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Article

Policy Framework of NBFCs in India: An Overview

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A B S T R A C T

This study deals with the performance evaluation of NBFCs especially the financial performance of NBFCs-ND-SI in India. The policy framework, which regulates the NBFC regime in India, has been examined. It focuses specifically on the growth of shadow banks in India. The contribution of main stream banking sector to the progress of these NBFCs has also been examined. The aspect of maturity transformation of NBFCs has also been subjected for evaluation.

Keywords: GDP, Emerging Market Economies (EMEs), Dynamic Stochastic General Equilibrium, Shadow Banks

Introduction

When taking in to account the percentage of shadow banks' assets in certain regions; In terms of GDP, it stood at 1190 percent, 147 percent, 90 percent and 82 percent in countries like Ireland, UK, Switzerland and the United States respectively.

The dimension of the assets of shadow banks were below 10 percent of GDP in Turkey, Argentina, Saudi Arabia, Russia and Indonesia. Hence, it can be inferred that, it is, the developed economies, who possess a good share of assets for shadow banks in their financial system. Even, this correlation established between shadow banking and degree of development, is not necessarily to assure that these intermediaries contribute positively to that economy. Literature validates that such mediation itself has gravely augmented the problems related to the financial crisis. So, supporters of shadow banks may or may not to be rationalised. Does India need shadow banks? This must be read together with the variations of performance, if any, of NBFCs in India from the expected standards. Government of India frame policies considering the supplementary or complementary role of NBFCs. This complementary process must be rationalised with effective channelization of savings and thereby development. Most of the Governments frame policies related to NBFCs in consonance with the developments in banking sector. Share of shadow banking assets of Emerging Market Economies (EMEs) doubled from 6% in 2010 to 12% in 2014. The consonance with the banking sector is complex in these economies. Thus, financial sector development and innovation will bring out risks and it is essential to put in place an effective regulatory and supervisory mechanisms and carry out structural reforms in developing the financial sector (Zhuang et al., 2009). Lack of comprehensive regulatory and policy frameworks for NBFIs is a major problem to develop the non bank finance industry in Asia and the Pacific (ADB, 2015). So, the post crises plot of such economies, especially India, require a serious revision. This chapter overviews the policy framework of NBFCs in India.

An Overview of Past Efforts

Claus, Jacobsen, Jera, (2004), developed an analytical framework to discuss the link between financial systems and economic growth.[1] The analysis conveys the magnitude of maintaining solid legal foundations since the financial system relies on these. In this context, it seems that this report is the pioneered work that cautiously necessities such legal framework.[2] Akinlo, Egbetunde (2010) examined the long run and causal relationship between financial development and economic growth for ten countries in sub-Saharan Africa. The study showed the need to develop the financial sector through appropriate regulatory and macroeconomic policies.[3] Report of Muller et al., (2012) addresses the risks run by non-bank financial institutions. As per their report, risks are credit, counterparty, liquidity, redemption, fire sales, etc. Further they report that the risk is magnified as a result of multipliers size, interconnectedness and regulatory features. Their study examined in detail the money market funds, private equity firms, hedge funds, pension funds and insurance undertakings, central counterparties, etc. According to them, risks to financial stability are broadly considered as risks to financial intermediation. The risks would threaten the flow of capital from investors to users of funds. The finding was fortified when European Central Bank (2012) presented evidence to the increasing interlinkage among the sectors in financial system. The interlinkage makes every sector vulnerable to stress in other sectors, in particular the MFI sector. Then how can the problem be solved?[4] As Ghilardi, Peiris (2014) observed, macro-prudential measures can usefully complement monetary policy. They developed an open-economy Dynamic Stochastic General Equilibrium (DSGE) model 5 with an optimizing banking sector to assess the role of capital flows, macro-financial linkages, and macroprudential policies in emerging Asia. The finding of Bruno, Shim, Shin (2015) reinforces that; macroprudential policies are more successful when they complement monetary policy by reinforcing monetary tightening, than they act in opposite directions.[5]

The view regarding a healthy financial intermediation is largely supported by a healthier banking and non banking mediation. The macro-prudential approach will sufficiently contribute towards the solidification of good legal framework.

Claessens, Kose, Terrones (2011) documented that there are strong interactions between business and financial cycles.[6] Their dataset includes 44 advanced and emerging economies over the period 1960 to 2007. The main variable they used to characterize business cycle is output. Credit, house and equity prices are three measures for financial cycle. The financial cycle is best captured by the joint behaviour of credit and property prices[7] (Borio, 2012). It is generally assumed that the credit behaviour will be vigoured by the relaxation in monetary conditions. But that relaxed monetary conditions may increase the risk appetite of banks (Ioannidou, Ongena, Peydró, 2008). Non relaxation will result in a limited access to bank credit. The limited access has increased the pressure on small and medium size enterprises (SMEs), forcing them to scale down investments and consequently production. In one paper it was explored the macroeconomic implications of such channel and found that countries with high prevalence of SMEs take more time to recover from global financial crisis than their peers. The "banking accelerator" transmission effect, a model of claims that it works in much the same way as the financial accelerator does in other existing models. The authors accorded that monetary stimulus to spending, like employment and output stimulating monetary policy, increases the demand for bank deposits. All these note the critical role played by the interaction of the economic structure and access to bank financing in economic recovery.[1]

Data and Method

In India, NBFCs are categorized by RBI into two types on the basis of liability structure Deposit-taking NBFCs (NBFCs-D) and non-deposit taking NBFCs (NBFCs-ND). There are 11522 NBFCs registered with the Reserve Bank of India (2017). Out of the registered NBFCs, 178 were NBFCs-D and 11344 were NBFCs-ND. There are 220 systemically important non-deposit taking NBFCs (NBFCs-ND-SI). These NBFCs are subject to more stringent prudential norms and provisioning requirements. This chapter deals with an overview of the regulatory framework of NBFCs in India. The period considered is from 2008 to 2016. Systemically important NBFCs showed an important role in the overall performance of NBFCs in India during this period. From 2010, RBI took serious measures to regulate NBFCs-ND-SI. So, to understand the impact of such initiatives, data for the period starting from 2010 was considered.[2]

- Assessment and alignment of the incentives associated with securitisation
- Dampening risks and pro-cyclical incentives associated with securities financing transactions such as repos and securities lending. The risk and incentives may exacerbate funding strains in times of market stress
- Assessment and mitigation of systemic risks 10 posed by other shadow banking entities and activities

As per IMF (2016), the growth of the non bank sector has not waned the effect of monetary policy. The report demands additional research on non banks concerned with the design of monetary policy responses over the business cycle. In India, the depositors' and borrowers' cautious behaviour, unlike in the case of developed regions, largely check the spill-over effect between the banking and shadow banking system.

NBFIs, emerged out of the necessity to have specialized financial institutions to cater for the diversified needs of financial services, have not contributed very much to the instability or to the ineffectiveness of monetary policy in the SEACEN region (Adhikary, 1989) 11. But the economic crisis (2007-08) brought some instability to the world financial market and thus developed a well categorisation and prudential norms. The post crisis period compelled the monetary authority in India to have some more prudential norms on non deposit taking NBFCs. Although systemic risk is not a serious problem in a well centrally managed banking system in India, the growth of total NBFCs is showing a declining trend, a farther Figure from the growth of commercial banking. Table 1, shows the number of NBFCs registered with RBI. (Table 1).

Table 1.Number of NBFCs Registered with Reserve Bank of India

Year	All NBFCs	NBFCs Accepting Public Deposits	NBFCs-ND
2008	12809	364	12445
2009	12740	336	12404
2010	12630	308	12322
2011	12409	297	12112
2012	12385	271	12114
2013	12225	254	11971
2014	12029	241	11788
2015	11842	220	11622
2016	11682	202	11480
2017	11522	178	11344

Source: Report on Trend and Progress of Banking in India for various years, RBI

Post crisis period witnessed a fall in the number of NBFCs in India. Both household sector and firms are benefitted with the vast financial services provided by the commercial banks during this period.[3]

Table 2.Growth in Total Assets and Net Worth of NBFCs-ND-SI[12] in India

Year	Net Worth (Rs Billion)	Growth (%)	Total Assets (Rs Billion)	Growth (%)
2007	731.86		3178.98	
2008	1055.45	44.21	4087.05	28.56
2009	1307.67	23.90	4829.07	18.16
2010	1635.93	25.10	5888.06	21.93
2011	1981.00	21.09	7613.00	29.30
2012	2415.00	21.91	9353.00	22.86
2013	2923.47	21.05	11601.27	24.04
2014	3168.00	8.36	12742.00	9.83
2015	3630.00	14.58	15232.00	19.54
2016	3425.00	-5.65	14832.00	-2.63
2017	4046.00	18.13	16917.00	14.06

As in the case of the number of entities, growth in net worth and assets shows a significant fall (Table 2). Average growth rate of shadow banks' assets for the period is 19.27 percent. Growth of such intermediaries is a positive thing to our financial system. Because, as RBI noted, shadow banks can provide some diversified services to the economy. But the emergence of shadow banks is primarily justified on account of the provision of long-term finance to projects.

Financial Stability Board (FSB) seeks to address the systemic risks related with shadow banking sector through indirect regulation. Its aim is to reduce the systemic risks carried out by regulating regular banks. So FSB focusses at three areas:[4]

- Prudential consolidation of banks' interactions wth shadow banking entities
- Introduction of prudential limits for banks' exposures to shadow banking entities
- A possible increase in capital requirements for banks' exposures to shadow banking entities (e.g. inclusion of investments in funds)

In practice, the high premium rates offered by the NBFCs ND-SI on debt instruments will result in a drain in the surplus savings of the community, which can otherwise, be received by the banking community. Capital requirements for NBFCs are reviewed periodically. Further, there are some established delays on account of the conflict between various levels of governance.[5]

RBI has been strengthening the regulatory and supervisory framework for NBFCs since 1997. NBFCs were advised in 2006 to prescribe the broad guidelines on fair practices that are to be framed and approved by the boards of directors of all non-banking financial companies.[6] The objective was the making of the NBFC sector vibrant and healthy. These efforts were pursued further during 2006-07.During the year, a major thrust was on strengthening the regulatory framework with regard to systemically important non-banking financial companies so as to reduce the regulatory gaps.

Accordingly, systemically important non-deposit taking NBFCs were defined, prudential norms were specified for these companies.[7-9]

Conclusion

RBI shall develop norms concerned with the volatility in the share capital of NBFCs. Charge on the assets, practically, would not fully compensate for the loss occurred to the fund providers of NBFCs. The loss mentioned here may be perceived from many perspectives. More acceptable views are related with the practical difficulties faced by the debenture holders. The regulatory frame work, on grounds of increasing volume of the debt of NBFCs, does not bother about it. Stringent and well-reviewed measures must be developed to manage such problems. Mere increase in the minimum capital requirements is a traditional method to overcome the systemic risks. Minimum CRAR determination shall be pegged around important macroeconomic factors and the scale of operation of NBFCs. RBI, through media, must inform the public about different avenues of investments and possible frauds.[10-12]

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