27 October 2014

SUBMISSION OF COMMENTS TO THE COMMITTEE ON ESTIMATES

"REGULATORY MECHANISM OF PROTECTION OF INTERESTS OF DEPOSITORS OF NON-BANKING FINANCIAL COMPANIES (NBFCS) – AN OVERVIEW"

1. Background

The Committee on Estimates (Sixteenth Lok Sabha) selected the subject of "Regulatory Mechanism of Protection of Interests of Depositors of Non-Banking Financial Companies (NBFCs) – An Overview" for examination during the year 2014-15 and presenting a Report thereon to Parliament. Pursuant to a press release dated 12 October 2014, the Committee invited suggestions on the subject from interested stakeholders.

Consumer Unity & Trust Society (CUTS) is a vigilant institution working in the area of economic regulation, consumer protection, competition, trade, and investment. CUTS' suggestions on the subject are set out in the following sections.

2. Regulation of NBFCs

NBFCs are engaged in varied financial activities and provide a wide range of financial services. NBFCs cover companies engaged in activities like Equipment Leasing, Hire Purchase Finance, Loans, Investments, Mutual Benefit Finances (Nidhis), Miscellaneous Non-banking (Chit funds), Housing Finance and Residuary Non-banking.

Principal legislation governing the NBFCs is the Reserve Bank of India Act, 1934 (RBI Act).[1] However, certain categories of NBFCs are under supervision of other regulators. Housing finance companies are regulated by National Housing Bank (NHB); merchant banker, venture capital fund, stock brokers, etc. by the Securities & Exchange Board of India (SEBI) and insurance companies by the Insurance Regulatory & Development Authority (IRDA). Similarly, Chit Fund Companies are regulated by the respective state governments and Nidhi Companies by the Ministry of Corporate Affairs (MCA).

While most of these NBFCs have access to public funds, the intensity of regulation varies. For instance, state governments and MCA have been alleged of under-regulating chit fund and nidhi companies, respectively, while the RBI has been accused of abusing its discretion. Under the RBI Act, RBI has the power to impose conditions as *it may think fit* under the guise of *public interest***,** while issuing certificates of registration to NBFCs.[2] Similarly, the Securities Appellate Tribunal, in the recent order of *Pancard Clubs Limited* v. *SEBI*[3], ruled that extreme powers to take extreme measures, as provided to SEBI under

[1] Chapter IIIB of the Reserve Bank of India Act, 1934
[2] Section 45-IA of the RBI Act
[3] Order dated September 17, 2014, available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1410940529477.pdf, last visited on October 27, 2014

sections 11 and 11B of the SEBI Act, should be used with extreme caution.[4] While the orders of SEBI are appealable at SAT, no such grievance redressal mechanism to a quasi-judicial body is available from orders of RBI.

As a result, the products issued by NBFCs are regulated differentially, resulting in creativity my market players to be subjected to loose regulation. Such incidents have been witnessed in past with respect to jurisdiction of unit linked insurance products (ULIPs), wherein the finance ministry had to step in to clarify that IRDA has the jurisdiction to regulate ULIPs.

The existence of multiple regulators with diverse regulatory powers, differentially regulating NBFCs within their jurisdiction has led to an increase in the scope of regulatory arbitrage, which has been exploited by entities such as financial conglomerates.

The draft Indian Financial Code (the draft code), formulated by the Financial Sector Legislative Reforms Commission, has proposed replacing the bulk of existing financial laws, and moving away from the current sector-wise regulation, by providing activity-based regulation. However, it has proposed different regulators for bank and non-bank entities, viz. RBI to regulate the banking and payments system and a Unified Financial Agency (UFA) to subsume existing regulators like SEBI, IRDA and PFRDA to regulate the rest of the financial markets.[5] This might not be an apt solution for the issue of regulatory arbitrage.

Suggestions:

It is suggested that financial sector regulators, i.e., RBI, SEBI, IRDA and PFRDA along with the Ministry of Finance, come together and join forces in a coordinated manner to check problem of differential regulation.

The Financial Stability and Development Council (FSDC), constituted in the wake of financial crisis, to institutionalise and strengthen financial stability, inter-regulatory coordination between financial sector regulators[6], could be the right platform to ensure constant communication and coordination amongst various financial sector regulators.[7] Experts have also recommended that the issue of SEBI regulated entities undertaking fund based business without capital adequacy type of stipulations may be reviewed by the sub-committee of the FSDC.[8]

[4] Somasekhar Sundaresan, *With great power comes great responsibility*, Business Standard, October 05, 2014, available at http://www.business-standard.com/article/opinion/with-great-power-comes-great-responsibility-114100500643_1.html, last visited on October 27, 2014

[5] Report of the Financial Sector Legislative Reforms Commission (FSLRC), 2013

[6] See, Ministry of Finance notification dated 30 December 2010, available at http://finmin.nic.in/fsdc/GazNote31122010.pdf, last visited on 27 October 2014

[7] The financial sector regulators recently signed MoU to jointly monitor financial conglomerates. Similar mechanisms could be developed for regulation of CIS'.

[8] RBI, Working Group on Issues and Concerns in the NBFC Sector, Report and Recommendations, August 2011

In addition to inter-regulatory interaction, development of a formal mechanism for constant interaction between financial sector regulators and central and state governments is imperative. Such mechanism would ensure concurrence in regulatory and governmental objectives, act as feedback and experience-sharing tool, and cross-learning between agencies and ensure that financial sector entities are efficiently regulated and the vulnerable are adequately protected

3. Differential regulation from banks

Under the present structure, NBFCs do not have to meet prudential norms like cash reserve ratio or high statutory liquidity ratio, unlike banks. While lighter prudential requirements in relation to exposure norms, capital adequacy, risk weights, asset classification and provisioning requirements, are applicable to NBFCs, banks are subject to stricter regulatory supervision and need many approvals (including RBI approval for branch expansion). Banks have been mandated priority sector lending requirements and are also subject to stringent foreign ownership requirements, which are either absent or are applicable to a limited extent in case of NBFCs.

Such restricted regulatory burden on NBFCs has lead to apprehensions that banks are routing funds through NBFCs to sectors in which bank investment is tightly regulated. Recent experiences show that such shadow banking entities can pose potential threats to long-term financial stability if their transactions connect to banks, the banking system, or asset markets[9].

In a recent study on regulation and competition in Indian financial sector, undertaken by CUTS, 46 percent of respondents believed differential regulation between banks and NBFC creates uneven playing field in the market.[10]

Experts, therefore, have recommended that bank-like financial institutions (having access to public funds) which provide similar products and services should be regulated similarly.[11] In addition, RBI has issued draft guidelines[12] that provide for increasing the NBFC capital requirements and risk weights (for Capital Market Exposures and Commercial Real Exposures) and making asset classification and provisioning norms similar to banks, in a phased manner. However, it remains to be seen if such recommendations are implemented.

Suggestions:

In the modern intricately inter-related financial world, banks and NBFCs act closely, often residing under one large conglomerate. Thus, it is important that NBFCs carrying on bank-like activities implement risk management policies similar to that of banks and follow capital adequacy and provisioning norms.

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[9] Liikanen et al, Final report of the High Level Expert Group on reforming the structure of the EU banking sector, October 2012

[10] Pradeep S. Mehta (ed.) *Competition and Regulation in India*, 2013

[11] RBI, India's Financial Sector, An Assessment, March 2009

[12] www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=2620, last visited on 27 October 2014

Additionally, tax benefits and benefits under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, accorded to banks should be extended to NBFCs so that they are able to adopt better fund management practices.

4. Preference to public sector entities

In India, public sector NBFCs have historically been preferentially treated, as against their private sector counterparts. Many privileges (government guarantee for sums assured)[13] have been granted to the Life Insurance Corporation of India (LIC) under the LIC Act, and not to private sector insurers. Certain government-owned NBFCs have also been exempted from prudential norms (including capital adequacy and credit exposure requirements) applicable to other NBFCs. Such benefits are not available to private players.

Suggestions:

There is an urgent need to create level playing field between the public sector and private sector NBFCs. The legislative benefits accorded to public sector entities must be immediately done away with. Greater competition will help in greater efficiency and better customer service in the market.

5. Need for impact assessment of regulatory requirements

Under the RBI Act, no NBFC can commence or carry on the business of a non banking financial institution without having net owned funds of INR 25 lakhs or such other amount not exceeding INR 2 crore as may be specified by the RBI. Thus, there is a statutory ceiling on the maximum amount that may be specified by RBI as the entry level NOF requirement.

Recently, amendments were suggested under the draft guidelines[14] pursuant to the recommendations of the Working Group on Issues and Concerns in the NBFC sector. Accordingly, new companies having NOF of not less than INR 2 crore and minimum assets size of INR 25 crore are required to obtain registration.

However, for considering an application of a company for grant of a certificate of registration (CoR), the RBI is required to satisfy itself that the NBFC concerned has an adequate capital structure and earning prospects.[15] This could have several ramifications. The legislation gives the unfettered discretion to the RBI to specify a minimum capital base for granting CoR and grant exemption[16] from the requirement of registration to those NBFCs that do not meet the minimum capital base specified by it.

[13] Applicability of laws governing winding-up of companies and liquidation only by an order of the government (s. 38), explicit government guarantee for all sums assured under LIC policies (s. 37), power to government to modify applicability of certain provisions of the Insurance Act for their applicability to LIC (s. 43), any interest or dividend payable to LIC in respect of any securities/ shares owned by it or in which it has full beneficial interest is not subject to deduction of income tax (s. 43A)
[14] Supra Note 7
[15] Section 45IA(4)(d) of the Reserve Bank of India, 1934
[16] Under section 45NC of the Reserve Bank of India, 1934

In an ideal scenario, it is the legislature which should determine the threshold and regulators should not be given this unfettered discretion, rather it must merely be tasked with the function of investigating if a particular entity falls within the scope determined by legislature or not.

Suggestions:

There is a need to review the (intended and unintended) impact / consequences of provisions of the RBI Act, which affect the regulation of NBFCs, and consult various stakeholders to reformulate the provisions.

This practice is known as impact assessment, and is widely followed in jurisdictions such as US, UK, Australia etc. and has been recommended for India as well.[17] It is high time that laws are made by following this scientific process, and a review of the parent act could be the right start.

6. Need for an omnibus Financial Consumer Protection Act

Financial consumer protection has historically been subjected to short shrift in the country. Illegitimate money collection, circulation, and ponzi schemes and sale of complex and unsuitable financial products by unaccountable financial firms, and practises such as product bundling etc. have been order of the day, more so by loosely regulated non-bank financial firms.

There is an urgent need of a strong consumer protection mechanism, setting clear rules for financial institutions regarding their dealings with retail customers. While experts have recommended reforms such as introduction of suitability requirements, simple and standard financial products, move to seller beware principles, much more needs to be done. Adoption and implementation of a strong and omnibus financial consumer protection law covering the entire sector to implement various suggestions is need of the hour.

Suggestions:

An omnibus Financial Consumer Protection Act must be adopted for regulating NBFCs and addressing on-going malpractices in the financial sector such as hidden and inflated charges or fees; undisclosed level of financial risk; etc. Such law must take into account successful and not-so-successful practices implemented by various regulators and comparable jurisdictions. In addition to creation of such law, capacity must be build existence of adequate infrastructure must be ensured to aim effective implementation of such law.

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[17] See, recommendations of the Financial Sector Legislative Reforms Commission (2013), and the Damodaran Committee (2013). CUTS is also working to facilitate ex-post impact assessment in India