial system, the Narasimham Committee's recommendations that ultimately there should only be banks and restructured NBFCs could be operationalised.

3.1.3 In tandem with the RBI policy pronouncement for DFIs, the GOI in the Mid-Year Review, 2002 made its intentions clear for decisive resolution of the problems being faced by some of the DFIs, by announcing that "financial sector reforms, involving interest rate deregulation, increased competition from banks, and lack of concessional funds have rendered the business models of development financial institutions (DFIs) unsustainable. Various expert committees have recommended measures to transform the DFIs. With the RBI's policy in this regard crystallizing last year, ICICI transformed itself into a bank. The Government proposes to address the problems of IDBI and IFCI. It is proposed to repeal the IDBI Act and facilitate its transformation into a bank. With regard to IFCI, the government proposes to take measures keeping in mind the interest of retail investors and government guaranteed lenders."

3.2. Efforts made by DFIs in the past to become banks

3.2.1 The operational guidelines for enabling a DFI to convert to universal bank were issued in 2001, following the policy pronouncement by RBI on 'Approach to Universal Banking'. The DFIs were advised that those who choose to convert into bank, may formulate a roadmap for the transition path and strategy for smooth conversion, over a specified time frame. It was also advised that the plan should specifically provide for full compliance with prudential norms, as applicable to banks over the proposed period and should be submitted to RBI for consideration and further discussion, if necessary.

3.2.2 Out of the ten DFIs then being regulated and supervised by RBI only two DFIs i.e. ICICI Ltd. and IDBI submitted the transition path to RBI and Government, respectively, for consideration. Two DFIs expressed their intention to submit the road map, but sought more time to concretize their plan by appointment of consultants, etc. One DFI forwarded a broad road map for conversion to a restructured NBFC by 2005, also seeking support from the Government, which was considered crucial for the success of the envisaged conversion. The proposal was forwarded by RBI to the Government for their consideration. The remaining five DFIs did not show any inclination to consider the option, as no proposal was received from them. Nothing further was heard from the DFIs who had sought time for formulating a plan for conversion. The transition plan of IDBI, which involved long winded legislative process and is finally at the stage of fructifying now, is discussed subsequently in this chapter. The road map submitted by ICICI Ltd. was successfully implemented and conversion to the bank was achieved in 2002.

3.3 Transformation of ICICI into a bank

3.3.1 The two most important factors enabling the smooth and speedy implementation of the plan of conversion by ICICI Ltd. were:

(i) The ready banking platform available with it for launching itself into a universal bank, by way of backward integration with its banking subsidiary.

(ii) The private company character of the DFI, with resultant operational freedom and ability to leverage, the superior managerial resources and skills available with it, in steering the organization along the transition path.

3.3.2 On scanning the transformation of the balance sheet of ICICI Ltd., over a five year period from 1997 to 2001, it can be concluded that the FI was working on a strategy to diversify its loans portfolio by exiting from the long term manufacturing sector project finance to short / medium term corporate lending. Clearly the FI had strategically embarked on repositioning itself, from a DFI catering largely to the project finance requirement of the industry to a provider of a variety of financial products, including the products for the retail segment and in the process, acquiring an asset profile more akin to the profile of assets, on a bank's balance sheet. A glance at the table below would eloquently depict the transformation.

Table 3

(In percentage to total credit at March 31)

Asset Type	1997	1998	1999	2000	2001
Manufacturing sector project finance	73.1	58.3	49.2	40.8	35.1
Oil, gas and petrochemical project finance	9.2	8.7	13.1	12.6	8.3
Infrastructure project finance	8.6	13.8	13.3	13.6	13.6
Corporate lending (Non project finance)	9.1	19.2	24.3	32.2	39.8
Retail lending	-	-	0.1	0.8	3.2
Total	100	100	100	100	100

Source: 46th annual report and accounts 2000-2001 of ICICI Ltd.

3.3.3 In tune with the policy stance of RBI, that the principle of Universal Banking was a desirable goal, but at the same time the banks have certain special characteristics and as such any dilution of RBI's prudential and supervisory norms for conduct of banking business, would be inadvisable and to this end a DFI would need to prepare a transition path in order to fully comply with the regulatory requirements of a bank, the proposal of the ICICI Ltd., for conversion into a bank was put to stringent scrutiny. The bank had to ensure that the fair valuation of the assets of the ICICI Ltd. before merger was completed to its satisfaction and provisioning requirement towards shortfall in the value of advances and investments was duly carried out in the books of ICICI Ltd., before the entities were merged. No relaxation was given for compliance with SLR / CRR requirements, income recognition, asset classification and provisioning norms, compliance with Sections 6 and 19(1) of B. R. Act, 1949 regarding the permissible banking activity for the subsidiaries of a bank, compliance with Section 19(2) of B. R. Act, 1949 relating to limit placed on investment in any company by a bank to the extent of 30% of its own capital or 30% of investee company's capital, compliance with Section 20 regarding prohibition on connected lending, etc. The relaxations were given to the bank in respect of shares acquired by way of assistance to project finance by ICICI Ltd., which could not be offloaded quickly and, therefore, were kept out side the limit of 5% on exposure to capital market for five years. Any incremental accretion to the equity investment as a part of project finance by the bank, however, was to be reckoned within the exposure limit on equity for the banks. The merged entity was also exempted by Government of India for five years, from the provision of Section 12 of the B. R. Act, 1949, which prohibits issue of preference shares by a banking company as ICICI Ltd. had outstanding preference share capital of Rs.350 crore, acquired under the scheme of merger with ITC Classic Finance Ltd. These exemptions were given more by way of taking a pragmatic view of the bank's position and giving it sufficient time for unwinding its portfolio of equity and preference shares, acquired in its previous incarnation. Similarly , the merged entity was advised to apportion a share of 50% of incremental lending to priority sector, so as to achieve the norm of 40% for priority sector lending at an early date. The interest of provident funds (PFs), which had invested in the debt instruments of ICICI Ltd. as PFI, was protected by transferring the Government guarantees on such instruments to the merged entity, even after conversion and consequent loss of PFI status.

3. 4 Current efforts by DFIs for similar transformation:

3.4.1 At present, the IDBI is in the process of conversion to a commercial bank. It had submitted in November 2001 a proposal for conversion into a bank to Govt. of India, MOF, wherein it had sought merger with another bank through amendment to the provisions of IDBI Act, for providing an enabling legal framework for merger and to set out the scheme for merger in addition to provision for certain other exemptions and concessions, which the merger would necessitate. Subsequently, it was announced in the budget speech for 2002-2003 of the Finance Minister, that IDBI would be corporatised. Accordingly, a new approach, of repealing the IDBI Act, 1964 in its entirety by passing a Repeal Act in the Parliament and building in the Repeal Act itself, various relaxations and concessions as well as the provision to confer the status of a bank on the DFI after conversion into a company, so as to obviate the need for grant of a banking licence by RBI under the BR Act, was adopted. A bill to this effect was introduced in the Parliament in December 2002. After necessary deliberations on the bill, the IDBI (Transfer of Undertaking and Repeal) Act, 2003 was passed by the Parliament and notified by the Government of India on December 30, 2003. However, the new banking entity, sought to be created by the Repeal Act, will come into being on the appointed day which is yet to be notified by the Government. Some notable features of the Repeal Act are as under :

(i) On the appointed date the undertaking of the IDBI would vest in the company to be formed and registered under Companies Act, 1956 under the name Industrial Development Bank of India Ltd.

(ii) The company shall be deemed to be a banking company under Section 5(c) of BR Act, 1949 and will not be required to obtain a banking licence from RBI under Section 22 of BR Act, 1949.

(iii) The company shall not be required to maintain for five years, from the appointed day, the prescribed percentage of liquid assets required to be maintained under Section 24 of the said Act. (SLR)

(iv) Central Government may in consultation with RBI direct by notification that any of the provisions of BR Act shall not apply to the company or shall apply with such exceptions, modifications and adaptations as may be specified in the notification.

3.4.2 IDBI, unlike ICICI Ltd., is being sought to be converted into a bank on a stand alone basis. For a new entrant to banking it will be very important to position itself correctly to stand up to the competition. There has been contraction of the balance sheet of IDBI over last 3-4 years. However, it has a preponderance of assets in the form of long term project finance. It is also carrying large amount of NPAs on its balance sheet and would require a substantial amount of provisioning for cleaning up. The provisioning requirement would further increase after migrating to stricter norm for classification of NPAs (both substandard and doubtful) as applicable to banks. The DFI has already made a request to the Government for infusion of funds. IDBI is also in touch with RBI to sort out various legal, regulatory and operational issues.

3.5. Lessons learnt from the conversion of ICICI into a bank

The WG has reviewed the experience of only one DFI, i.e. ICICI Ltd., which has so far successfully converted into a bank. The organisational dynamics of ICICI Ltd. was different from the other DFIs especially in the public sector; therefore, the exact replication of its experience by others may not be possible. However, some tentative conclusions can be drawn from the experience of ICICI Ltd., which can serve as reference points and the underlying hypothesis can be further tested by applying these principles to future attempts at conversion by any of the DFIs. The conclusions are as under :

3.5.1 Existing banking platform for conversion

A ready banking platform would greatly facilitate the conversion of a DFI into a bank. A DFI by forward or backward integration into a bank would land at a higher point on a learning curve in terms of banking experience and operational readiness. A ready infrastructure of branch network, operating procedures, technology platform, skilled manpower, etc., will make the transformation much smoother and efficient than conversion of a DFI on a stand alone basis and attempting to build the entire banking infrastructure from the scratch. The process of transformation on a stand alone basis would require higher degree of change management skills and may have adverse effect on the operations, unless sufficient and long preparations are made for conversion. The asset liability management could cause serious concern in case of conversion on stand alone basis. The assets liability mismatch could arise since the deposit base of the converted entity would build up only gradually. Unless the bank has ready and liquid assets to discharge its short and medium term liabilities or alternatively it is permitted to raise resources through bond issue, serious liquidity problems could arise. The teething problem would be manageable in case of a DFI merging with a bank of a size commensurate with the balance sheet of DFI.

3.5.2 De-risking and diversification of loan portfolio

Long term project finance is a risky proposition for any financial intermediary and more so for a DFI whose loan portfolio is almost exclusively comprised of project financing. Therefore, in preparation for conversion to a bank the DFI should consciously scale down the proportion of project financing by resorting to diversified products, e.g., structured finance and innovative financial techniques. It would be much easier for DFI to transform to a bank if its asset profile, is poised somewhere between a DFI and bank's assets profile rather than exclusively a DFI's asset profile. A bank's liquidity profile is very crucial from a systemic point of view and therefore the regulator would also be comfortable with a bank, which would not pose any risks to the system because of its highly illiquid asset portfolio.

3.5.3 Flexibility of organisational structure

A flexible and agile organisational structure is a pre-requisite for meeting the challenges in a competitive environment. A company structure possesses the attributes of operational flexibility and is best suited for the role of a financial intermediary. Therefore, any DFI seeking transformation to a bank should necessarily migrate to the structure of a company, preferably with a large and diversified share holding .

3.5.4 Correct positioning and business strategy

The choice of the target clientele, appropriate business and product mix to be offered, in face of the acute competition in the banking sector and mechanism for delivery of banking services and compliance with statutory and regulatory requirements, over a self determined time horizon despite relaxations given for a specified time period, should be formulated well before embarking on conversion to bank and there should be ongoing monitoring of the business and strategic plan till the entity is fully integrated into the banking system.

3.5.5 Availability of management skills

In an organisation transforming to a new role, there would be a significant need for skilful change management, by retraining and equipping the managerial personnel with new set of skills and facilitating their adaptation to a new working style and environment. An organisation undergoing a transformation must give top priority to this aspect.

3.5.6 Brand Equity

The brand image of an organisation would determine its success or failure in any role. A good image has to be assiduously built over a long time span and a poor image which can not be shaken off easily would be a hindrance in the transformation process. A DFI possessing brand equity can in a very short time establish itself in the market after conversion into a bank.

3.6 Regulatory Framework for transition of DFI into bank:

3.6.1 A regulatory framework would be necessary to facilitate the smooth migration of a DFI into a bank . The objective of the framework would be not to dilute the rigours of the regulation for banks, but to take a pragmatic view on certain regulations and to defer their application for a specified period of time to allow the newly created bank to smoothly adjust its asset pattern to the requirements of prudential/ statutory regulation. On grounds of practical considerations, the entities may need relaxations in the application of the regulations relating to restrictions on equity holdings acquired by way of project finance and lending to priority sector. The relaxations may, however, be given only for a specified time-period of 3 to 5 years in respect of legacy portfolio of assets as on the day of conversion and the incremental portfolio should be subject to the full rigour of regulations from the inception of the converted bank.

3.6.2 No relaxation should be given, unless mandated by statute, from the prudential regulations such as minimum capital requirements, income recognition, asset classifications and provisioning norms, capital adequacy prescriptions, maintenance of CRR and SLR, building up of reserve funds besides other regulations relating to drawing of accounts and audit, permissible banking business, restriction on common directors and connected lending etc.

Chapter IV

Regulatory framework for DFIs

4.1 Purpose of RBI regulation and its legal responsibilities and powers

RBI regulation covering financial intermediaries is premised on two primary factors – protecting depositors' interest, in case public deposits are accepted, and the systemic stability considerations. The responsibility and associated regulatory and supervisory powers are conferred upon RBI under the Banking Regulations Act, 1949 in regard to banks and in RBI Act, 1934 in regard to non-banking institutions.

4.2 Assessment of regulatory framework for existing DFIs

4.2.1 Regulation of DFIs during the period 1964 to 1990

It may be observed that banks are a part of the payment system and 'creators' of credit. RBI's regulation over them has historically been far more comprehensive than that over non-banking institutions (NBIs), which include FIs established by statute and NBFCs. While the comprehensive legislation and regulations concerning banks have been in place for a long time under the BR Act, 1949, the regulation on NBIs was introduced comparatively late in 1964 when by an amendment to the RBI Act, 1934 a new Chapter IIIB was inserted in the Act to give necessary powers to the RBI to regulate the deposit acceptance activities of the NBIs. Significant amendments to the Chapter IIIB were effected in 1974 and 1997 vesting the RBI with greater powers to exercise control over the NBIs, in particular over NBFCs.

Broadly speaking, under the Reserve Bank of India Act, 1934, the terms 'Non-Banking Institutions' (NBI), 'Financial Institutions' (FI) and 'Non-Banking Financial Companies" (NBFC) are defined as follows.

"Non-banking institution" means a company, corporation or co-operative society. The term "financial institution" (FI) means any non-banking institution which carries on as its business or part of its business any of the activities such as the financing of any activity other than its own; the acquisition of marketable securities; letting or delivering of goods under a hire-purchase agreement; insurance business; chits or kuries business and running schemes involving collection of monies and awarding prizes or gifts or disbursing monies in any other way. However, the term does not include any institution, which carries on as its principal business, agricultural operations; or industrial activity; or the purchase or sale of any goods (other than securities) or the providing of any services; or the purchase, construction or sale of immovable property. The term "non-banking financial company" means a financial institution which is a company; a non banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner; and such other non-banking institutions as RBI may specify.

Thus, it may be noted that RBI had been vested with certain powers over NBIs including DFIs and NBFCs since 1964. However, till about 1990, the thrust of RBI's regulatory action remained confined to the deposit taking activities of the NBIs. There was practically no regulation of FIs other than NBFCs till 1990.

Around 1990, the significant growth and diversification of Indian financial system in some preceding years, coupled with its development from the short end to the long into a continuum, made it necessary for the RBI to take an integrated view of the operations of banks and select all India FIs for providing more comprehensive basis to the formation of monetary and credit policies. Accordingly, certain steps were initiated by RBI to widen the scope of its oversight beyond banks, so as to gradually encompass the broader financial system.

As a part of the decision to undertake active monitoring and regulation of FIs, in 1990, RBI took a close look at the powers available to it under the RBI Act, 1934 in relation to FIs and it was noted that even though the provisions of the Chapter IIIB of RBI Act were introduced in the context of the NBIs receiving deposits, the RBI had been empowered under the provisions of RBI Act to require the FIs, *independent of their deposit taking activities,* to furnish information to RBI and it was also sufficiently empowered to carry out inspection of FIs. Further, it was noted that RBI also had powers to give directions to FIs not only in relation to acceptance of public deposits but also in matters related to conduct of business by the FIs *provided* RBI was satisfied that it was necessary to do so for the purpose of regulating the credit system of the country to its advantage *and* in issuing such directions to FIs, RBI has due regard to the conditions in which, and the objects for which, the FI has been established, its statutory responsibilities, if any, and the effect the business of such FI is likely to have on trends in the money and capital markets.

4.2.2 RBI's approach towards regulation of DFIs from 1991 till date

During 1990-91, as an adjunct to the monetary and credit policy, RBI had started monitoring the activities of select large size FIs, viz., IDBI, IFCI, ICICI Ltd., IRBI, EXIM Bank, NABARD, SIDBI, NHB, LIC, GIC and UTI. Accordingly, to know the size and nature of the financial flows, particularly the total debt and investment instruments which go to finance the non-financial sectors of the economy, a system called Financial Institutions Information System (FIIS) was introduced.

Subsequently, the Committee on Financial System (Narasimham Committee-I) had recommended, in its report released in November 1991, that a quasi-autonomous Banking Supervisory Board might be set up under the aegis of RBI and it should have supervisory jurisdiction not only over banks and NBFCs but also over FIs. Near about the same time, the committee appointed by Governor, RBI to enquire into the securities transactions of banks and FIs (Janakiraman Committee) had, in its first report, brought out several serious irregularities in these securities transactions. Following the recommendations of the above two committees, approach of RBI towards regulation and supervision of the select FIs monitored by it underwent a change. Beginning from issuance in 1992 of guidelines relating to transactions in securities held in the investment portfolio by the select FIs (one of the follow up measures on the Janakiraman Committee), RBI started issuing regulatory instructions to the FIs. After prolonged consultations with the select FIs and Government of India, RBI extended prudential norms relating to income recognition, asset classification and provisioning as also the capital adequacy to the select DFIs, in phases, since 1994. Besides, since 1995, after the setting up of the Board for Financial Supervision (BFS) in keeping with the recommendations of the Narasimham Committee-I, RBI also started conducting periodical inspection of these DFIs.

Later, in 1997, in the wake of certain adverse developments in the NBFCs sector, RBI Act, 1934 was further amended extensively and RBI regulation over NBFCs was made quite comprehensive. Some of the select FIs already being regulated and supervised by RBI e.g. ICICI Ltd. and IFCI Ltd., which were constituted as companies, got covered by the definition of NBFCs as given in the amended RBI Act, 1934. RBI, however, on a case to case basis and for specific periods rolled over, did not apply the regulatory guidelines for NBFCs to them and instead continued to regulate and supervise them only as DFIs.

Notwithstanding the above-mentioned developments that took place from 1964 till date in regard to the RBI's regulation over DFIs, it is observed that there are still many areas in which the regulatory structure for DFIs differs significantly from that applicable to banks and NBFCs. The differences are discussed hereunder.

4.3 RBI regulation over DFIs

Whenever a bank emerges on the Indian scene, it automatically gets covered under RBI's regulatory framework in terms of BR Act, 1949. In respect of NBIs it is observed that two types have emerged on the Indian scene. The first comprises the statutory FIs set up under their respective statute. The second type comprises the FIs that are set up as companies under

Companies Act, 1956, and hence, by definition, are NBFCs. Since the 1997 amendment to the Chapter IIIB of RBI Act, 1934 *all NBFCs* have to adhere to the provisions of the Chapter IIIB and the guidelines issued by RBI thereunder unless specifically exempted from doing so by RBI. In regard to the FIs established under the statute, over which RBI has been given enabling powers under the RBI Act, 1934, RBI has been using its discretion in deciding which of the FIs are to be regulated and supervised. The entity wise decisions so far taken in this regard appear to have been taken on a case to case basis. At present RBI regulates and supervises only nine select DFIs, viz., IDBI, IFCI Ltd. TFCI Ltd., IDFC Ltd., IIBI Ltd., EXIM Bank, NABARD, NHB and SIDBI. Of these, IFCI Ltd. TFCI Ltd., IDFC Ltd. and IIBI Ltd., being companies, are, by definition, NBFCs. As stated in para. 4.2.2, they continue to be regulated and supervised by RBI as DFIs.

In this connection, it is also noted that under the provisions of RBI Act, 1934, only NBFCs are required to get registered with RBI. There is no provision for similar registration with RBI of the FIs established by statute. On account of this it is possible that, at any given time, RBI may not be formally notified with regard to all FIs established by statute.

4.4 Appropriate regulatory framework for DFIs having common characteristics

4.4.1 Common characteristics of DFIs

As stated earlier in the report, there is no clear definition of the term “Development Financial Institution”. However, it is recognised that as a category, DFIs are characterised by the following functions.

They are engaged in financing of sectors of economy where the risks involved are beyond the acceptance limits of commercial banks. Also, DFIs are mainly engaged in providing long-term assistance. DFIs generally meet the credit needs of riskier but socially and economically desirable objectives of the State Policy.

4.4.2 Approach of the Working Group to regulation of DFIs

The basic approach of the Working Group is that the DFIs being non-banks, are functionally more akin to NBFCs than banks and, therefore, should, as a general rule, be subject to the general principles of NBFC guidelines. However, it is also recognised that the dominant theme of NBFC guidelines is to protect the depositors’ interest and to ensure the viability of the NBFCs for the purpose. In the case of DFIs, it is observed that most of them either do not accept public deposits or where they do so, the public deposits constitute a very small proportion of their total liabilities / resources. As such, seen solely from the viewpoint of protecting depositors’ interest, these DFIs as a group may not give rise to RBI’s regulatory or supervisory concerns. However, on account of large-scale borrowings resorted to by these DFIs by way of bonds issued, from domestic banks, Provident Funds, Insurance Companies, Trusts and general public, failure of any of the larger DFIs could have adverse effect on the entire financial system. The regulation of these DFIs should, therefore, be so designed as to ensure that the regulatory framework along with the committed Government support available to the DFI works towards ensuring their financial soundness so that the overall systemic stability is not endangered.

4.4.3 Keeping the above-mentioned approach in mind, the Working Group compared the regulatory framework under which the banks, select DFIs being currently regulated by RBI, NBFCs and RNBCs are functioning in India. For the purpose of this comparison, besides the prudential norms, the other regulations governing these institutions were also examined and it was noticed that the regulatory framework for DFIs needed some further strengthening.

4.4.4 Identification and Categories of DFIs

For the purpose of the exercise taken up by the Working Group, all institutions regarded or notified as PFIs under Section 4A of Companies Act, 1956 (list appended at Annexure II) and the SIDCs not so notified are being reckoned as DFIs, excluding the undernoted institutions. The reasons for their exclusion are given below.

(i) ICICI Ltd. and SCICI Ltd.: After merger of the latter with it, ICICI Ltd has since converted to a bank.
(ii) UTI, which is regulated by SEBI.
(iii) LIC, GIC and other insurance companies viz., NIA, NIC, OIC and UII, which are regulated by IRDA.
(iv) The two Venture Capital Funds viz., IFCI Venture Capital Funds Ltd. and ICICI Venture Funds Management Co. Ltd., which need not be regulated by RBI as DFIs as size wise they are too small to be of systemic significance.
(v) HUDCO Ltd., which, being a housing finance company, is being regulated by NHB.
(vi) National Co-operative Development Corporation and National Dairy Development Board recently notified by GOI as PFIs: they do not appear to be financial institutions in the classical mould.

The WG noted that out of the DFIs identified by it as above, two other institutions viz., IDBI and IFCI Ltd. are well on their way to transform into banks and, therefore, need not be taken into consideration as DFIs. After all the exclusions, only three categories of institutions remain in the list of DFIs. The first category is the all India DFIs established by statute viz., NHB, SIDBI, NABARD and EXIM Bank. The second is the state level institutions set up by statute viz., SFCs. The third is the DFIs that have been constituted as companies under the Companies Act, 1956 and hence are, by definition, NBFCs. These are IIBI Ltd., TFCI Ltd., PFC Ltd., REC Ltd., IRFC Ltd., IREDA Ltd., NEDFi Ltd., IDFC Ltd., and SIDCs (whether notified as PFIs or not).

In respect of the above categories of institutions the Working Group makes the following recommendations.

4.4.5 All India DFIs established by statute

As mentioned above, there remain four all India DFIs established by statute viz., EXIM Bank and three Refinancing Institutions - NABARD, SIDBI and NHB for consideration by the WG. It is observed that these four institutions will continue to function as DFIs. As these institutions also act as instruments of public policy, the WG is of the view that Central Government should oversee their functions arising out of such public policy. However, considering the systemic significance of these institutions and their linkages with other financial intermediaries, the WG recommends that RBI may continue to regulate these four institutions, purely from the considerations of systemic stability irrespective of whether they accept public deposits or not. It is also observed that RBI has ownership interest in NABARD and NHB. As there is a scope for a conflict of ownership and regulatory / supervisory interests, the WG recommends that the RBI may divest its stakes in these two institutions.

To varying degrees NABARD, SIDBI and NHB also shoulder responsibilities of regulating and / or supervising the financial intermediaries falling under their respective domains - Housing Finance Companies in the case of NHB, SFCs and SIDCs in the case of SIDBI, and State Co-operative Banks, District Central Co-operative Banks and Regional Rural Banks in the case of NABARD. RBI, however, may have to ensure that the standard of regulation and / or supervision exercised by the NHB, SIDBI and NABARD over the institutions falling under their respective domains is broadly at par with that maintained by RBI.

4.4.6 State level DFIs established by statute

There are 18 SFCs of which 17 were set up under the SFCs Act 1951, while Tamil Nadu Industrial Investment Corporation Ltd., was incorporated under the Companies Act, 1956 and functions as a SFC. As stated in para. 2.4.1 in Chapter II, it is felt that these 18 SFCs have outlived their utility in the present context and should be phased out within a definite time frame. As regards their regulation in the interim period, the WG makes the following observations and recommendations.

It is observed that there is lack of clarity as to regulatory arrangement for SFCs. Till the year 2000, IDBI was customarily prescribing prudential regulation for the SFCs. Pursuant to the enactment of the SFCs (Amendment) Act, 2000, SIDBI carried on with the practice. However, neither IDBI had nor SIDBI has any statutory powers either under their own statute (i.e., IDBI Act or SIDBI Act) or under the SFCs Act, 1951 for issuing any instructions / directions to the SFCs. The powers for giving directions to the SFCs in the matters of policy are vested exclusively in the respective State Governments under the provisions of Section 39 of the SFCs Act, to be exercised in consultation with and after obtaining the advice of SIDBI (of IDBI, earlier). At the same time, as an enabling measure RBI is vested with adequate powers under Section 45L of the RBI Act to issue directions even to the SFCs, since they fall within the definition of the term “financial institution” as contained in Section 45-I(c) of the Act. In view of this position, the WG recommends that suitable regulatory and supervisory powers in respect of SFCs should be vested in SIDBI.

4.4.7 DFIs which are companies

In respect of the DFIs which have been constituted as companies under the Companies Act, 1956 and hence are, by definition, NBFCs (listed in para 4.4.4 above), the WG notes that IIBI Ltd., TFCI Ltd., and IDFC Ltd., are being regulated by RBI as FIs and certain others, though they are NBFCs, have been exempted by RBI from regulations applicable to NBFCs as they are Government Companies. The WG recommends that as all such institutions perform developmental functions, they should be subjected to uniform and discrete regulation. For this purpose, they could be classified as a new category of NBFC called "Development Finance Companies" (DFCs). The decision to include or continue a company engaged in development financing in the category of DFCs may be taken by RBI, on the basis of the business conducted by the institution, its systemic significance and geographical reach. As a general rule, state level or region specific NBFCs, established for developmental work but of small size might not qualify for the status of DFCs. The Working Group, therefore, recommends that SIDCs and NEDFi may not be treated as DFCs and subjected to the proposed rigorous regulations for DFCs. However, in select cases, based on the need therefor, RBI may include such companies under DFCs for the purpose of regulation.

4.5 Recommendations as to regulatory framework for the four DFIs/ DFCs

As stated in para. 4.4.2 above, the basic approach of the Working Group is that the four DFIs established by statute viz., EXIM Bank and three Refinancing Institutions - NABARD, SIDBI and NHB, and DFCs being non-banks, are functionally more akin to NBFCs than banks and, therefore, should, as a general rule, be subject to the general principles of NBFC guidelines. However, considering the greater systemic significance of these DFIs and DFCs as also the fact that some of them are already subject to a host of regulations applied to them by RBI, the WG recommends that the following essential regulations may be applied to the four DFIs / DFCs, except that the recommendations relating to registration with RBI, entry point norms and composition of Board of Directors indicated below may not be made applicable to the four DFIs.

4.5.1 Registration requirements

The WG recommends that considering the structural, functional and operational flexibility available to companies as opposed to statutory bodies, as a general policy, all institutions meant for development financing that might be set up in future may be constituted as companies (DFCs). As a category of NBFCs, DFCs will be required to be registered with RBI like other NBFCs.

4.5.2 Entry point norms

The WG recommends that considering the nature of business of development financing, the entry point norm should be set sufficiently high to keep out non-serious players. Accordingly, it is recommended that an entry point norm of net owned funds of Rs. 100 crore should be prescribed for DFCs.

4.5.3 Maintenance of liquid assets & transfer of profit to reserve fund

DFCs accepting public deposits should maintain liquid assets as provided for other NBFCs in terms of Section 45-IB of RBI Act, 1934. Similarly, DFCs will also be statutorily required to transfer certain proportion of their annual profits to reserve funds, as required in term of the provisions of Section 45-IC of the RBI Act, 1934.

4.5.4 Resource raising norms

The WG has noted that the guidelines issued by RBI to the select nine FIs currently regulated by it prescribe that the outstanding of total resources mobilised at any point of time by an FI, including various short-term and medium-term funds mobilised under the 'umbrella limit', as prescribed by the Reserve Bank, should not exceed 10 times its net owned funds (NOF) as per its latest audited balance sheet. The 'umbrella limit' applies to the borrowings made by a FI though term deposits, term money borrowings, certificates of deposits (CDs), commercial papers (CPs) and inter-corporate deposits (ICDs) and it has been specified that the aggregate borrowings through these instruments should not any time exceed the net owned funds of the FIs concerned, as per its latest audited balance sheet.

The WG is of the view that the current RBI prescription for select FIs restricting their total resources mobilised to 10 times their NOF serves as a benchmark for controlling expansion of resources by DFIs. The same may be extended to all DFCs. However, restrictions on access to short-term and medium-term resources by way of an 'umbrella limit' need to be revisited in the context of the ALM guidelines issued to DFIs regulated by RBI, which prescribe, among other things, gap limits of 10 and 15 percentages for the first two time buckets of 1 to 14 days and 15 to 28 days. Further, there is a case for providing to the institutions engaged in development financing, larger access to short and medium term resources so as to enable them to reduce their cost of funds.

The WG recommends that the above-mentioned umbrella limit placed on DFIs in regard to resource raising may be removed / not applied in the case of healthy DFIs which include DFCs and EXIM Bank, NHB, SIDBI and NABARD (which would continue to remain under RBI regulation) subject to the condition that public deposit will not exceed 1.5 times NOF as prescribed for loan / investment companies. For this purpose, the entities which have a minimum CRAR of 15% and net NPAs of not more than 5% and are fully complying with the above mentioned ALM guidelines applicable / to be applied to them might be considered as 'healthy'.

4.5.5 Control over lending and investment activities

The Working Group has noted that although, as a general policy, RBI does not interfere in the lending operations of the FIs, from time to time, RBI has issued directions to the FI being regulated by it, in regard to their lending activities when issuance of such directions was necessitated for regulating the country's credit system. Accordingly, RBI has laid down guidelines for the select FIs in respect of their investment operations, grant of bridge loans, underwriting commitments, interest rate surcharge on import finance, export credit, monitoring of end-use of funds, lending to NBFCs, recovery of dues relating to NPAs, prohibition on connected lending etc. The WG is of the view that RBI may adopt similar approach in respect of all DFCs keeping in view their systemic importance.

4.5.6 Prudential norms

The Working Group has examined the structure of prudential norms relating to income recognition, asset classification, provisioning and capital adequacy as also exposure norms etc. for the banks, NBFCs and DFIs being regulated by RBI. The Working Group recommends that as these norms flow from functions of the DFCs and not from their institutional form, the norms prescribed by RBI for the DFIs currently being regulated by it should be extended to all DFCs on account of their functional similarity. As stated in Chapter II para. 2.3.3, the WG recommends that the concessional risk weight of 20%

allowed for exposure by banks, FIs, NBFCs and RNBCs for investments in the bonds issued by certain PFIs may be done away with.

Further, the WG recommends that, in view of the Government support available to DFCs and economic desirability of their activity, DFCs may not be required to maintain 15% CRAR as prescribed for NBFCs. Accordingly, the CRAR for the DFIs may be retained at 9% as at present and there is no immediate case for putting them at par with other NBFCs.

4.5.7 Accounts

Considering the systemic significance of DFCs, and as a measure for facilitating better regulatory oversight over DFCs and securing more transparency in their functioning, the WG recommends that the DFCs may be required to submit their audited annual accounts to RBI within a specified time after the end of the accounting year of the DFC.

4.5.8 Appointment and removal of auditors

Keeping in view the systemic significance of DFCs, the WG recommends that, as is being done in the case of banks, DFCs too may be required to obtain prior approval of RBI before appointing, re-appointing or removing any statutory auditor or auditors.

4.5.9 Composition of Board

The Working Group recommends that as in case of banks, RBI should have powers to prescribe the composition of Board of DFCs so as to ensure inclusion in the Board, of professionals having special knowledge or practical experience in the matters of finance, accountancy, management, industry or any other area of importance, which RBI might consider useful to the DFC.

4.5.10 Corporate Governance

The Working Group noted that in line with the action taken by SEBI, of circulating to all stock exchanges the recommendations of the Committee on Corporate Governance constituted by it for implementation by listed entities as part of the listing agreement, RBI had issued appropriate guidelines for adoption by those commercial banks which are listed in stock exchanges so that they can harmonise their existing corporate governance requirements with the requirements of SEBI, wherever considered appropriate. The WG notes that the listed DFCs would anyway be subject to SEBI guidelines and it may be advisable for all other DFCs also to adopt the broad principles of corporate governance enunciated in the SEBI guidelines. Accordingly, it is recommended that RBI may consider issuing suitable guidelines to DFCs in the matter.

4.6 Recommendations as to supervisory arrangement for the four DFIs and DFCs

The WG noted that, in respect of the supervision of the select FIs being regulated and supervised by RBI, a well established supervisory process exists in RBI which involves off-site surveillance, annual on-site inspection on CAMELS pattern and placing the summary of findings of the inspection and follow-up action to the Board for Financial Supervision. The WG also noted that an Informal Advisory Group (IAG) on Regulation & Supervision of FIs constituted in March 1999 by the Governor, RBI in consultation with the Government of India, Ministry of Finance, to look into the various aspects of regulation and supervision of FIs had submitted its report in May 2000 and its recommendations were accepted for implementation, in principle, by the Board for Financial Supervision (BFS) at its meeting held in November 2000 and accordingly, the process of inspection was suitably refined/ amended by RBI in 2001. As the above mentioned supervisory process is working satisfactorily, the WG recommends that the same may be extended to supervision of all DFCs and continued in case of EXIM Bank, NHB, SIDBI and NABARD as hitherto.

Chapter V

Non-Banking Financial Companies (NBFCs)

5.1 Introduction

As mentioned in the previous Chapter, Non-Banking Financial Companies are companies incorporated under the Companies Act, 1956 and conducting financial business as their principal business. The companies whose principal business is other than financial business (viz. companies with the principal business of agricultural operations, industrial activities, trading, services and construction) are known as non-banking non-financial companies. Any company engaged in the business of lease finance, hire purchase finance, investments in securities, grant of loans in any manner including bills discounting, chit fund, insurance, stock broking, merchant banking, housing finance or that of accepting deposits, is identified as NBFC. The NBFCs in India are broadly classified on the basis of their principal activities as under. The names of their regulatory authority are also indicated against each type of NBFC:

Table 4

Type of NBFC	Name of the Regulatory Authority
Equipment Leasing Companies [EL]	Reserve Bank of India
Hire Purchase Finance Companies [HP]	Reserve Bank of India
Loan Companies	Reserve Bank of India
Investment Companies	Reserve Bank of India
Residuary Non-Banking Companies	Reserve Bank of India
Miscellaneous Non-Banking Companies (Chit Fund)	Reserve Bank of India* and Registrars of Chits of the concerned States
Mutual Benefit Finance Companies (Nidhis and Potential Nidhis)	Department of Company Affairs of GoI
Micro financial companies	Department of Company Affairs of GoI
Housing Finance Companies	National Housing Bank
Insurance Companies	Insurance Regulatory and Development Authority
Stock Broking Companies	Securities and Exchange Board of India
Merchant Banking Companies	Securities and Exchange Board of India

* deposit taking activity only

Deposit taking activities of non-financial companies are regulated by Department of Company Affairs (DCA) of Government of India under section 58A of the Companies Act.

5.2 Statutory powers of RBI

Reserve Bank regulates and supervises non-banking financial companies (NBFCs) as defined in Section 45-I(f) read with Section 45-I(c) of RBI Act, 1934. RBI Act as amended in January 1997 vests considerable powers with RBI for effective regulation and supervision over NBFCs with a view to ensuring that they function on sound and healthy lines and only well run NBFCs are allowed to access public deposits because public interest involved in it needs to be protected. Accordingly, RBI has put in place a set directions to regulate the activities of NBFCs under its jurisdiction. Certain other directions, issued by RBI, are aimed at controlling the deposits of chit fund companies, the business activities of residuary non-banking companies and setting up prudential norms for all the NBFCs. The regulations issued to NBFCs, cover acceptance of public deposits by the four categories of NBFCs viz., EL, HP, Loan and Investment.

5.3 Regulations over NBFCs accepting public deposits (PD Companies)

Adequate safeguards have been instituted in the regulatory framework for acceptance of public deposits by prescribing detailed regulations covering deposit taking activities of NBFCs in the category of equipment leasing, hire purchase finance, loan and investment companies viz., the requirement of minimum investment grade credit rating, quantum of public deposits, interest rate on deposits, brokerage, period of deposits, etc. RBI has also prescribed disclosure norms and submission of periodic returns on various aspects of the functioning of these companies. The prudential norms on income recognition, provisioning etc., akin to those applicable to the scheduled commercial banks, have been stipulated. These regulations are modified as and when felt necessary in response to the market requirements and other developments in the system. RBI has further introduced ALM guidelines for NBFCs having an asset size of Rs. 100 crore or with public deposits of Rs. 20 crore and above. These companies are subjected to on-site examination and off-site surveillance.

5.4 Regulations over NBFCs not accepting public deposits (non PD Companies)

The companies not accepting public deposits are regulated in a limited manner. Such companies are not required to furnish any statutory return to the Reserve Bank unlike the deposit accepting NBFCs. The compliance of regulatory framework by these companies is to be monitored by RBI on the basis of exception report of the statutory auditors as prescribed by RBI, the Bank's market intelligence system and a check of the operations of a sample set of these companies, to ensure that they have not accepted public deposits and they continue to be eligible for holding the certificate of registration.

5.5 Financial Companies Regulation Bill, 2000

The regulatory structure pertaining to NBFCs as on date comprises the chapter IIIB of the RBI Act and the directions issued thereunder. A need has been felt over the years to bring forth a separate enactment covering the financial companies. Towards this, the Financial Companies Regulation Bill, 2000 (FCRB) has been drawn and placed before the Parliament. The Bill has been examined by the Standing Committee on Finance of Parliament, which has given its recommendations to the Government. These, inter alia, called for exclusion of non-deposit taking companies from the purview of FCRB. The changes in the Bill, in line with the recommendations of the Standing Committee and additional inputs which RBI has given to the Government on the subject, are expected to be carried out and the Bill approved by the Parliament in due course of time.

5.6 Profile of NBFCs

RBI's supervision of NBFCs since the amendment to the RBI Act in 1997 has shown that these companies are in a wide range in size - from the small with just the minimum prescribed NOF of Rs. 25 lakhs and assets built with this, to the large with deposits/assets of over Rs. 500 crore (RNBCs have deposits of very large size comparable to small sized banks and stand as a distinct set of NBFCs: these companies are examined separately in the next Chapter). In the category of deposit taking companies, as at March 31, 2003, 673 companies were subject to RBI Regulations and supervision; these had assets of an aggregate value of Rs. 36,584 crore and deposits of Rs. 4,434 crore. A sizewise break up of these is furnished below:

Table 5

NBFCs (EL,HP,Loan & Investment Cos) Accepting Public Deposits: March 31, 2003.

Range	No. of NBFCs	Amount of Assets	% to total assets	No. of NBFCs	Amount of public deposits	% to total public deposits
Up to 10 Cr	558	1268.20	3.47	628	437.06	9.86
10 Cr & < 20 Cr	33	463.08	1.27	16	212.39	4.79
20Cr & < 50 Cr	23	671.76	1.84	7	224.29	5.06
50Cr & < 100Cr	16	1079.54	2.95	11	739.79	16.68
>= 100Cr	43	33101.69	90.48	11	2820.63	63.61
	673	36584.27	100.00	673	4434.16	100

As regards NBFCs not accepting public deposits, 13746 companies of this category were registered with RBI; these companies also reflect a wide range of size and activities.

5.7 Recommendations

The terms of reference to the WG seeks advice as to whether NBFCs of large sized liabilities should automatically be brought under a separate category of NBFCs on the lines of categorizing DFIs. The WG has examined this question from the angle of regulations applicable to NBFCs and the proposals relating to DFIs set out in the previous chapter. The Group's observations on this question are furnished in the following paragraph.

It is seen that from the regulatory perspective, the emphasis on large size should not be exclusively related to a company's commitment towards public deposits and the protection of the depositors' interest involved in this. It should take into account the significance of the company's role in the financial system – its market related obligations, the manner in which its assets impact on the system etc., and other systemic considerations involved. On this basis, the WG is of the view that all NBFCs (other than RNBCs) carrying assets of value of Rs. 500 crore or above would need to be dealt with as a separate category of NBFCs. It is reported that about 43 companies of this size registered with RBI, fall under this category: 17 PD companies and 26 non-PD companies.

As discussed in the previous Chapter, DFIs, which are established as companies, undertake specialized financial activities; by nature these companies are large sized NBFCs. The regulations covering these have been examined and it is proposed that the companies be handled for regulation and supervision as a sub-set of NBFCs under the style Development Finance Companies and on a footing different from what is applicable to large sized NBFCs. The WG examined the manner in which RBI would need to focus on the potential of the large sized NBFCs (asset Rs.500 crore and above) to create aberrations in the financial system and monitor them as a distinct category. The group finds that as regards the PD companies in the set, the regulations and supervision applicable to them as on date fully address the systemic concerns relating to them. As opposed to this, RBI does not now oversee the non-PD companies as rigorously as it monitors the PD companies. While the regulations covering NBFCs lay down a detailed reporting system for the PD companies, for non-PD companies there is no requirement to submit to RBI their financial and other information relevant to systemic stability. The WG recommends that even though the non-PD companies are slated to be excluded from the purview of FCRB, RBI should put in place, as an initial measure, a system of collection at regular intervals of all information relevant to the systemic concerns pertaining to large sized non-PD companies. This system may also be specified for PD companies to the extent required. The information system may include, besides submission of annual financials, quarterly reporting of specific details of the company's assets and liabilities with focus on their linkages to the market, inter-group / inter-company and capital market exposures, and all other sensitive information. This initiative may be followed up with more rigorous measures, specific to any one or class of PD / non-PD companies, to prevent any threat to the systemic stability. The rigour may include direction covering composition of the board of the company, appointment / removal of statutory auditors, observance of corporate governance initiatives and where necessary, extension of select prudential norms. It may be noted that suitable enabling provisions would require to be built into the FCRB to provide for appropriate powers to RBI in this regard, even as the non PD companies as a whole stand excluded from the purview of the Bill / Act.

Chapter VI
Residuary Non-Banking Companies (RNBCs)

6.1 Introduction

In terms of chapter III B of the Reserve Bank of India Act, a non-banking financial company (NBFC) is a company which is a financial institution as defined or a company which has as its principal business, deposit collection under any scheme or arrangement or lending. RNBC is a sub-category of NBFCs. RNBC is a NBFC which receives deposits and is not one of the defined categories of NBFCs (i. e. leasing company, hire purchase finance company, loan company, etc.). RNBCs are classified as a separate category as their business, which has evolved over the years, does not conform to any of the other defined NBFC businesses. The developments over the years in the regulation of this group of entities have left the field now with only four companies which operate as RNBCs and are registered with RBI. As on 31 March 2003 these four companies carried an aggregate liability of Rs.15,061 crore to the depositors. A summary of the regulations which presently cover the RNBCs is given in the Annexure III. RBI supervises the companies through a mechanism of off-site surveillance, on-site inspection and commissioned audit.

6.2 RNBCs registered with RBI

Two of the registered RNBCs which are large sized have been into this business since 1932 and 1987 respectively. Other two companies had a recent entry into this line of NBFC activity. As on 31 March 2003 the aggregate deposits of the two large companies stood at Rs.15,058 crore and accounted for 99.98% of the deposits with all the RNBCs; 77.25% of the public deposits with all the NBFCs; and 1.18% of the aggregate deposits with All Scheduled Commercial Banks. It would, therefore, be worthwhile to examine the performance of the two large RNBCs in terms of significance of this class of companies as deposit taking entities and their compliance with extant RBI Regulations. There is also a need to review the supervisory concerns relating to this segment in general and from the two large companies in particular. It is reported that in the past the operations of these two companies had caused supervisory concerns to RBI. While one company had weak financials, the growth in deposits in the other company needed a great deal of RBI's attention to ensure that the company fully complied with the requirements of the investment and the specified pattern of asset cover for the depositors.

6.3 The characteristics of RNBCs

NBFCs, in general, are credited with tapping dormant savings with personalized approach from the household sector. RNBCs are a sub-section of NBFCs and they also mobilize deposits in the same manner. However, there are certain striking features in RNBCs. Although the RNBC Regulations permit the companies to access, borrowings from banks, financial institutions and corporates, secured debentures, etc., in practice, the four RNBCs have accessed only public deposits. Traditionally these deposits are in different categories in terms of collection process and maturity. In the large two RNBCs, around 24.9% of the deposits are in the form of daily deposits, 50.9% in other recurring deposits, and the balance 24.2% in fixed deposits. The maturities of these deposits, as specified in the Regulations, range between 1 year to 7 years. The RNBCs are permitted to fix the interest on these deposits at their discretion; however, to protect the interest of the depositors, in the Regulations, minimum rates of interest on deposits have been prescribed (now 3.5% on daily deposits;

5% on other deposits). Another feature is that the deposit business is conducted by RNBCs through their branches and through a wide network of agents. The agents comprise mostly individuals working on the basis of commission. In the case of one of the large RNBCs, the agency work is taken up by a partnership firm, which operates through its own branches, field staff and agents.
A striking feature of the deposits raised by RNBCs is the leeway given in the regulations to mobilize deposits without any restriction on the quantum of public deposits with reference to the NOF. In effect, as long as RNBCs deploy 80 per cent or more of their deposits in mandated securities, they are free to increase their deposits to any level. This is, of course, subject to the continued compliance with the laid down prudential norms, including CRAR.

As these companies have an unlimited access to public deposits they are required to invest the depositors' funds in Government securities, guaranteed bonds issued by the PSUs of the Central or State Governments, rated non-guaranteed bonds of PSUs, debentures of private sector companies, commercial papers, units of mutual funds, etc, the market value of which should at least be 80 per cent of the liabilities to the depositors. The remaining depositors' funds to the extent of 20% of the liability to the depositors or 10 times their NOF, whichever is lower, is allowed to be invested in any manner in securities and other assets, including non-financial assets as per the discretion of their board of directors. It is seen that as on date, the two large RNBCs carry, to a large extent within their discretionary portfolio, assets in the form of real estate, receivables from Revenue Department (TDS / Advance Tax), and investment in shares.

The WG has noted that, while the regulation of RNBCs by RBI needs to be viewed in the historical perspective of evolution of such companies and the concerns of RBI to protect the interest of depositors, the Group is of the view that there is a need for revisiting the existing regulatory structure in the current context.

6.4 Comparison of RNBCs with DFIs

The WG has examined the nature of operations of the RNBCs vis-à-vis the DFIs, the sources from which they raise funds and uses of these funds. It is seen that in the case of DFIs, the resources are mobilized in large amounts and through a variety of long-term securities offered in the market. In the case of RNBCs, their resources are altogether of a different nature comprising savings from individuals garnered under various deposit schemes involving daily, monthly collections and with maturities ranging from 1 to 7 years. The resource profiles of these two sets of institutions have no element of commonality.

In the area of deployment of funds, there is again a wide divergence between DFIs and RNBCs. The former is by nature in the business of taking exposures in debt and equity carrying inherent credit risks and long maturities. Because of the risk element, DFIs received in the past support in a variety of ways from the Government. In the case of RNBCs, the deployment of funds is strictly a matter of the regulations imposed on them. As explained earlier, eighty per cent of the deposits mobilized are to be deployed in Government securities/guaranteed bonds etc., and 20 per cent is available for deployment in the assets of the choice of the company. While there is some element of similarity in the use of the funds by DFIs and RNBCs, the nature of the assets and the maturities are at variance. Accordingly, even the asset pattern of DFIs differs from RNBCs.

Organisationally the DFIs are distinct and separate from RNBCs: DFIs are either chartered under Statute or publicly held companies, often owned by the Government and operate under policy prescriptions of the Government. On the other hand, RNBCs are closely held private companies, which are purely commercial in nature and with long time association in the business of deposit taking. In an overall comparison, the DFIs and RNBCs stand apart without any significant common characteristics.

6.5 Transformation dynamics of RNBCs into any definable category of NBFCs or DFIs

The WG has considered this issue at length and has deliberated on the feasibility of transformation of RNBCs into a regular NBFC/DFI category. The group also considered in detail the inputs on the subject it received from the large RNBCs.

As mentioned earlier, there is no commonality of characteristics between the RNBCs and DFIs. Therefore, the transformation of RNBCs into the DFI mould would be neither feasible nor desirable.

As regards the prospect of RNBCs transforming to the business and financial structure of NBFCs, the WG has noted that at present there are eight categories of NBFCs, four of which are insurance, housing finance, nidhis (including potential nidhis) and chit-funds carrying asset profiles entirely different from the asset profile of the RNBCs. Conversion of RNBCs to these four categories may not be appropriate. Turning to the other four categories namely, equipment leasing, hire purchase, loan and investment company, the WG finds that it may be possible for RNBCs to convert their asset profile to these categories.

Any such conversion would involve the companies submitting themselves to the regulations relating to the liabilities, especially NOF related restrictions on quantum of public deposits, applicable to these categories of companies.

The restrictions placed on NBFCs with respect to raising of public deposits are: EL or HP companies are allowed to raise public deposits up to 4 or 1.5 times their NOF depending upon their CRAR and availability of minimum investment grade credit rating for their fixed deposit programme. In the case of loan or investment companies, the entitlement for public deposits is 1.5 times the NOF subject to their having minimum CRAR of 15% and minimum investment grade credit rating for their fixed deposits. In case the RNBCs move on to any NBFC category, immediate compliance by them with the applicable regulations on public deposits would not be possible and regulatory relaxations would be required.

6.6 Need for limiting access to public deposits

While RBI may indicate the option available to RNBCs to move into the NBFC status, it is possible that the existing RNBCs – particularly the large two – may choose to remain in the type of business they conduct now. This may arise due to their long years of experience in the deposit oriented business, skill level of their staff being oriented towards this business, and the restrictions they would face on accessing public deposits once they choose to convert to NBFCs. The WG is of the view that continuation of RNBCs in their current mould is not desirable because the scope that exists now for unrestricted growth of deposits in RNBCs poses serious concerns relating to the depositors' interest.

6.6.1 The WG considered at length the question of placing a limit on the growth of RNBCs. The issue was also raised in the interactions the WG had with the two large companies. Both the companies submitted in strong terms that the future growth of these companies on the same lines as in the recent past would not pose any risk to the stakeholders. They both contended that any restriction on their growth would severely affect the employees and the agents who are dependent on the companies and their business.

6.6.2 The Working Group finds that the companies' contentions are not acceptable in view of the following serious concerns :

(i) There has been a very steep growth in the deposits in the two large RNBCs – a growth of Rs.3,219 crore in the last three years reflecting an increase of 26% over the March 2001 level of Rs.11,972 crore. While it may be argued that this shows the success of the business strategy, it is undeniable that a rapid growth within a short time frame is unhealthy and is fraught with risks.

(ii) The two large RNBCs together have deposits of over Rs.15,100 crore as on 31 March 2004. The deposits held by the largest RNBC exceeds the deposits of many small Indian Banks. It is recognised that in the case of banks, they are widely held public companies with long established systems and operational controls, the advantage of mandated corporate governance, and a strong regulatory oversight. These positive features not being present with respect to the RNBCs, accumulation of large sized public deposit liabilities in their hands reflects an inherent risk.

(iii) Unlike in NBFCs, the deposits of RNBCs are not rated and the benefit of the external scrutiny and evaluation involved in rating is not available to the depositors of RNBCs.

(iv) The growth of deposits in two large RNBCs over the years has led to a huge volume of deposit accounts being serviced by them. The two companies reportedly have in all 563 lakhs deposit accounts. This large number of accounts, with a potential to grow to a much larger number, would involve operational risks which may not be effectively managed at all times. The system which these companies have adopted for deposit business involves use of wide and far-flung networks of agents for servicing these deposit accounts. Apparently, there is only a limited or total lack of interface of the companies themselves with the depositors; this aspect underscores the operational risks. The large volume in deposits has also led to chronic problems of accounting for deposit liabilities in one company.

(v) Eighty per cent of the deposits gathered are to be placed in mandated investments. It is observed that when this prescription was given in 1987, the market risk for such instruments was low and they presented a desirable asset cover for the deposits. With the sweeping changes in economic environment in the country since the 90's, the market risk in such portfolio has become significant. If the volumes in this asset segment are allowed to grow at a high rate as before, the market risk may not be managed effectively.

(vi) For the same reason of changes in the economic environment over the years, the yields on the investments have dropped. Given an adverse movement in interest rates in the future, portfolio values would face significant depreciation. The losses on this score may not be manageable if the portfolio of investments grows without restriction. To the extent the companies are able to restructure their assets into businesses with higher yields, like lease, hire purchase and secured loans, the narrowing margins on the investment portfolio can be offset. One RNBC has specifically asked for expanding the discretionary investment level to 35% of the deposits, stating that under the enlarged discretion, it would expand into investment in financial subsidiaries, retail lending, capital market exposures, etc. The WG examined to see whether and to what extent, the concerns arising from the risks in the investment portfolio can be mitigated through such a change in the discretionary investment. The present composition of discretionary portfolio in the two companies, mentioned earlier, in itself is not all that comfortable when viewed from the angle of safety for the depositors. If a higher allocation for discretionary use is given, it is possible that deployment of larger funds in future with full freedom may result in asset losses. This would not be acceptable. More than this, the serious concern in this would be the fact that under the present dispensation public deposits can be raised upto 10 times the NOF and used with full freedom for financing this discretionary segment. The appropriate strategy for moving over to a different asset portfolio yielding higher returns and at the same time not enlarging the risks, would, therefore, be to link the freedom to deploy larger funds under own discretion to a planned entry into one of the defined NBFC activities and compliance with the related restriction on the access to public deposits.

6.6.3 All considered, the WG is of the view that there is a need to prescribe to RNBCs an appropriate prudential norm by way of a regulatory ceiling on the quantum of public deposits. Any limit on the growth of public deposits would not in any case limit the growth of their business and assets, as the RNBCs would have the freedom to raise resources not merely from public deposits but also other sources. The WG accordingly recommends that a cap in terms of NOF may be fixed for mobilization by RNBCs of public deposits. The cap would be in terms of public deposits, as opposed to all deposits, which are covered by the extant regulations.

6.7 Fixation of a cap on acceptance of public deposits

The data relating to two large RNBCs, as on March 31, 2003 (audited) and March 31, 2004 (provisional/ad-hoc computation) shows the extent to which the public deposits raised by the two companies was leveraged with reference to their NOF.

Table 6

(Rs. in crores)

Particulars	31.3.2003 (Audited)	31.3.2004 (Prov/ad-hoc)
Public deposits of two companies	15,058	15,191
Aggregate NOF of the two companies	799	986
Deposits to NOF (Times) : Both companies together	18.85	15.40
First company	32.98	15.20
Second company	13.30	15.54

The WG suggests that to avoid any hardship to the existing RNBCs, the cap for the quantum of public deposits may be fixed in terms of the NOF. This cap may be stipulated, as an initial measure, at a level of 16 times the NOF, along with a direction that the RNBCs will ultimately have to conform to the norms for raising of public deposits for NBFCs in general i.e. ceiling of 4 times or 1.5 times, as applicable. The Group is of the view that the time for such transition should be preferably not more than 5 years, although extension of time may be warranted by, among other reasons, the future cash flows arising out of the deposit contracts already entered into by the respective RNBCs and the nature of the fixed costs built into their operations. The Group also recommends that the progressive reduction of the cap on deposits in terms of NOF may be accompanied by a commensurate progressive increase in the discretion to be allowed to the RNBCs for deployment of funds so that on the completion of transition, the RNBCs would comply with the norms for raising public deposits, while enjoying the freedom to use the deposit and other funds in the manner applicable to other NBFCs.

6.8 Composition of Investment Pattern during transition

As the RNBCs would hold large volume of deposits in relation to their NOF during the transition period, it is necessary to ensure that the quality of their investments is of a high order. The Group is of the view that unlisted and unrated bonds issued by any company/institution, including PFIs, should not be part of the investments. Further, investments in unlisted but rated bonds and debentures should be only to an extent of 5% of their total investments in debt securities. Suitable caps may be fixed by RBI for exposures to capital market, real estate, unlisted but rated securities and units of equity oriented mutual funds. Above all, the directed investments may comprise only the rated and listed securities or the units of debt oriented mutual funds as per prudential guidelines for non-SLR securities for banks besides the Government Bonds and listed and rated Government Guaranteed bonds. If rating of any of the investments in the directed category is downgraded below the prescribed grade, the investments should be shifted to discretionary category with immediate effect and no fresh investment should be made in the discretionary category until any resultant shortfall in the directed investment is made good.

6.9 Removal of the floor rate on interest

Keeping in view the prevalent interest rates in the financial markets, the RNBCs have to compete with the rates offered by banks on their deposits, small savings schemes of Government etc. In such a scenario, removal of the floor rate on interest to be offered by the RNBCs is not going to affect the market and will also be in order, keeping in view the conscious policy of moving away from an administered interest rate regime.

6.10 Refund of Service Charges

RNBCs are permitted to levy non-refundable service charges to the depositors to cover their collection costs. Keeping in view the progressive freedom to be granted to RNBCs in respect of their investments / lending operations as discussed above, their rate of return on assets is expected to increase substantially. The benefit of higher yield on assets may, therefore, be passed on to the depositors in the form of interest to compensate for the service charges levied at the time of maturity.

6.11 Discontinuity of Deposits, and the Commission Structure

The WG has been informed that the rate of discontinuity of deposit schemes is high in respect of one RNBC because the commission paid on collection of deposit instalments in respect of recurring deposit is very high for the first year as compared to those paid in the subsequent years. The Group is of the view that the rate of discontinuity may be minimised if the commission structure is uniform for collection of all deposit instalments and the agency agreements provide for disincentives to agents for failure to collect all instalments.

6.12 Prudential Norms

The Working Group has been informed that certain categories of investments such as bonds issued by PFIs etc. carry risk weightage of 20% indicating relative safety of such investments. The Group recommends that risk weightage for such investments should be increased to 100% immediately as these investments are fraught with substantial credit risks.

Report of the Working Group on Development Financial Institutions (DFIs)

Summary of Recommendations

Recommendation No.1

In view of the banking system having acquired the skills of managing risks in extending finance to different sectors of the economy including long term finance and the capital market, (both equity and debt taken together) providing significantly larger resources to the corporate sector, the need for DFIs as the exclusive providers of development finance has diminished. The banks may be encouraged to extend high risk project finance with suitable Government support with a view to distributing risks and funding sources as also developing appropriate credit appraisals and monitoring skills across the financial system. Banks may also be permitted to raise long term resources through issuance of development bonds for the purpose of long term project finance so that problems of asset liability management can also be taken care of. (Paragraph 2.2.2)

Recommendation No.2

In a purely market driven situation, the business model of any DFI which raises long term resources from the market at rates governed by the market forces and extends only very long term credit to fund capital formation of long gestation is unlikely to succeed on account of threat to its spreads from high-cost of funds and high propensity to accumulate NPAs owing to exposures to very high credit risks. DFIs are, therefore, crucially dependent for their existence on Government commitment for continued support. Central Government need to decide after a detailed social cost benefit analysis on the areas of activities which require development financing and only those DFIs which the Central Government decides to support, for the time being, may continue as DFIs. The rest of the DFIs must convert to either a bank or a NBFC as recommended by the Narasimham Committee and should be subject to full rigour of RBI regulations as applicable to the respective categories. Further, no DFI should be established in future without the Central Government support. (Paragraph 2.2.4)

Recommendation No.3

Many of the institutions notified as PFIs under Section 4A of the Companies Act, 1956 have become financially weak and act without any assurance of Government support. The bonds issued by these PFIs and their certain other liabilities are treated as eligible investments for insurance companies, PFs, mutual funds and RNBCs. Such exposures on select PFIs also qualify for concessional risk weight of 20% for banks, FIs, NBFCs and RNBCs under RBI guidelines. The eligibility of resources raised by these entities as ‘approved investments’ and concessional risk weight of 20% allowed for exposure by banks, FIs, NBFCs and RNBCs are based on a perception of safety merely on account of the PFI status being conferred on them and the same should be done away with. (Paragraph 2.3.3)

Recommendation No.4

In the current scenario SFCs have outlived their utility and should be phased out within a definite time frame. The credit gap, if any, created by the exit of the SFCs from the market can be filled up by banks and also by suitably repositioning SIDBI. (Paragraph 2.4)

Recommendation No.5

The DFIs which convert into banks are expected to comply with all the regulations applicable to banks from the date of conversion. However, on grounds of practical considerations the entities may need exemption / relaxations in regard to certain norms relating to equity holdings and priority sector lending for a period of 3-5 years after conversion depending on the situation in which they are placed. No relaxations should be granted unless mandated by statute in respect of requirements such as minimum capital, income recognition, asset classification and provisioning, capital adequacy, maintenance of CRR and SLR, drawing of accounts and building of reserves, permissible banking business etc. (Paragraph 3.6.1)

Recommendation No.6

The DFIs being non banks are more akin to NBFCs and, therefore, should as a general rule be subject to NBFC guidelines. However, while the dominant theme of the NBFC guidelines is to protect the depositors’ interest and ensure the viability of the NBFCs for that purpose, such regulatory or supervisory concerns from the view point of protecting depositors’ interest are very much less in respect of DFIs, most of which do not accept public deposits or even if they do, have very small proportion of public deposits as compared to their total resources raised. Yet, failure of any of the larger DFIs could have adverse effect on the entire financial system as these entities raise resources on large scale, by issuance of bonds, from domestic banks, PFs, insurance companies, trusts as also the general public. The regulation of these DFIs should, therefore, be so designed as to ensure that the regulatory framework along with the Government support available to the

DFIs works towards ensuring their financial soundness so that the overall systemic stability is not endangered. (Paragraph 4.4.2)

Recommendation No.7

Of all India DFIs established by statute, IDBI is converting itself into a bank. After such transformation, only four viz. Exim Bank and three Refinancing Institutions NABARD, SIDBI and NHB will continue to function as DFIs established by statute. These institutions work as instruments of public policy and as such their functions arising out of implementation of public policy may be overseen by Central Government. Considering their systemic importance RBI may continue to regulate the financial and related aspects of these DFIs irrespective of whether they accept public deposits or not. All the recommendations for regulation made for Development Finance Companies (DFC) except recommendations relating to registration with RBI, entry-point norms and composition of Board of Directors should be made applicable to these four DFIs. It is observed that RBI has ownership interest in two DFIs viz. NABARD and NHB. As there is a scope for conflict of interest, RBI may divest its ownership stakes in these two institutions. (Paragraphs 4.4.5 & 4.5)

Recommendation No.8

In varying degrees three refinancing institutions NHB, SIDBI and NABARD shoulder responsibilities of regulating and / or supervising the financial intermediaries falling under their respective domains viz. Housing Finance Companies in case of NHB, SFCs and SIDCs in case of SIDBI and State Co-operative Banks, District Central Co-operative Banks and RRBs in case of NABARD. RBI may ensure that the standard of regulations or supervision exercised by the NHB, SIDBI and NABARD over the institutions falling under their respective domains are broadly at par with that maintained by RBI. Till the state level DFIs established by statute such as SFCs are phased out, suitable regulatory and supervisory powers in respect of these entities may be vested in SIDBI. (Paragraph 4.4.5)

Recommendation No.9

DFIs which have been constituted as companies and are performing developmental roles should be classified as a new category of NBFCs called 'Development Financial Companies' (DFCs) and subjected to uniform regulation. (Paragraph 4.4.7)

Recommendation No.10

Considering the structural, functional and operational flexibility available to companies as opposed to statutory bodies, as a general policy, all DFIs that may be set up in future may be constituted as companies (DFCs). As a category of NBFCs, DFCs will be required to be registered with RBI like all other NBFCs. (Paragraph 4.5.1)

Recommendation No.11

Considering the nature of business of development financing, the entry point norms for DFCs should be set sufficiently high at NOF of Rs.100 crore. (Paragraph 4.5.2)

Recommendation No.12

DFCs accepting public deposits should maintain liquid assets as prescribed for other NBFCs in terms of Section 45-IB of the RBI Act. Similarly, DFCs will also be statutorily required to transfer certain proportion of annual profits to reserve funds, as required in terms of provision of Section 45-IC of the RBI Act. (Paragraph 4.5.3)

Recommendation No.13

With a view to enabling the DFCs to access short term and medium term resources to a larger extent and thereby reducing their cost of funds, the present prescription of limiting such access to the extent of NOF may be done away with in respect of those DFCs which have the minimum CRAR of 15%, net NPAs not exceeding 5% of total assets and are fully complying with the ALM guidelines issued by RBI restricting the gap limits to 10 and 15% for the first two time buckets of 1-14 days and 15-28 days respectively subject to the condition that public deposit will not exceed 1.5 times of NOF as prescribed for loans / investment companies. Restrictions will continue to remain in force for DFCs which do not satisfy the above requirements. (Paragraph 4.5.4)

Recommendation No.14

Keeping in view their systemic importance, the DFCs may be subjected to the guidelines laid down by RBI for the select FIs in respect of their investments and credit portfolio. (Paragraph 4.5.5)

Recommendation No.15

The extant prudential norms relating to income recognition, asset classification, provisioning, capital adequacy and single and group exposures etc. applicable to select FIs currently regulated by RBI flow from their functions as DFCs and not from their institutional forms and as such, the same may be adopted for DFCs. Thus, DFCs may be required to maintain CRAR of 9% only instead of 15% as prescribed for NBFCs in general. (Paragraph 4.5.6)

Recommendation No.16

Considering their systemic significance, the DFCs may be required to submit their audited annual accounts to RBI within a specified time frame after the end of each accounting year. They may also be required to obtain prior approval of RBI before appointing / re-appointing / removing the statutory auditor / auditors. (Paragraphs 4.5.7 & 4.5.8)

Recommendation No.17

Keeping in view the systemic importance of DFCs, RBI should have the powers to prescribe composition of Board of Directors of DFCs so as to ensure inclusion in the Board, of professionals having special knowledge or practical experience in the matters of finance, accountancy, management, industry or any other area of importance which RBI might consider useful to the DFCs. RBI may also consider issuing suitable guidelines on the broad principles of corporate governance to be adopted by DFCs.
(Paragraph 4.5.9; 4.5.10)

Recommendation No.18

The supervisory process in respect of the select DFIs established following the recommendations of the Informal Advisory Group on Regulation and Supervision of FIs is working satisfactorily. The same may be extended to supervision of all DFCs as well. (Paragraph 4.6)

Recommendation No.19

Even though the non public deposit taking companies are slated to be excluded from the purview of Financial Companies Regulations Bill 2000, RBI should put in place as an initial measure, a system of periodical collection of all information relevant to the systemic concerns pertaining to large sized non public deposit taking companies say with total assets of Rs.500 crore and above. The information system may include, besides submission of annual financials, quarterly reporting of specific details of the company's assets and liabilities which focus on their linkages to the market, inter-corporate / intercompany and capital market exposures and all other sensitive information. This system may also be specified for public deposit taking companies to the extent required. (Paragraph 5.7)

Recommendation No.20

The scope that exists for unlimited access to public deposits by RNBCs poses serious concerns relating to the depositors' interest. A cap in terms of NOF may, therefore, be fixed for mobilization of public deposits by RNBCs. To avoid any hardship to the existing RNBCs, the cap on public deposits may be fixed at a level of 16 times of NOF, as an initial measure along with a direction that the RNBCs will ultimately have to conform to the norms for raising of public deposits for NBFCs in general i.e. four times or 1.5 times of NOF as applicable. The time of such transition should preferably be not more than five years, although extension of time may be warranted by, among other reasons, the future cash flows arising out of the deposit contracts already entered into by the respective RNBCs and the nature of fixed expenses built into their operations. (Paragraphs 6.6.3 & 6.7)

Recommendation No.21

RNBCs are at present required to deploy to the extent of 80% of their deposits funds mobilized in some specified categories of investments and have the freedom to deploy funds only to the extent of 20% of their deposit liabilities or 10 times of NOF, whichever is lower so as to ensure protection to the depositors. With the progressive reduction of the cap on deposits in terms of NOF, commensurate progressive increase in the discretion for deployment of funds may be allowed to RNBCs so that on completion of transition they would comply with the norms for raising public deposits while enjoying the freedom to use the deposit and other funds in the manner applicable to other NBFCs. (Paragraph 6.7)

Recommendation No.22

To ensure that the quality of investments by RNBCs remains good during the period of transition, unlisted and unrated bonds issued by any company / institution including PFI should not be part of the investments. Further, investments in unlisted but rated bonds and debentures should be only to the extent of 5% of their total investments in debt securities. Suitable caps may be fixed by RBI for exposures to capital market, real estate, unlisted but rated securities and units of equity oriented mutual funds. Above all, the directed investments may comprise only the rated and listed securities or the units of debt oriented mutual funds as per prudential guidelines for non-SLR securities for banks besides the Government Bonds and listed and rated Government guaranteed bonds. If rating of any of the investments in the directed category is downgraded below the prescribed grade, the same should be shifted to discretionary category with immediate effect and no fresh investment should be made in the discretionary category until any resultant shortfall in the directed investment is made good. (Paragraph 6.8)

Recommendation No.23
Keeping in view the conscious policy of moving away from the administered interests rate regime and also the prevalent interest rate, the floor limit on the rate of interest which can be offered by the RNBCs to the depositors may be removed. (Paragraph 6.9)

Recommendation No.24
RNBCs are allowed to levy service charges for collection of deposits as per the extant guidelines. The benefit of higher yield on assets, consequent upon progressive freedom to be granted to RNBCs in respect of their investments / lending operations may be passed on to the depositors at the time of maturity payment in the form of interest to compensate for the service charges levied. (Paragraph 6.10)

Recommendation No.25
In order to minimize the rate of discontinuity in collection of installments relating to recurring deposits mobilized by RNBCs, the commission structure should be uniform for collection of all deposit instalments and the agency agreements should provide for dis-incentives to agents for failure to collect all instalments. (Paragraph 6.11)

(N. Sadasivan)
Chairman

(S.S. Gangopadhyay)
Member

(O.P. Aggarwal)
Member

(Deepak Mohanty)
Member

(Amarendra Mohan)
Member

(M.K. Samantaray)
Member

May 10, 2004

Annexure I

Objectives behind setting up of the DFIs

A. All India FIs

i) Term lending institutions (IFCI, ICICI Ltd., IDBI, IDFC Ltd., IRCI Ltd.)

The first FI to be established in India was IFCI. It was established by statute in 1948 for the purpose of making medium and long-term credit more readily available to medium and large industrial concerns in corporate and co-operative sectors in India.

The setting up of the next all India term lending FI was sponsored by the World Bank when Industrial Credit and Investment Corporation of India Ltd. was established in 1955 as a company established under the Indian Companies Act, 1913 and with the primary objective of promoting industries in the private sector and meeting their foreign exchange requirements.

On July 1, 1964, IDBI was established under Industrial Development Bank of India Act, 1964, as the principal financial institution for industrial development in the country for co-ordinating, in conformity with the national priorities, the working of institutions engaged in financing, promotion and development of industry and assisting the development of such institutions for providing credit and other facilities for the development of industry. IDBI had taken over the functions of the erstwhile Refinance Corporation for Industries Ltd., set up in 1958. Besides providing direct finance by way of term loans, IDBI also refinances term loans given by eligible institutions specified in the IDBI Act to medium and large-scale units and rediscounts/discounts bills of exchange and promissory notes arising out of the sale/purchase of machinery and equipment. It operates special products for technology upgradation, energy conservation and pollution control and provided venture capital not only for development and use of indigenous technology and adaptation of imported technology but also to leverage new opportunities thrown open by developments in emerging sectors like information technology, biotechnology, etc. It provides a wide range of merchant banking and advisory services, which includes issue management, project advisory, credit syndication, valuation and corporate restructuring. It also extends loans to various financial intermediaries and invests in their shares and bonds. EXIM Bank and SIDBI, which were established as statutory bodies in 1982 and 1990, respectively took over certain functions from IDBI. While EXIM Bank took over the export finance function of the IDBI and began functioning on March 1, 1982, SIDBI commenced its operations in April 1990 by taking over the outstanding portfolio and activities of IDBI pertaining to the small-scale sector.

Much later, IDFC Ltd. was incorporated in January 1997 as a non-government company to foster the growth of private capital flows for infrastructure finance, on a commercially viable basis with a mandate to lead capital to infrastructure sector.

In 1997, IIBI Ltd. was incorporated as a government company and it took over business and functions of the erstwhile Industrial Reconstruction Bank of India established under IRBI Act, 1984 (which itself was originally set up as Industrial Reconstruction Corporation of India in 1971) to function as the principal credit and reconstruction agency for industrial revival and to co-ordinate the work of other institutions engaged in a similar activity, assisting and promoting industrial development and rehabilitating sick and closed industrial concerns. Besides project finance, IIBI also provides short duration non-project asset-backed financing in the form of underwriting/direct subscription, deferred payment guarantees and working capital/other short-term loans to companies to meet their fund requirement.

ii) Refinancing institutions (NABARD, NHB, SIDBI)

NABARD was established in December 1981, under the National Bank for Agriculture and Rural Development Act 1981, as an Apex institution at the national level, for providing credit for the promotion of agriculture, small scale industries, cottage and village industries, handicrafts, other rural crafts and other allied economic activities in rural areas, with a view to promoting integrated rural development and securing the prosperity of rural areas. Prior to setting up of NABARD some of its functions were being discharged by RBI through its Agriculture Credit Department set up in 1935 and Agricultural Refinance Corporation set up by an Act of Parliament in 1963 which was renamed as and Agricultural Refinance and Development Corporation (ARDC) by an amendment to Act in 1975.

NHB was set up as per the provisions of National Housing Bank Act, 1987 and it started functioning from July 9, 1988. NHB is wholly owned subsidiary of RBI and, apart from being a refinancing institution, is also the regulator and supervisor of housing finance companies. Its primary responsibility is to promote and develop specialized housing finance institutions for mobilizing resources and extending credit for housing. It has powers to grant loans and advances and provides other financial support to housing finance institutions and scheduled banks and has various other important functions.

SIDBI was set up in 1990 under an Act of Parliament (SIDBI Act, 1989) as a wholly owned subsidiary of IDBI. It is the principal financial institution for promoting and financing development of industry in the small-scale sector as also for co-ordinating the functions of institutions engaged in similar activities. As stated earlier, SIDBI commenced its operations in April 1990 by taking over the outstanding portfolio and activities of IDBI pertaining to the small-scale sector.

iii) Investment institutions (LIC, UTI, GIC, IFCI Venture Capital Funds Ltd., ICICI Venture Funds Management Co. Ltd.)

The nationalisation of insurance business in the country resulted in the establishment of Life Insurance Corporation of India (LIC) in 1956 as a wholly owned corporation of the Government of India. The broad objectives of LIC are to spread life insurance across the country, particularly in the rural areas and to the socially and economically backward classes.

Unit Trust of India (UTI), the largest mutual fund organisation in India, was set up in 1964 by an Act of Parliament to fulfil the objectives of mobilising retail savings, investing them in the capital market and passing on the benefits accrued from the acquisition, holding, management and disposal of securities to the small investors.

The General Insurance Corporation of India was formed on January 1, 1973 as a holding company, with four subsidiary companies (now de-linked) and has been operating a number of need-based insurance schemes to meet the diverse and emerging needs of various segments of society and provides financial assistance to industrial projects. GIC is now in the process of implementing comprehensive strategies to meet the opportunities and challenges emanating from private sector participation in the insurance and re-insurance business.

IFCI Venture Capital Funds Ltd. (IVCF) and ICICI Venture Funds Management Co. Ltd. were set up in 1988 as venture capital finance companies. While IVCF was previously known as Risk Capital and Technology Finance Corporation Ltd. (RCTC), ICICI Venture Funds Management Company Ltd. was known as TDICI Ltd.

iv) Sector Specific/specialised institutions (EXIM Bank, SCICI Ltd., TFCI Ltd., REC Ltd., HUDCO Ltd., IREDA Ltd, PFC Ltd., IRFC Ltd.)

EXIM Bank, wholly owned by the GOI was established under the EXIM Bank Act, 1981 with a view to promoting India's international trade and for all matters connected therewith. SCICI Ltd. was set up by ICICI Ltd. in 1986 was later merged back into ICICI Ltd. in 1997.

TFCI Ltd. was set up in February 1989 as a specialised all-India Development Financial Institution catering to the needs of the tourism industry by IFCI, some nationalised banks, and other FIs.

RECL was established in 1969-70 as a Government company to facilitate availability of electricity for rural and semi-urban population and to act as an organization for financing and promoting projects covering generation, conservation, transmission and distribution of power in the country. HUDCO Ltd. was set up in 1969-70 as a company, initially for financing of public sector housing agencies such as Housing Boards and Development Authorities. Later, in mid-seventies, it diversified into financing of co-operative housing and subsequently also undertook financing of corporates – both in public and private sector. It has further diversified into financing real estate builders and is progressively moving towards provision of individual housing loans as also extending techno-financial assistance to individuals. HUDCO Ltd., being a HFC is being regulated

IREDA Ltd. was incorporated as a company with effect from 11 March 1987 primarily as one of the instruments for promoting, developing and financing New and Renewable Sources of Energy (NRSE) technologies and thereby accelerating the momentum of development and help in large-scale utilisation of renewable energy sources.

PFC Ltd. was established in July 1986 as a company to act as DFI dedicated to the Power Sector. It, along with REC Ltd., provides financial assistance / services for the power projects, raises resources from international and domestic sources, lends to power projects in India, to acts as catalyst to bring improvement in the functioning of state power utilities and assists state power sectors in carrying out reforms.

IRFC Ltd. was incorporated in 1986 as Central Government Company to acquire the "Rolling Stock" (i.e. the locomotives, freight wagons and passenger coaches) for leasing out to Indian Railways for which it mobilises funds from various sources. The lease rentals from the Indian Railways form its principal source of income.

B. State level / Regional Institutions (SFCs, SIDCs, NEDFi Ltd.)

State Financial Corporations Act, 1951 was enacted by the Parliament to provide institutional framework for financing medium and small-scale industries, which fell outside the operational scope of IFCI. After enactment of the Act, SFCs were set up in the various States over a period of time. The Act provides special role for the State Governments in the promotion and management of the affairs of the SFCs. At present, there are 18 SFCs of which 17 were set up under the SFC Act, 1951 while the Tamil Nadu Industrial Investment Corporation Ltd. was incorporated under the Companies Act, 1956 but still functions as SFC. Their main objectives are to finance and promote small and medium enterprise in the States concerned for achieving balanced regional growth, catalyse investment, generate employment and widen the ownership base of industries by way of providing term loans, direct subscription to equity / debentures, extending guarantees, discounting of bills and providing special / seed capital, etc.

State Industrial Development Corporations (SIDCs) are State level institutions established under the Companies Act 1956 as wholly owned undertakings of State governments for promotion and development of medium and large industries in the respective States. Most of the SIDCs have not yet been notified by the government as PFIs under the Companies Act, 1956 but being companies and engaged in making loans and advances, fall within the definition of non-banking financial companies under the RBI Act, 1934, and were subject to the RBI (DNBS) Directions till recently. These Corporations provide financial assistance in the form of rupee loans, underwriting /direct subscriptions to shares/debentures and guarantees and also undertake a range of promotional activities. SIDCs are also involved in setting up of medium and large industrial projects in the joint sector /assisted sector in collaboration with private entrepreneurs or as wholly owned subsidiaries. In keeping with the changing environment, many SIDCs are trying to diversify their activities and enter into areas of equipment leasing, merchant banking, venture capital and mutual funds. As on 31 December 1999, there were 28 SIDCs of which 11 SIDCs – in eight States and three Union Territories – also function as SFCs to provide assistance to small and medium enterprises and act as promotional agencies.

NEDFi Ltd. was incorporated on August 9, 1995 under the Companies Act, 1956 for development in the North Eastern states of India. It was promoted by IDBI, ICICI Ltd., IFCI Ltd., SIDBI, LIC, GIC and its subsidiaries, UTI and SBI, which own the FI's entire paid up capital of Rs.100 crore. NEDFi Ltd. was conceptualised in the Borathakur Committee Report in 1994 to cater to the needs of the North-Eastern Region which was endowed with rich natural resources and nearly one-third of the country's hydro power potential (84,000 MW) but was yet to experience industrial development on a scale achieved by other regions of the country. NEDFi Ltd. aims to be a dynamic and responsive organization to catalyse the economic growth of the Northeast. It will assist in the efficient formation of fixed assets by identifying, financing and nurturing eco-friendly and commercially viable industrial, infrastructure, agro-horticulture, fishery and animal-husbandry projects in the region.

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Annexure II

List of Public Financial Institutions as per Section 4A of Companies Act, 1956

1*	Industrial Credit and Investment Corporation of India Ltd.	ICICI Ltd.
2	Industrial Development Bank of India	IDBI
3*	Industrial Finance Corporation of India	IFCI
4.	Life Insurance corporation of India	LIC
5.	Unit Trust of India	UTI
6.	General Insurance Corporation of India	GIC
7.	National Insurance Company Ltd.	NIC Ltd.
8.	New India Assurance Company Ltd.	NIA Ltd.
9.	Oriental Fire and General Insurance Company Ltd.	OIC Ltd.
10.	United Fire and General Insurance Company Ltd.	UII Ltd.
11*	SCICI Ltd.	SCICI Ltd.
12.	Industrial Reconstruction Bank of India/ now Industrial Investment Bank of India Ltd.)	IIBI Ltd.
13.	Tourism Finance Corporation of India Ltd.	TFCI Ltd.
14	Risk capital and Technology Finance Corporation Ltd./ Now IFCI Venture Capital Funds Ltd.	RCTC Ltd./ IVCF Ltd.
15	Technology Development and Information Company of India Ltd./ ICICI Venture Funds Management Ltd	TDICI Ltd./ ICICI Venture Ltd.
16.	Power Finance Corporation Ltd.	PFC Ltd.
17.	National Housing Bank	NHB
18.	Small Industries Development Bank of India	SIDBI
19.	Rural Electrification corporation Ltd.	REC Ltd.
20.	Indian Railways Finance Corporation Ltd.	IRFC Ltd.
21.	IFCI Ltd.	IFCI Ltd.
22.	Andhra Pradesh State Financial Corporation	APSFC
23.	Assam Financial Corporation	AFC
24.	Bihar State Financial Corporation	BSFC
25.	Delhi Financial Corporation	DFC
26.	Gujarat State Financial Corporation	GSFC
27.	Haryana Financial Corporation	HFC
28.	Himachal Pradesh Financial Corporation	HPFC
29.	Jammu & Kashmir State Financial Corporation	JKSFC
30.	Karnataka State Financial Corporation	KSFC
31.	Kerala Financial Corporation	KFC
32.	Madhya Pradesh Financial Corporation	MPFC
33.	Maharashtra State Financial Corporation	MSFC
34.	Orissa State Financial Corporation	OSFC
35.	Punjab Financial Corporation	PFC
36.	Rajasthan Financial Corporation	RFC
37.	Uttar Pradesh Financial Corporation	UPFC
38.	West Bengal Financial Corporation	WBFC
39.	Indian Renewable Energy Development Agency Ltd.	IREDA Ltd.
40.	Tamilnadu Industrial Investment corporation Ltd.	TIIC Ltd.
41.	North Eastern Development Finance Corporation Ltd.	NEDFi Ltd.
42.	Housing and Urban Development Corpn. Ltd.	HUDCO Ltd.
43.	Infrastructure Development Finance Company Ltd.	IDFC Ltd.
44.	Export-Import Bank of India	EXIM Bank
45	National Bank for Agriculture and Rural Development	NABARD
46**	National Cooperative Development Corporation	NCDC
47**	National Dairy Development Board	NDDB
48	Pradeshiya Industrial and Investment Corporation of U.P. Ltd.	PICUP Ltd.
49	Rajasthan State Industrial Development & Investment Corporation Ltd.	RIICO Ltd.
50	State Industrial Development Corporation of Maharashtra Ltd.	SICOM Ltd.
51	West Bengal Industrial Development Corporation Ltd.	WBIDC Ltd.
52	Tamil Nadu Industrial Development Corporation Ltd.	TIDCO Ltd.

Note: SIDCs other than those mentioned above have not been notified as PFIs. * Not in existence on date; ** Not treated as DFIs.

Annexure III

Residuary Non-Banking Finance Companies (RNBCs)

Due to historical reasons, NBFCs which could not be classified as equipment Leasing, hire purchase, loan, investment, nidhi or chit fund companies (a normal NBFC or an MNBC) but which tap public savings by operating various deposit schemes, akin to recurring deposit schemes of banks, were classified as RNBCs and a separate set of directions were issued to them.

A summary of the core provisions of RNBC Directions and other RBI Regulations, applicable to these companies at present is now as under:

(i) The minimum (not less than 12 months) and maximum period (not exceeding 84 months) of deposits;

(ii) Minimum rate of return payable to the depositors as under:

(a) at the rate of 5 per cent per annum (to be compounded annually) on the amount deposited in lump sum or at monthly or longer intervals; and

(b) at the rate of 3.5 per cent per annum (to be compounded annually) on the amount deposited under daily deposit schemes:

The RNBCs are the only class of NBFCs which are enjoined to pay a minimum rate of interest on their deposits. There is no upper limit prescribed for RNBCs unlike other NBFCs, which can pay any rate of interest subject to the ceiling of 11.0 per cent prescribed by the Reserve Bank.

(iii) Prohibition from forfeiture of any part of the deposit or interest payable thereon;

(iv) Service charges up to Rs 80 as an initial amount are allowed for fresh deposits of Rs 500 in the first year. In case of amount of fresh deposit in the first year is less than Rs 500, the service charges have to be proportionate;

(v) Disclosure requirements in the application forms and the advertisements soliciting deposits and periodical returns and information to be furnished to the Reserve Bank;

(vi) Disclosure in the books of accounts and balance sheet the aggregate liabilities to depositors on accrual basis.

(vii) Not less than 80 per cent of the aggregate liabilities to the depositors are required to be invested in the manner and the nature of securities prescribed by RBI. The remaining amount of 20% of the deposit liabilities can be invested in the manner decided by its board of directors. A chart showing the investment pattern prescribed by the Reserve Bank to ensure adequate security for depositors' money is given in the Chart below.

(viii) Stipulation of entrustment of the securities relating to such investments with a scheduled commercial bank or SHCIL or in demat account with a depository participant or CSGL account with a condition that withdrawal of these securities must be only for repayment of deposits;

(ix) Opening of new branches outside the state in which the company has registered office requires the company to have minimum NOF of Rs. 50 crore;

(x) The prudential norms on income recognition, accounting standard, asset classification, provisioning for bad and doubtful debts, capital adequacy, exposure norms for single party and a group, etc. have been extended to RNBCs, under the provisions of the Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998. CRAR of 12 per cent has been prescribed for these companies as is applicable to the NBFCs.

(xi) The ALM Guidelines issued to NBFCs having public deposits of Rs. 20 crore or assets size of Rs. 100 crore are applicable to these companies also.

Chart showing the investment pattern stipulated by RBI for RNBCs

Requirement	As to % of aggregate Deposit liabilities
(i) Investment in approved securities (Government securities/guaranteed bonds) under **Section 45-IB of the RBI Act**	Not less than 10%
(ii) Investments in FDs/CDs of scheduled commercial banks and **public financial institutions** *(Rating not prescribed) in terms of RNBC Directions*	Not less than 10%
(iii) Investments in bonds/debentures **rated AA+ and above**, commercial papers *(Rated as per IECD prescriptions)* of public sector banks, **public financial institutions**, Government/ private sector companies, units of mutual funds *(under SEBI Regulations)* of Which (a) investments in bonds and debentures of PSUs or private sector companies rated at least AA+ (b) investments in schemes of a Mutual Fund not to exceed 2 per cent of the aggregate liabilities to the depositors ***in terms of RNBC Directions***	Not less than 60% Not more than 10% Not more than 10%
Total	Not less than 80 %
(iv) Other investments ***in terms of RNBC Directions***	Not more than 20% or 10* times the NOF whichever is lower
Grand Total the deposit liabilities	Not less than 100%

Note: The market value of the securities should be not less than the sub-ceilings against each item mentioned above and the aggregate of the market value of all these securities/assets should be not less than the aggregate liabilities to the depositors as outstanding as at the end of last working day of the second preceding quarter.

* For Sahara India Financial Corporation Ltd., the limit was restricted to 5 times the NOF when the company was allowed to net off the loans against its own deposits from the aggregate liabilities to the depositors.

Annexure IV

List of experts consulted by the Working Group of DFIs

Sr. No.	Expert	Date of meeting
1	Dr. Rakesh Mohan Deputy Governor Reserve Bank of India Mumbai	February 26, 2004
2	Shri T C Venkat Subramanian Chairman and Managing Director, EXIM Bank, Centre – I, World Trade Centre, Cuffe Parade Colaba, Mumbai – 400 005	March 4, 2004
3	Shri T T Srinivasraghavan Managing Director Sundaram Finance Limited 21, Patullos Road Chennai – 660 002	March 4, 2004
4	Shri D. N. Ghosh Chairman, ICRA Limited Kailash Building, 4th Floor 26, Kasturba Gandhi Marg New Delhi – 110 001	March 11, 2004
5	Dr. Basudeb Sen 109, Rastraguru Avenue (First Floor), Dum Dum Kolkata	March 12, 2004
6	Shri Vinod Rai Additional Secretary (Financial Sector), Government of India, Jeevan Deep Building, Parliament Street New Delhi 110 001	March 12, 2004
7	Shri S. K. Roy, Managing Director Peerless General Finance & Investment Company Limited Peerless Bhavan, 3, Esplanade Estate, Kolkata – 700 069.	March 22, 2004
8	Shri Arvind Virmani Director & Chief Executive Indian Council for Research in International Economic Relations India Habitat Centre, Core 6-A, Lodhi Road, New Delhi – 110 003	March 29, 2004
9	Shri Subrata Roy Sahara Managing Worker & Chairman Sahara India Financial Corporation Limited, Sahara India Bhawan 1, Kapoorthala Complex Lucknow – 226 024	April 27, 2004

Executive Summary

1. In order to address the regulatory and supervisory issues relating to the existing term lending and refinancing institutions and for improving the flow of resources to them, RBI in terms of the Mid Term Review of Monetary and Credit Policy for the year 2003-04 set up a Working Group (WG), for examining, within the broader framework of NBFCs, various regulatory and supervisory aspects including access to short term resources for the DFIs as a separate category. The terms of reference of the Working Group are as under:

a) to review the experience of DFIs which have transformed as banks;

h) to indicate the status and prospects of those DFIs which are moving in a similar direction and which are likely to move in a similar direction;

i) to assess the financial position and the regulatory framework in regard to all the existing Financial Institutions;

j) to identify the common characteristics of DFIs as a category and explore the appropriate framework for regulation of such DFIs keeping in view the fact that they are not banks but still accept public deposits;

k) to recommend a regulatory framework for DFIs in the above light after assessing the current status and keeping in view the need to bring them under the overall regulatory framework of Non-Banking Finance Companies (NBFCs) but treating the DFIs as a separate category;

l) to advise whether NBFCs of large sized liabilities should automatically be brought under the separate category of NBFCs as applicable to DFIs; and

m) to review the status of Residuary Non-Banking Companies (RNBCs)and identify where they have characteristics of DFIs and suggest mechanisms by which the companies under this category could move into one of the definable categories of NBFCs including that of the DFIs.

The Group examined in depth the issues flagged by the terms of reference by consulting several experts in the field of DFIs and NBFCs and perusing the available literature on the subject. The summary of findings of the WG is given below.

2. In a developing country, financial sectors are usually incomplete inasmuch as they lack a full range of markets and institutions that meet all the financing needs of the economy. For example, there is generally a lack of availability of long-term finance for infrastructure and industry, finance for agriculture and small and medium enterprises (SME) development and financial products for certain sections of the people. The role of development finance is to identify the gaps in institutions and markets in a country's financial sector and act as a 'gap-filler'. The principal motivation for developmental finance is, therefore, to make up for the failure of financial markets and institutions to provide certain kinds of finance to certain kinds of economic agents. The failure may arise because the expected return to the provider of finance is lower than the market-related return (notwithstanding the higher social return) or the credit risk involved cannot be covered by high risk premium as economic activity to be financed becomes unviable at such risk-based price. Development finance is, thus, targeted at economic activities or agents, which are rationed out of market. The vehicle for extending development finance is called development financial institution (DFI) or development bank. A DFI is defined as 'an institution promoted or assisted by Government mainly to provide development finance to one or more sectors or sub-sectors of the economy'.

3. The DFIs played a very significant role in rapid industrialisation of the Continental Europe and Japan. The success of these institutions provided strong impetus for creation of DFIs in India after independence in the context of the felt need for raising the investment rate. RBI was entrusted with the task of developing an appropriate financial architecture through institution building so as to mobilise and direct resources to preferred sectors as per the plan priorities. While the reach of the banking system was expanded to mobilise resources and extend working capital finance on an ever-increasing scale to different sectors of the economy, DFIs were established mainly to cater to the demand for long-term finance by the industrial sector.

4. DFIs can be broadly categorised as All-India or State / regional level institutions depending on their geographical coverage of operation. Functionally, All-India institutions can be classified as (i) term-lending institutions (IFCI Ltd., IDBI, IDFC Ltd., IIBI Ltd.) extending long-term finance to different industrial sectors, (ii) refinancing institutions (NABARD, SIDBI, NHB) extending refinance to banking as well as non-banking intermediaries for finance to agriculture, SSIs and housing sector, respectively (iii) sector-specific / specialised institutions (EXIM Bank, TFCI Ltd., REC Ltd., HUDCO Ltd., IREDA Ltd., PFC Ltd., IRFC Ltd.), and (iv) investment institutions (LIC, UTI, GIC, IFCI Venture Capital Funds Ltd., ICICI Venture Funds Management Co Ltd.). State / regional level institutions are various SFCs, SIDCs and NEDFi Ltd.

5. Historically, low-cost funds were made available to DFIs to ensure that the spread on their lending operations did not come under pressure. DFIs had access to soft window of Long Term Operation (LTO) funds from RBI at concessional rates. They also had access to cheap funds from multilateral and bilateral agencies duly guaranteed by the Government. They were also allowed to issue bonds, which qualified for SLR investment by banks. For deployment of funds, they faced little competition as the banking system mainly concentrated on working capital finance. With initiation of financial sector reforms, the operating environment for DFIs changed substantially. The supply of low-cost funds was withdrawn forcing DFIs to raise resources at market-related rates. On the other hand, they had to face competition in the areas of term-finance from banks offering lower rates. The change in operating environment coupled with high accumulation of non-performing assets due to a combination of factors caused serious stress to the financial position of term-lending institutions.

6. Out of nine select all India financial institutions being regulated and supervised by RBI at present, three institutions viz., NABARD, NHB and SIDBI extend indirect financial assistance by way of refinance. The financial health of these three institutions is sound as their exposures are to other financial intermediaries, which in certain cases are also supported by State Government guarantees. Of the remaining six institutions, two niche players viz. EXIM Bank and IDFC Ltd. are also quite healthy. The former operates in the area of international trade financing and the latter is a new generation FI with a mandate of leading private capital into the infrastructure sector, rather than itself being a direct lender. The remaining four institutions that have been operating as providers of direct assistance, are all in poor financial health. In regard to the DFIs not regulated by RBI, viz., PFC Ltd., REC Ltd., and IRFC Ltd. are making large profits. Same is the case with LIC and GIC (and its erstwhile subsidiaries which have since been delinked) and UTI, being regulated by IRDA and SEBI, respectively. However, UTI had to undergo a massive restructuring in 2001-02 as it faced severe liquidity problems. While IREDA Ltd. and NEDFi Ltd. are somewhat profitable, the two venture capital companies seem to be too small to be systemically significant. HUDCO Ltd., being a housing finance company is within the regulatory and supervisory domain of National Housing Bank, and had declared profits. The financial position of state level institutions, in general and of SFCs, in particular, is very poor.

7. Certain institutions including DFIs are notified by Government of India as Public Financial Institutions (PFI) under Section 4A of the Companies Act, 1956. The PFIs enjoy certain advantages under the Companies Act, 1956, Recovery of Debts due to Banks and FIs Act, 1993, Income Tax Act etc. However, the foremost advantage that accrue to the PFIs is that the bonds issued and certain other liabilities of PFIs are treated as eligible investments for insurance companies, Provident Funds, Mutual Funds and Residuary Non-Banking Companies (RNBCs). Such exposures on select PFIs also qualify for concessional risk weight of 20% for banks, FIs, NBFCs and RNBCs under RBI guidelines. Such dispensation is fraught with risks for the entities having exposure to the PFIs as the PFIs are disparate entities and majority of them are not subject to adequate and robust regulatory regime. Besides the financial position of some of the PFIs has become extremely weak without any assurance of Government support. The WG is of the view that the eligibility of resources raised by these entities as approved investment and concessional risk weight of 20% allowed for exposure by banks, FIs, NBFCs and RNBCs regulated by RBI are based on perception of safety merely on account of the PFI status being conferred upon them and the same should be done away with.

8. As it generally happens in the evolution of all dynamic systems, the Indian financial system has also come of age. The capital market, both equity and debt taken together, is providing significantly larger resources to the corporate sector in the 1990s. The banking system is well diversified with public, private and foreign banks of varying sizes operating efficiently and has acquired the skills of managing risks involved in extending finance to different sectors of the economy, including long term finance. Thus the need for DFIs as the exclusive providers of development finance has diminished. The banks may be encouraged to extend high risk project finance with suitable Central Government support with a view to distributing risks and funding sources as also developing appropriate credit appraisal and monitoring skills across the financial system. Banks may also be permitted to raise long term resources through issuance of development bonds for the purpose of extending long term project finance so that problems of asset liability management can also be taken care of.

9. Banks enjoy the natural advantage of low cost funds and are, therefore, capable of providing long term finance at lower rates despite higher intermediation cost and can derive at the same time the benefit of risk diversification across a wide spectrum of assets of varying maturities, subject of course, to the limitations imposed by their ALM considerations. With the change in the operating environment, the supply of low cost funds has dried up for the DFIs forcing them to raise resources at market related rates. The DFIs are unable to withstand the competition from banks due to their higher cost of funds. DFIs are also burdened with large NPAs due to exposure to certain sectors which have not performed well due to downturn in the business cycle further adding to their cost of doing business. Further their portfolio is almost entirely composed of long-term high risk project finance and consequently the viability of their business model has come under strain. In a purely market-driven situation, the business model of any DFI which raises long-term resources from the market at rates governed by the market forces and extends only very long-term high risk credit to fund capital formation of long gestation is unlikely to succeed on account of threat to its spread from higher cost of funds and higher propensity to accumulate non-performing assets, notwithstanding lower operating expenses vis-a-vis banks. DFIs are, therefore, crucially dependent for their continued existence on Government commitment for support. As support from the government has a social cost, Central Government need to decide, after a detailed social cost-benefit analysis, on the areas of activities which require developmental financing and only those DFIs which the Central Government decide to support may continue as DFIs. The rest of the DFIs must convert to either a bank or a regular NBFC as recommended by the Narasimhan Committee and should be subject to full rigor of RBI regulations as applicable to the respective category. Further, no DFI should be established in future without the Central Government support.

10. State Financial Corporations (SFCs) had been established as state level institutions for meeting the financial requirements of small scale and medium industries under State Financial Corporations Act, 1951. SFCs have, however, even after their long existence remained largely "single product" provider extending only term loans assistance to SSIs. They have not been able to diversify products and services to ward off the competition from banks which are today in a position to perform all those functions being done by the SFCs. Due to combination of the several factors the SFCs' financial position has irretrievably deteriorated. Barring four of these, all SFCs in different states have hugely negative CRAR and very high NPAs. In the final analysis the SFCs have outlived their utility in the present context and should be phased out within a definite time frame. The credit gap, if any, created by the exit of the SFCs from the market can be filled by banks and also by suitably repositioning SIDBI.

11. Pursuant to the recommendations of the Khan Working Group on Harmonizing the Role and Operations of the Development Financial Institutions and Banks, a Discussion Paper was prepared outlining the issues arising out of the recommendations of the Narasimham Committee II and the Khan Working Group. Extensive discussions were held on the issues brought out in the paper and a broad policy framework was outlined in the Mid-Term Review of Monetary and Credit Policy of 1999-2000 of RBI. The principle of Universal Banking was recognised as a desirable goal. It was also recognized that the DFIs would continue to have a special role in Indian financial system until the debt market demonstrated substantial improvement in terms of liquidity and depth. However, any DFI which wishes to transform into a bank should have the option provided the prudential norms applicable to the banks are fully satisfied. To this end a DFI would need to prepare a transition path in order to fully comply with the regulatory requirements of a bank. The DFIs were, therefore, advised to consult RBI for such transition arrangements which RBI will consider on a case-to-case basis. The need for strengthening the regulatory framework of RBI in respect of DFIs, if they were to be given greater access to short-term resources for meeting their financing requirements, was recognized. It was expected that in the light of the evolution of the financial system, the Narasimham Committee's recommendation that ultimately there should only be banks and restructured NBFCs, could be operationalised. The operational guidelines for enabling a DFI to convert to universal bank were issued in 2001 following the policy pronouncement by RBI on 'Approach to Universal Banking'. The DFIs were advised that those who choose to convert into bank may formulate a roadmap for the transition path and strategy for smooth conversion over a specified time frame. It was also advised that the plan should specifically provide for full compliance with prudential norms as applicable to banks over the proposed period and should be submitted to RBI for consideration.

12. While ICICI Ltd. converted into a bank by way of a reverse merger with ICICI Bank in 2002, IDBI is in the process of conversion to a commercial bank. The IDBI (Transfer of Undertaking and Repeal) Act, 2003 was passed by the Parliament and notified by the Government of India on December 30, 2003. The new banking entity, sought to be created by the repeal act, will come into being on the appointed day which is yet to be notified by the Government. On the appointed date the undertaking of the IDBI would vest in the company to be formed and registered under Companies Act, 1956 under the name Industrial Development Bank of India Ltd. The company shall be deemed to be a banking company under Section 5(c) of BR Act, 1949 and will not be required to obtain a banking licence from RBI under Section 22 of BR Act, 1949.The new entity shall not be required to maintain for five years from the appointed day, the prescribed percentage of liquid assets (SLR) required under Section 24 of the said Act. Further, Central Government may in consultation with RBI direct by notification that any of the provisions of BR Act shall not apply to the company or shall apply with such exceptions, modifications and the adaptations as may be specified in the notification. IDBI has already made a request to the Government for infusion of funds. IDBI is also in touch with RBI to sort out various legal, regulatory and operational issues.

13. The WG has reviewed the experience of ICICI Ltd., the only DFI which has so far successfully converted into a bank. Although, the exact replication of its experience may not be possible, some tentative conclusions can be drawn from the experience of ICICI Ltd., which can serve as reference points. The conclusions are:

(i) A ready banking platform would greatly facilitate the conversion of a DFI into a bank.

(ii) In preparation for conversion to bank a DFI should consciously scale down the proportion of project financing in its business by resorting to innovative products. The choice of the target clientele, appropriate business and product mix to be offered in face of the acute competition in the banking sector, the mechanism for delivery of banking services and compliance with statutory and regulatory requirements over a self determined time horizon should be formulated well before embarking on conversion to bank. There should be ongoing monitoring of the business and strategic plan till the entity is fully integrated into the banking system.

(iii) A company structure possesses the attributes of operational flexibility and is best suited for role transformation of a DFI into a bank.

(iv) A DFI possessing brand equity can, in a very short time, establish itself in the market after conversion into a bank.

(v) In an organisation transforming to a new role there is a great need for skilful change management by retraining and equipping the managerial personnel with new set of skills and facilitating their adaptation to a new working style and environment.

14. A regulatory framework would be necessary to facilitate the smooth migration of a DFI into a bank. On grounds of practical considerations the entities may need relaxations in application of the regulations relating to restrictions on equity holdings acquired by way of project finance and lending to priority sector. The relaxations may, however, be given only for a specified time-period in respect of legacy portfolio of assets as on the day of conversion and the incremental portfolio should be subjected to the full rigour of regulations from the inception of the converted bank. No relaxation should be given, unless mandated by statute, from the prudential / statutory regulations such as minimum capital requirements, income recognition, asset classification and provisioning norms, capital adequacy prescriptions, maintenance of CRR and SLR, building up of reserves funds etc., besides other regulations relating to drawing of accounts and audit, permissible banking business, restriction on common directors and connected lending etc.

15. RBI regulation on financial intermediaries is premised on two primary factors – protecting depositors' interest, in case public deposits are accepted, and the systemic stability considerations. The responsibility and associated regulatory and supervisory powers are conferred upon RBI under the Banking Regulations Act, 1949 in regard to banks and in RBI Act, 1934 in regard to non-banking institutions.

16. After prolonged consultations with the select FIs and Government of India, RBI extended prudential norms relating to income recognition, asset classification and provisioning as also the capital adequacy to the select DFIs, in phases, since 1994. Besides, since 1995, after the setting up of the Board for Financial Supervision (BFS) in keeping with the recommendations of the Narasimham Committee-I, RBI also started conducting periodical inspection of these DFIs. The entity wise decisions for regulation and supervision so far taken in this regard appear to have been taken on a case-to-case basis. At present RBI regulates and supervises only nine select DFIs, viz., IDBI, IFCI Ltd. TFCI Ltd., IDFC Ltd., IIBI Ltd., EXIM Bank, NABARD, NHB and SIDBI.

17. In regard to DFIs, the basic approach of the WG is that the DFIs being non-banks, are functionally more akin to NBFCs than banks and, therefore, should, as a general rule, be subject to the general principles of NBFC guidelines. However, it is also recognised that the dominant theme of NBFC guidelines is to protect the depositors' interest and to ensure the viability of the NBFCs for the purpose. In the case of DFIs, It is observed that most of these DFIs either do not accept public deposits or where they do so, the public deposits constitute a very small proportion of their total liabilities / resources. As such, seen solely from the viewpoint of protecting depositors' interest, these DFIs as a group may not give rise to RBI's regulatory or supervisory concerns. However, on account of large-scale borrowings being resorted to by these DFIs by way of bonds issued, from domestic banks, Provident Funds, Insurance Companies, Trusts and general public, failure of any of the larger DFIs could have adverse effect on the entire financial system. The regulation of these DFIs should, therefore, be so designed as to ensure that the regulatory framework along with the committed Government support available to the DFI works towards ensuring their financial soundness so that the overall systemic stability is not endangered.

18. After excluding IDBI and IFCI Ltd. which are on their way to transform into banks, institutions which are regulated by NHB, SEBI and IRDA, and certain other institutions which are either not systemically important or not strictly DFIs, the WG studied for its purpose three categories of DFIs. The first category comprises the four All India DFIs established by statute viz., NHB, SIDBI, NABARD and EXIM Bank. The second category comprises the state level institutions set up by statute viz., SFCs. The third category comprises the DFIs that have been constituted as companies under the Companies Act, 1956 and hence are, by definition, NBFCs viz, IIBI Ltd., TFCI Ltd., PFC Ltd., REC Ltd., IRFC Ltd., IREDA Ltd., NEDFi Ltd., IDFC Ltd., and SIDCs.

19. The above mentioned four DFIs established by statute also act as instruments of public policy and the WG is of the view that Central Government should oversee their functions arising out of such public policy. However, considering their linkages with other financial intermediaries, the WG recommends that RBI may continue to regulate these four institutions, purely from the considerations of systemic stability, irrespective of whether they accept public deposits or not. It is also observed that RBI has ownership interest in NABARD and NHB. As there is a scope for conflict of ownership and regulatory / supervisory interests, the WG recommends that the RBI may divest its stakes in these two institutions.

20. To varying degrees NHB, SIDBI and NABARD also shoulder responsibilities of regulating and / or supervising the financial intermediaries falling under their respective domains - Housing Finance Companies in the case of NHB, SFCs and SIDCs in the case of SIDBI, and State Co-operative Banks, District Central Co-operative Banks and Regional Rural Banks in the case of NABARD. RBI, may have to ensure that the standard of regulation and / or supervision exercised by the NHB, SIDBI and NABARD over the institutions falling under their respective domains is broadly at par with that maintained by RBI.

21. There are 18 SFCs of which 17 were set up under the SFCs Act 1951, while Tamil Nadu Industrial Investment Corporation Ltd., was incorporated under the Companies Act, 1956 and functions as a SFC. These 18 SFCs have outlived their utility in the present context and should be phased out within a definite timeframe. As regards the regulation in the interim period, the Working Group recommends that suitable regulatory and supervisory powers in respect of SFCs should be vested in SIDBI.

22. In respect of the DFIs which have been constituted as companies under the Companies Act, 1956 and hence are, by definition, NBFCs (viz., IIBI Ltd., TFCI Ltd., PFC Ltd., REC Ltd., IRFC Ltd., IREDA Ltd., NEDFi Ltd., IDFC Ltd., and SIDCs), the Working Group notes that IIBI Ltd., TFCI Ltd., and IDFC Ltd., are being regulated by RBI as FIs and certain others, though they are NBFCs, have been exempted by RBI from regulations applicable to NBFCs as they are Government Companies. As all such institutions are performing developmental functions, they should be subjected to uniform and discrete regulation. For this purpose, they could be classified as a new category of NBFC called "Development Finance Companies" (DFCs). The decision to classify any company as DFC should be based on the business conducted by the institution, it's geographical coverage and systemic importance and rest with RBI. SIDCs and NEDFi Ltd. may not be treated as DFCs and subjected to the proposed rigorous regulations for DFCs.

23. The WG recommends that the following essential regulations may be applied to the four DFIs established by statute (viz., EXIM Bank, NHB, NABARD and SIDBI) and DFCs, except that the recommendations relating to registration with RBI, entry point norms and composition of Board of Directors indicated below may not be made applicable to the aforesaid four DFIs.

24. As a general policy, all institutions meant for development financing that might be set up in future may be constituted as companies (DFCs). As a category of NBFCs, DFCs will be required to be registered with RBI like other NBFCs.

25. Considering the nature of business of development financing, the entry point norm should be set sufficiently high to keep out non-serious players. Accordingly, it is recommended that an entry point norm of net owned funds of Rs. 100 crore should be prescribed for DFCs.

26. DFCs accepting public deposits should maintain liquid assets as provided for other NBFCs in terms of Section 45-IB of RBI Act, 1934. Similarly, DFCs will also be statutorily required to transfer certain proportion of their annual profits to reserve funds, as required in term of the provisions of Section 45-IC of the RBI Act, 1934**.**

27. With a view to enabling the DFCs to access short term and medium term resources to a larger extent and thereby reducing their cost of funds, the present prescription of limiting such access to the extent of NOF may be done away with in respect of those DFCs which have the minimum CRAR of 15%, net NPAs not exceeding 5% of total assets and are fully complying with the ALM guidelines issued by RBI restricting the gap limits to 10 and 15% for the first two time buckets of 1-14 days and 15-28 days respectively subject to the condition that public deposit will not exceed 1.5 times of NOF as prescribed for loan / investment companies. Restrictions will continue to remain in force for DFCs which do not satisfy the above requirements.

28. Keeping in view the systemic importance, the DFCs may be subjected to the guidelines laid down by RBI for the select FIs in respect of their investments and credit portfolio. The extant prudential norms relating to income recognition, asset classification, provisioning, capital adequacy and single and group exposures etc. applicable to select FIs currently regulated by RBI flow from their functions as DFCs and not from their institutional forms and as such, the same may be adopted for DFCs. Thus, DFCs may be required to maintain CRAR of 9% only instead of 15% as prescribed for NBFCs in general.

29. **Considering their systemic significance, the DFCs may be required to submit their audited annual accounts to RBI within a specified time frame after the end of each accounting year. They may also be required to obtain prior approval of RBI before appointing / re-appointing / removing the statutory auditor / auditors.**

30**. RBI should have the powers to prescribe composition of Board of Directors of DFCs so as to ensure inclusion in the Board of professionals having special knowledge or practical experience in the matters of finance, accountancy, management, industry or any other area of importance which RBI might consider useful to the DFCs. RBI may also consider issuing suitable guidelines on the broad principles of corporate governance to be adopted by DFCs.**

31. The supervisory process in respect of the select DFIs established following the recommendations of the Informal Advisory Group on Regulation and Supervision of FIs is working satisfactorily. The same may be extended to supervision of all DFCs as well.

32. The Non Banking Financial Companies (NBFCs) as defined in the RBI Act, 1934 are broadly classified in different categories on the basis of their principal activities. RBI regulates and supervises the NBFCs in terms of Chapter III B of the RBI Act. RBI has put in place a set of directions to regulate the activities of NBFCs under its jurisdiction. The directions are aimed at, controlling the deposit acceptance activity of NBFCs in the four categories of EL, HP, Loan and Investment Companies, deposits and business activities of residuary non-banking companies, and setting up prudential norms for all the NBFCs.

33.Regulation covering deposit taking include the requirement of minimum investment grade credit rating, quantum of public deposits, interest rate on deposits, brokerage, period of deposits, etc. RBI has also prescribed disclosure norms and prudential norms akin to those applicable to the scheduled commercial banks. However, the non-public deposit taking NBFCs are regulated in a very limited manner.

34. The WG finds that while non-public deposit taking NBFCs are slated to be excluded from the purview of RBI regulations, there is a need to focus on all large sized NBFCs from the angle of their systemic significance. The Group recommends that for this RBI should put in place as an initial measure, a system of periodical collection of all information relevant to the systemic concerns pertaining to large sized non public deposit taking companies say with total assets of Rs.500 crore and above. The information system may include, besides submission of annual financials, quarterly reporting of specific details of the company's assets and liabilities which focus on their linkages to the market, inter-corporate / intercompany and capital market exposures and all other sensitive information. This system may also be specified for public deposit taking companies to the extent required.

35. RNBCs are classified as a separate category as their business, which has evolved over the years, does not conform to any of the other defined NBFC businesses. The developments over the years in the regulation of this group of entities have left the field now with only four companies which operate as RNBCs and are registered with RBI. As on 31 March 2003 these four companies carried an aggregate liability of Rs.15,061 crore to the depositors. RBI supervises the companies through a mechanism of off-site surveillance, on-site inspection and commissioned audit.

36. Although the RNBC Regulations permit the companies to access borrowings from banks, financial institutions and corporates, secured debentures, etc., in practice, the four RNBCs have accessed only public deposits. Traditionally these deposits are in different categories in terms of collection process and maturity (e.g. daily deposits, recurring deposits, fixed deposits). The maturities of these deposits, as specified in the Regulations, range between 1 year to 7 years. The RNBCs are permitted to fix the interest on these deposits at their discretion subject to some minimum rates of interest on deposits which have been prescribed (now 3.5% on daily deposits; 5% on other deposits). The deposit business is conducted by RNBCs through their branches and through a wide network of agents.

37. As these companies have an unlimited access to public deposits they are required to invest the depositors' funds in Government securities, guaranteed bonds issued by the PSUs of the Central or State Governments, rated non-guaranteed bonds of PSUs, debentures of private sector companies, commercial papers, units of mutual funds, etc, the market value of which should at least be 80 per cent of the liabilities to the depositors. The remaining depositors' funds to the extent of 20% of the liability to the depositors or 10 times their NOF**,** whichever is lower, is allowed to be invested in any manner in securities and other assets, including non-financial assets as per the discretion of their board of directors. It is seen that as on date, the two large RNBCs carry, to a large extent within their discretionary portfolio, assets in the form of real estate, receivables from Revenue Department (TDS / Advance Tax), and investment in shares. While the regulation of RNBCs by RBI needs to be viewed in the historical perspective of evolution of such companies and the concerns of RBI to protect the interest of depositors, there is a need for revisiting the existing regulatory structure in the current context.

38.As regards conversion of RNBCs to the category of DFIs, the WG finds that as there is no commonality of characteristics between the RNBCs and DFIs the transformation of RNBCs into the DFI mould would be neither feasible nor desirable.

39. As regards the prospect of RNBCs transforming to other categories of NBFCs, namely, equipment leasing (EL), hire purchase (HP), loan and investment company, the WG finds that it may be possible for RNBCs to convert their asset profile to these categories. Any such conversion would involve the companies submitting themselves to the regulations relating to the liabilities, especially NOF related restrictions on quantum of public deposits, applicable to these categories of companies.

40. The restrictions placed on NBFCs with respect to raising of public deposits are: EL or HP companies are allowed to raise public deposits up to 4 or 1.5 times their NOF depending upon their CRAR and availability of minimum investment grade credit rating for their fixed deposit programme. In the case of loan or investment companies, the entitlement for public deposits is 1.5 times the NOF subject to their having minimum CRAR of 15% and minimum investment grade credit rating for their fixed deposits. In case the RNBCs move on to any NBFC category, immediate compliance by them with the applicable regulations on public deposits would not be possible and regulatory relaxations would be required.

41. The WG is of the view that continuation of RNBCs in their current mould is not desirable because the scope that exists now for unrestricted growth of deposits in RNBCs poses serious concerns relating to the depositors' interest. A cap in terms of NOF may be fixed for mobilization by RNBCs of public deposits. The cap would be in terms of public deposits, as opposed to all deposits, which are covered by the extant regulations. The cap on RNBCs' access to public deposits may be stipulated, as an initial measure, at a level of 16 times the NOF, along with a direction that the RNBCs will ultimately have to conform to the norms for raising of public deposits for NBFCs in general i.e. ceiling of 4 times or 1.5 times, as applicable. The Group is of the view that the time for such transition should be preferably not more than 5 years, although extension of time may be warranted by, among other reasons, the future cash flows arising out of the deposit contracts already entered into by the respective RNBCs and the nature of the fixed costs built into their operations. The progressive reduction of the cap on deposits in terms of NOF may be accompanied by a commensurate progressive increase in the discretion to be allowed to the RNBCs for deployment of funds so that on the completion of transition, the RNBCs would comply with the norms for raising public deposits, while enjoying the freedom to use the deposit and other funds in the manner applicable to other NBFCs.

42. As the RNBCs would hold large volume of deposits in relation to their NOF during the transition period, it is necessary to ensure that the quality of their investments is of a high order. The Group is of the view that unlisted and unrated bonds issued by any company/institution, including PFIs, should not be part of the investments. Further, investments in unlisted but rated bonds and debentures should be only to an extent of 5% of their total investments in debt securities. Suitable caps may be fixed by RBI for exposures to capital market, real estate, unlisted but rated securities and units of equity oriented mutual funds. Above all, the directed investments may comprise only the rated and listed securities or the units of debt oriented mutual funds as per prudential guidelines for non-SLR securities for banks besides the Government Bonds and listed and rated Government Guaranteed bonds. If rating of any of the investments in the directed category is downgraded below the prescribed grade, the investments should be shifted to discretionary category with immediate effect and no fresh investment should be made in the discretionary category until any resultant shortfall in the directed investment is made good.

43. Keeping in view the prevalent interest rates in the financial markets, the RNBCs have to compete with the rates offered by banks on their deposits, small savings schemes of Government etc. In such a scenario, removal of the floor rate on interest to be offered by the RNBCs is not going to affect the market and will also be in order, keeping in view the conscious policy of moving away from an administered interest rate regime.

44. RNBCs are permitted to levy non-refundable service charges to the depositors to cover their collection costs. Keeping in view the progressive freedom to be granted to RNBCs in respect of their investments / lending operations as discussed above, their rate of return on assets is expected to increase substantially. The benefit of higher yield on assets may, therefore, be passed on to the depositors in the form of interest to compensate for the service charges levied at the time of maturity.

45. The WG has been informed that the rate of discontinuity of deposit schemes is high in respect of one RNBC because the commission paid on collection of deposit instalments in respect of recurring deposit is very high for the first year as compared to those paid in the subsequent years. The Group is of the view that the rate of discontinuity may be minimised if the commission structure is uniform for collection of all deposit instalments and the agency agreements provide for disincentives to agents for failure to collect all instalments.