REGULATION – BANKING & NON-BANKING

Scheme of presentation

- Regulation – Concepts
- Banking Regulation & Non-Banking Regulation
  - Evolution
  - Some specific regulations
  - Debates & Dilemmas
- Systemic risk & macroprudential regulation
- Concluding thoughts
- Q & A
- Disclaimer

Regulation – Conceptual framework

- Why regulate?
- Is regulation always welfare enhancing?
- Rationale for regulation – market failures
  - Since the world is not perfect

Yes.. The world is not perfect

- Market failures
  - Imperfect competition
  - Information asymmetry
    - I can't differentiate between lemons and peaches
  - Externalities
    - Who pays for it eventually?
  - Distributional concerns
    - Not all market efficient outcomes are socially welfare enhancing
  - Customers' safety – behavioural concerns
    - Are customers rational?
    - But, do regulators/law makers know better about me than myself?
  - Participant safety
    - Let us race…..……to the bottom

Fin. Intermediation – warehousing of risk

Financial Intermediation

Maturity Transformation

Obtaining short term funds to invest in long term assets

Liquidity Transformation

Using cash like Liabilities to buy harder-to-sell assets

Leverage

Borrowing money to buy fixed income assets to magnify the potential gains (or losses) on an investment;

Credit Risk Transfer

Taking the risk of a borrower’s default and transferring it from the originator of the loan to another party.

Financial regulation- a different game

- Financial products are different
  - Search, experience and credence goods
  - Linked to the wellbeing of the supplier
- Significant costs of externalities
  - Social costs of bankruptcy exceeds private costs
  - Recessions following financial crises are bigger than normal recessions- (output losses 2-3 times larger)
  - Recoveries from recessions following financial crisis are slower (normally, the deeper the recession, the sharper the recovery)
    - The debt incurred during the crisis acts as a dragging anchor on the economy
  - Loss of information
  - Contagion
- Among financial enitities- Banks are more special

Goals of Regulation

- Protection of users of the financial system
  - Depositors
  - Investors
  - Customers
- Promoting competition
  - Licensing of new entities – right balance
- Market efficiency
- Financial Stability

What regulations do not seek to accomplish

- Preventing failure of individual institutions – not the primary focus
  – Subject to the condition that depositors are protected and the critical services are maintained
- Regulation not to substitute bankers' decisions
- Not to impinge on competition

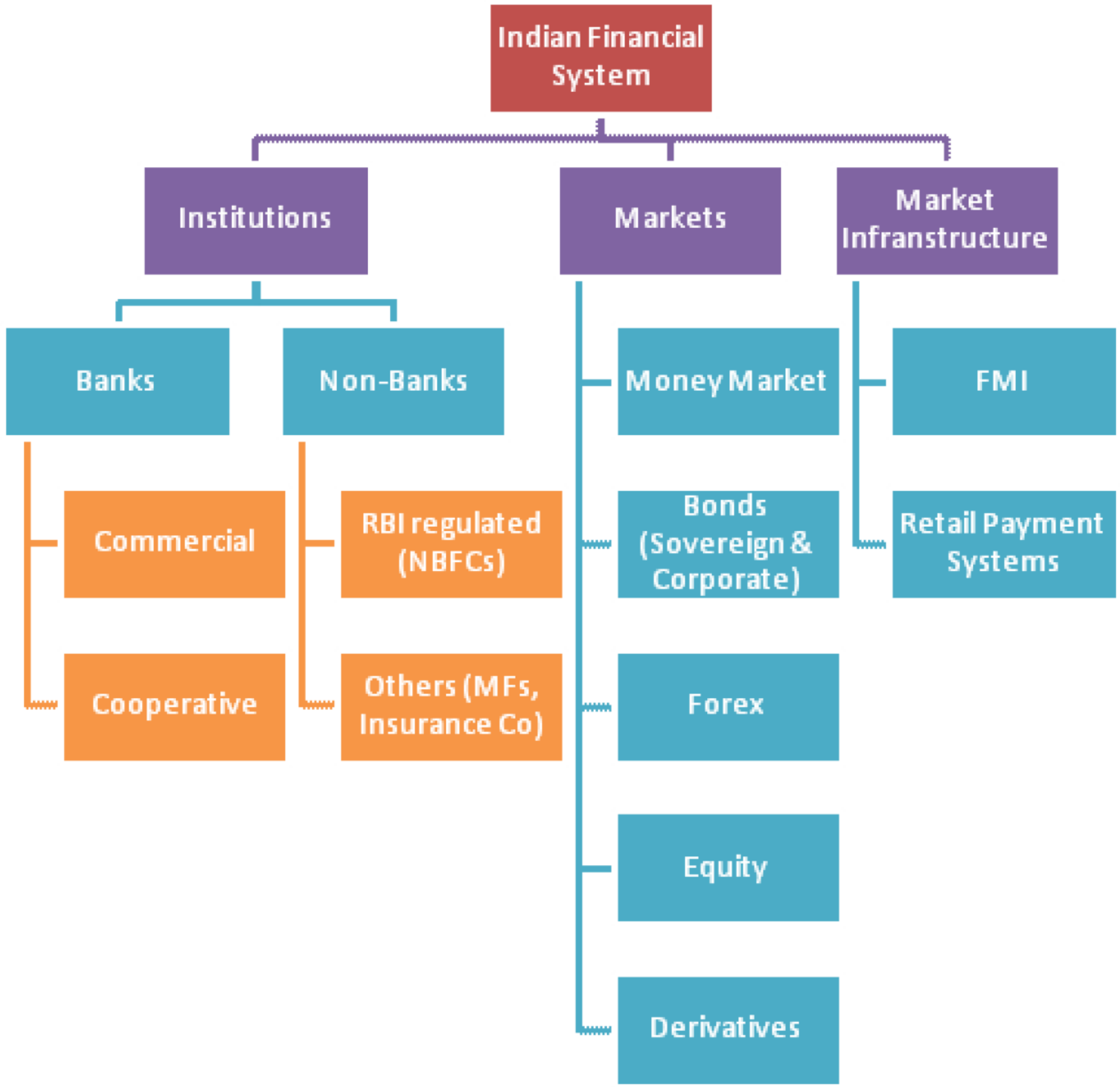

Indian Financial System
Institutions
Markets
Market Infrastructure
Banks
Non-Banks
Money Market
FMI
Commercial
RBI regulated (NBFCs)
Bonds (Sovereign & Corporate)
Retail Payment Systems
Cooperative
Others (MFs, Insurance Co)
Forex
Equity
Derivatives

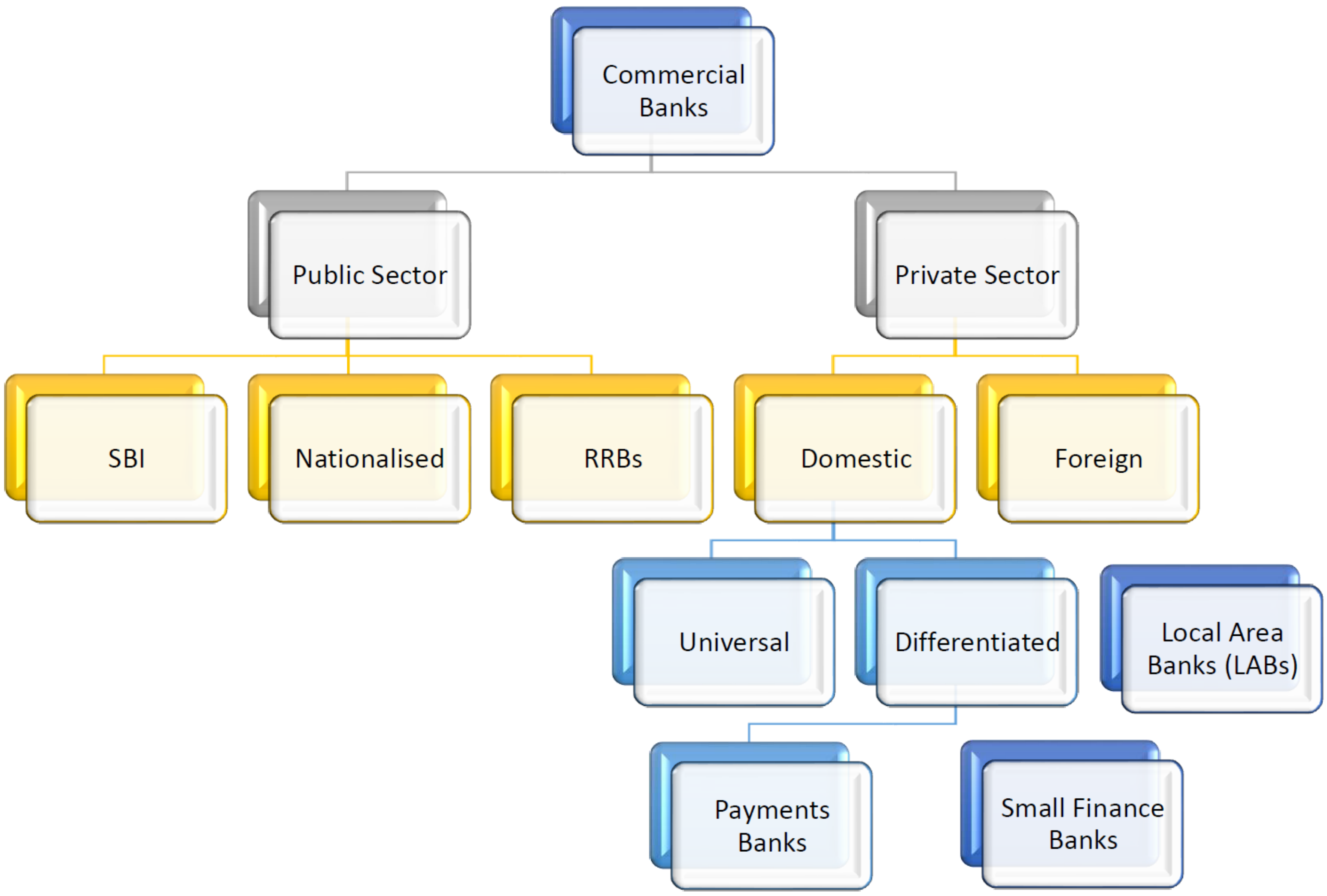
Table 1. India: Structure of the Financial System[1]

	Total assets-2010/11				Total assets-2016/17			
	No of institutions	In INR billion	Percent of total assets	Percent of GDP	No of institutions	In INR billion	Percent of total assets	Percent of GDP
Total	163	117,107		134.1	148	235,053		138.5
Scheduled Commercial Banks	81	71,834	61.3	82.2	92	137,469	58.5	81.0
Public Sector Banks	26	52,940	45.2	60.6	27	93,941	40.0	55.4
Private Sector Banks	21	13,982	11.9	16.0	21	35,514	15.1	20.9
Foreign Banks	34	4,912	4.2	5.6	44	8,015	3.4	4.7
Regional Rural Banks	82	2,154	1.8	2.5	56	4,105	1.7	2.4
Local Area Banks	4	11	0.0	0.0	3	7.8	0.0	0.0
Cooperative Credit Institutions	96,176	8,555	7.3	9.8	95,558	11,660	5.0	6.9
Urban Cooperative Banks	1,645	2,733	2.3	3.1	1,645	2,718	1.2	1.6
Rural Cooperative Credit Institutions	94,531	5,822	5.0	6.7	93,913	8,942	3.8	5.3
Non-banking Financial Companies	12409	6,689	5.7	7.7	11,523	19,614	8.3	11.6
Deposit-taking NBFCs	297	1,054	0.9	1.2	178	2,715	1.2	1.6
Non-Deposit taking NBFCs	12112	5,635	4.8	6.5	11,345	16,899	7.2	10.0
o/w: Nondeposit taking NBFCs systemically important	319	5,635	4.8	6.5	220	16,888	7.2	10.0
Other Financial Institutions	5	2,469	2.1	2.8	4	5,613	2.4	3.3
Standalone Primary dealers	20	103	0.1	0.1	7	311.6	0.1	0.2
Insurance Companies	49	15,126	12.9	17.3	55	30,760	13.1	18.1
Non-life Insurance	24	627	0.5	0.7	29	1,823	0.8	1.1
Life-Insurance	24	14,301	12.2	16.4	24	28,542	12.1	16.8
Reinsurance	1	198	0.2	0.2	2	394.5	0.2	0.2
Provident and Pension Fund		4,243	3.6	4.9	8	7,966	4.0	4.7
Mutual Funds	51	5,922	5.1	6.8	45	17,546	7.5	10.3

Sources: Reserve Bank of India; Insurance Regulatory and Development Authority of India, Securities and Exchange Board of India; IMF World Economic Outlook; and IMF staff calculations.

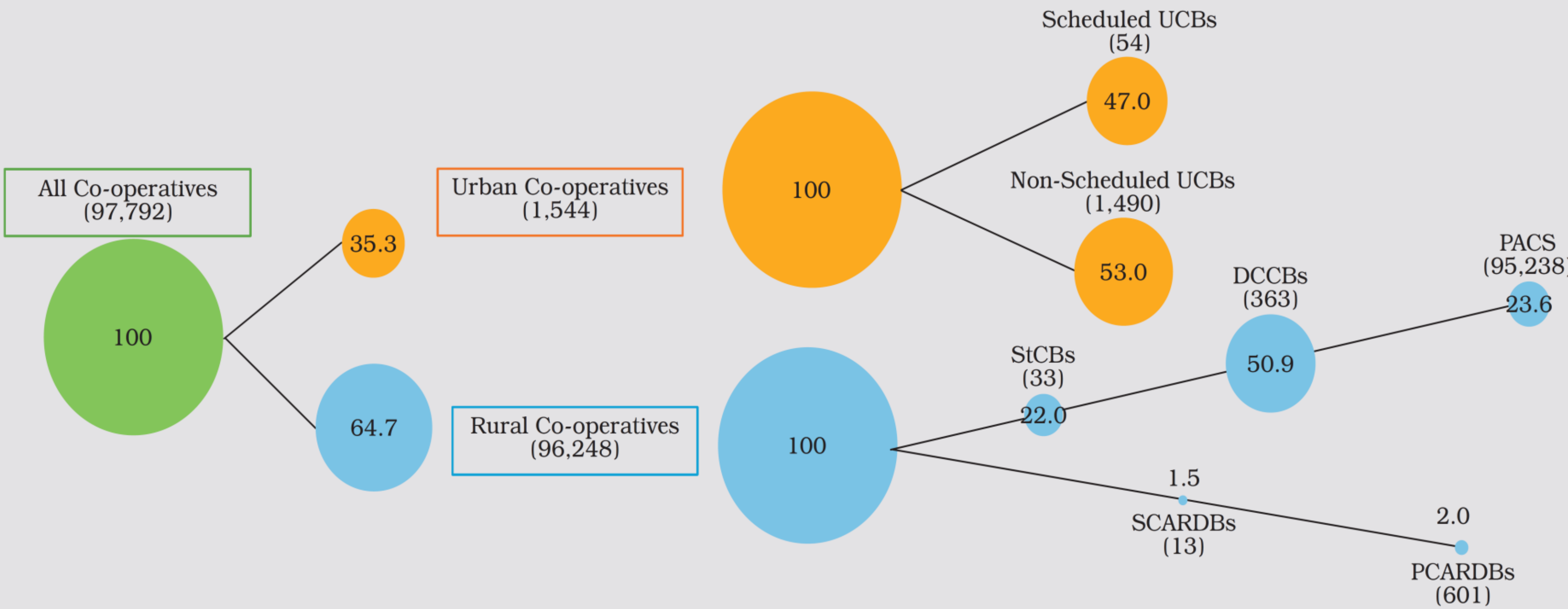
1/ Other Financial Institutions includes development banks (National Bank for Agriculture and Rural Development, Exim Bank, National Housing Bank, and Small Industries Development Bank of India).

Indian Banking System – Commercial Banks



Indian Banking System – Coop Banks

Chart V.1: The Structure of Co-operatives by Asset Size



Notes: 1. Figures in per cent and bubble size is scaled to asset size.

2. StCBs: State Co-operative Banks; DCCBs: District Central Co-operative Banks; PACS: Primary Agricultural Credit Societies; SCARDBs: State Co-operative Agriculture and Rural Development Banks; PCARDBs: Primary Co-operative Agriculture and Rural Development Banks

3. Figures in parentheses indicate the number of institutions at end-March 2019 for UCBs and at end-March 2018 for rural co-operatives. Out of 54 scheduled UCBs- 34 are multi-state and 20 are single-state. Out of 1,490 non-scheduled UCBs – 24 are multi-state and 1,466 are single state.

[1] Data on rural co-operatives are available with a lag of one year, the latest being for 2017-18.

Why banks are special

- Functions
  - Intermediation – savers and borrowers
  - Economic growth – studies
  - Poverty reduction
- Risks
  - Transformation function – Risk, size, maturity and liquidity - runs
  - Leverage
- Impact of failure
  - Depositors
  - Other institutions – contagion, common exposures, confidence
  - Economic impact
    - Japan (90s) – 20 percent of GDP
    - Fiscal costs of banking crises in developing countries exceeded $ 1trillion in 1980s and 90s – equivalent to all foreign assistance transfers to developing countries during 1950-2001

When people don't believe in banking…

- "I can assure you that it is safer to keep your money in a reopened bank than under the mattress"

  - President Roosevelt in March 1933, after declaring a nationwide bank holiday

Sometime during the 2007-08 GFC

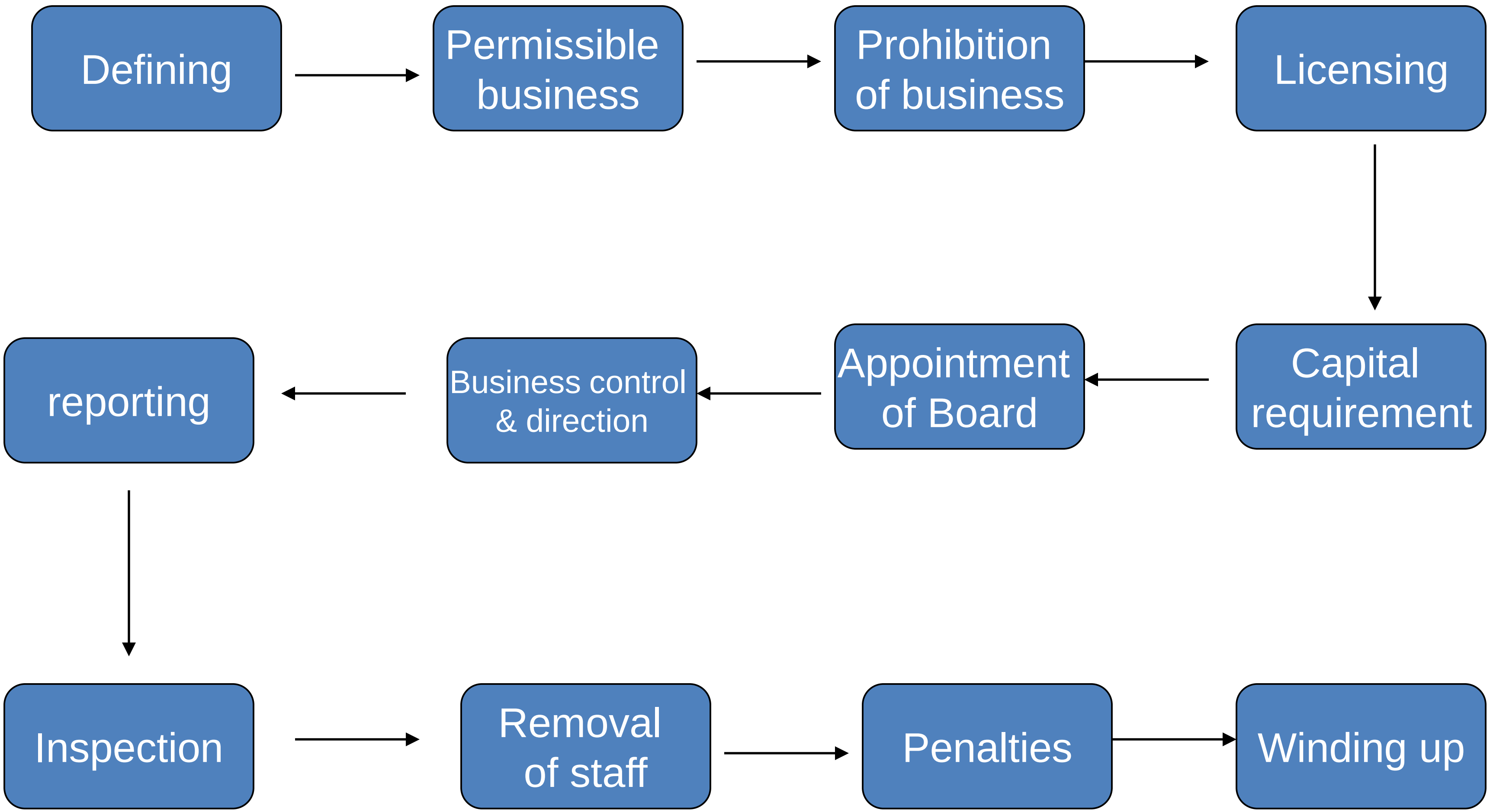
Evolution of Bank Regulation in India

- Companies Act, 1850
  - Unlimited liability at par with other jurisdictions
  - Limited liability provisions in 1860 – flourishing of banking industry
- The Presidency Bank Act, 1876
  - Certain restrictions on their business & periodic inspection of books
- Indian Companies Act, 1913 – common for banks and non-banks
- RBI Act, 1934
- RBI, in the initial years, did not have adequate powers of control of regulation
  - RBI's permission was not required for setting up a new bank
  - Section 42(2) was to ensure compliance with CRR
  - Inspection to determine eligibility for inclusion in 2nd Schedule
  - Small and non-scheduled banks remained out of purview
- Banking Companies Act 1949 – BR Act

Suite of regulations

- Entry regulations
  - Licensing, initial capital requirements, suitability of promoters
  - Issues with too stringent & too lax policies
- Activity regulations
  - Exposure norms, permitted activities, rate regulations – transmission
- Conduct regulations
  - Conduct of business, customer protection
  - Twin peaks
- Governance regulations
  - Board, Management, corporate governance, compensation
- Prudential regulations
  - Capital and liquidity, IRAC, investment
- Resolution regulations
  - Fail if you must, but in an orderly manner

Life Cycle of regulation – BR Act



Licensing

- Statutory provisions
  - Licensing – Sec 22 "…. *no company shall carryon banking business in India unless it holds a licence issued in that behalf by the Reserve Bank* …"
  - Minimum capital requirements- Sec 11
- Regulatory requirements
  - Eligibility of promoters (Residents/entities owned and controlled by residents)
  - Fit and Proper criteria
    - Experience
    - Sound credentials and integrity
  - Corporate structure
    - Non-Operative Financial Holding Company (NOFHC) – ring fencing other activities
  - Minimum Capital requirement
  - Diversified holding in the bank

Branch Expansion

- Statutory – BR Act (Sec 23)
- "*Without obtaining the prior permission of the Reserve Bank, no banking company shall open a new place of business in India or change otherwise than within the same city, town or village, the location of an existing place of business situated in India….;*
- Regulatory
  - Domestic SCBs(excluding RRBs) are permitted to open, unless otherwise specifically restricted, Banking Outlets in Tier 1 to Tier 6 centres without having the need to take permission from Reserve Bank of India
  - At least 25 percent of the total number of 'Banking Outlets' opened during a financial year should be opened in unbanked rural centres n each case.
    - Banking outlets – 4 hrs of operation a day for 5 days
    - Unbanked rural centre (Tier 5 & 6 centre not having a CBS enabled banking outlet)
  - Banks having general permission may shift, merge or close all 'Banking Outlets' (except rural outlets and sole semi-urban outlets) at their discretion.

What banks can do and cannot do

- Statutory
  - Permitted businesses/activities prescribed in B R Act
  - Restrictions on
    - Holding non-banking assets – section 9
    - Formation of subsidiaries - section 19
    - Advancing against own shares – section 20
    - Advances to Directors – section 20
- Regulatory
  - Restrictions on granting loans and advances to officers and relatives of senior officers of banks
  - Restrictions on advances against sensitive commodities
    - Food grains, raw cotton, sugar etc.
  - Restriction on payment of commission to staff members and officers
  - Many more….

Activity Regulations

- Regulations on lending - Purpose, quantum, interest rate
- Exposure Limits
- Interest rate regulations
  - New guidelines on linking to external benchmarks
- Capital Market Exposures
- Priority Sector Norms

Statutory pre-emptions

- Cash Reserve Ratio (CRR) – Section 42 of RBI Act
  - Without any floor or ceiling
  - Currently 3%
- Statutory Liquidity Ratio (SLR) – Section 24 of BR Act
  - Currently 18.0%

Prudential Regulations

- Capital to Risk-weighted Asset Ratio (CRAR) guidelines
- Income Recognition, Asset Quality and Provisioning (IRACP) guidelines
- Investment guidelines- classification and valuation

Capital regulations..

- Why regulate capital?
  - Capital as buffer to absorb losses
  - Capital as a regulatory tool
- Capital concepts -
  - Equity vs Debt
  - Accounting vs regulator
- Basel Regulations – journey from Basel 1 to 3 and beyond

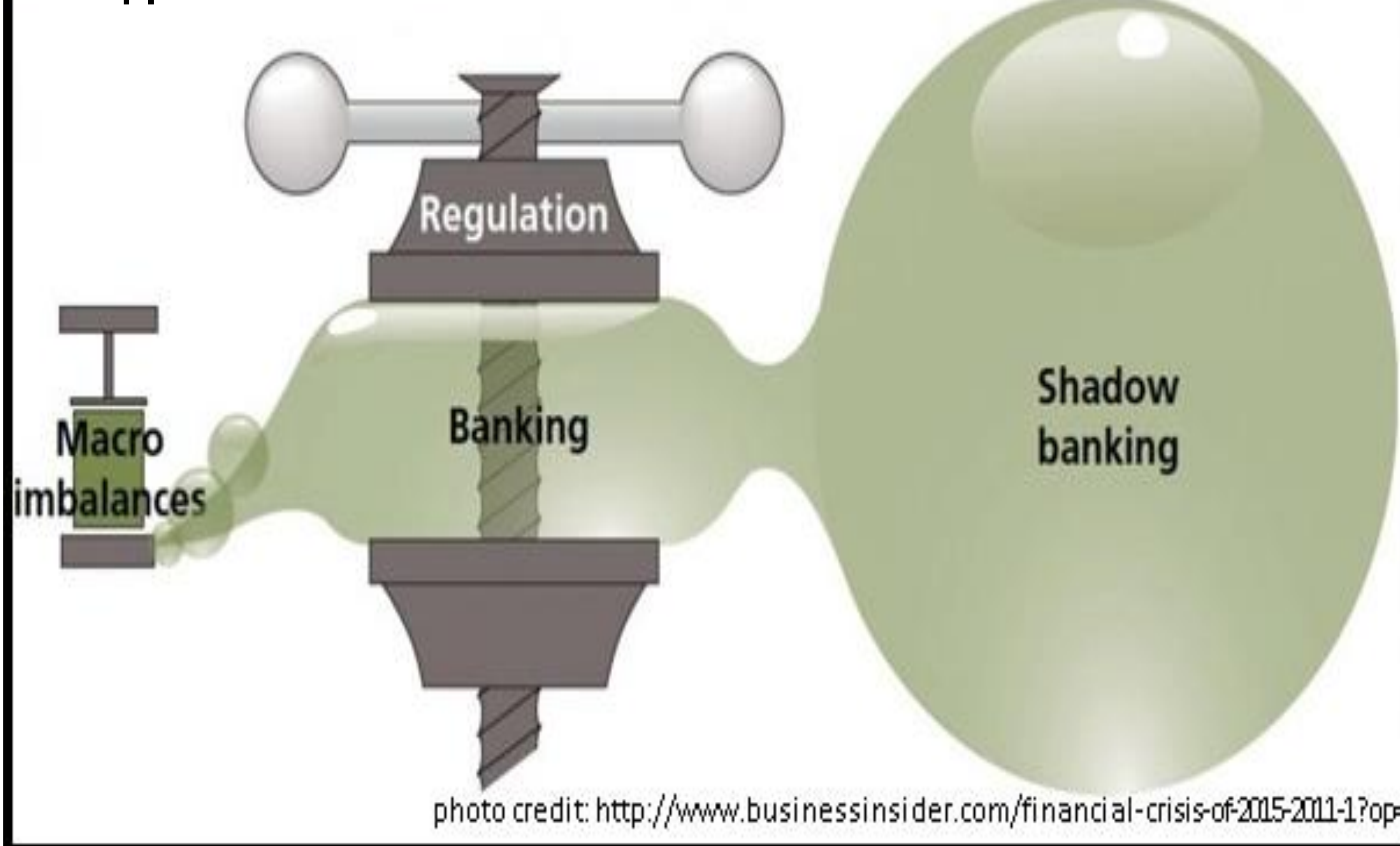
Resolution

- Necessary to preserve the resources
- Amalgamation or liquidation
- Voluntary and compulsory
- Statutory provisions
- Scheme for amalgamation of private sector banks – April 21, 2016
- Resolution – FRDI – ‘Bail in’ issues
- DICGC (1966)

NON-BANKING REGULATION

Shadow Banking

Supplements to banks – more innovative & nimble footed

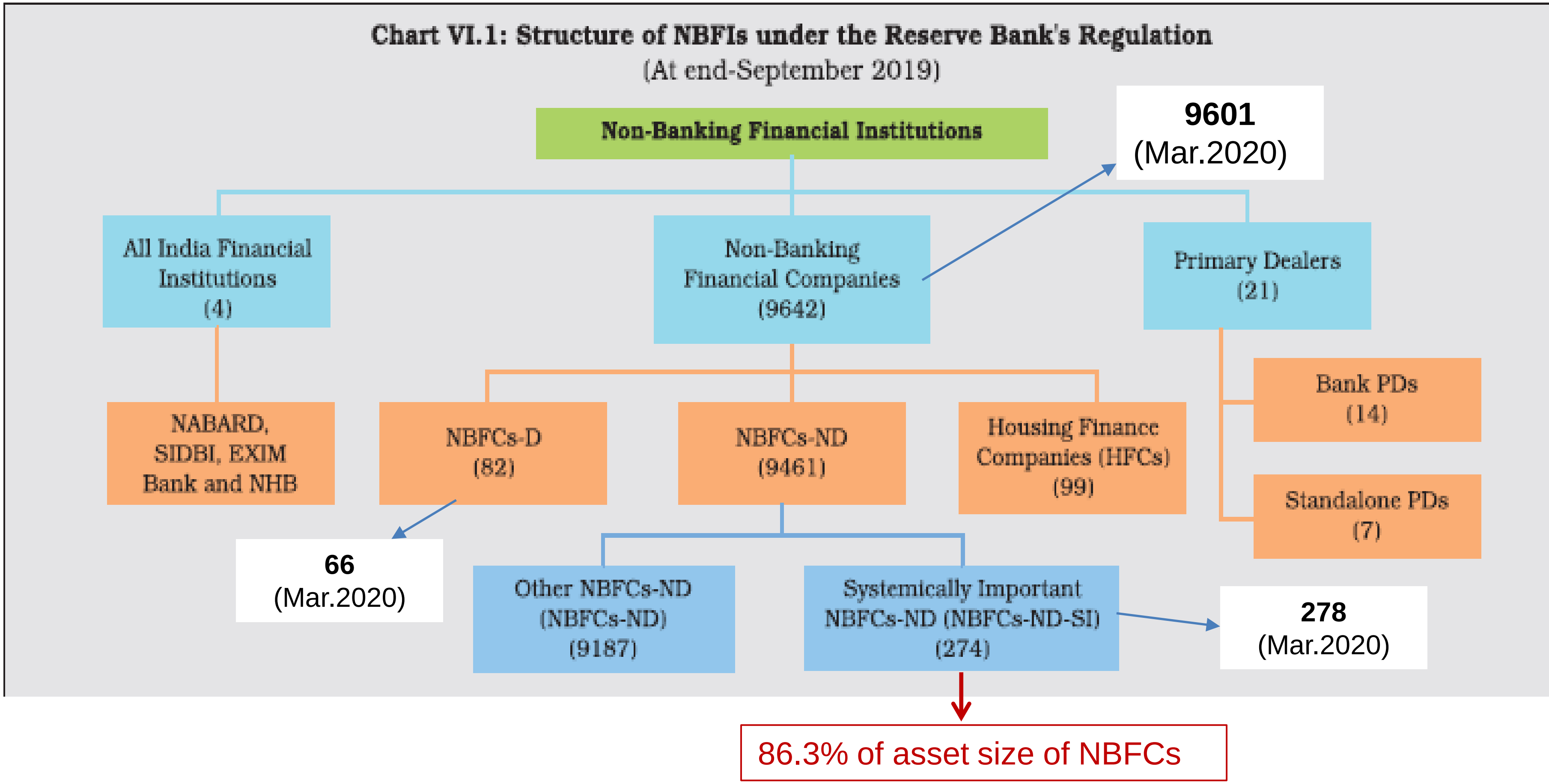


Defining Shadow Banking

- A system of credit intermediation that involves entities and activities outside the regular banking system – Financial Stability Board (FSB)
- Discomfort with the word ‘Shadow’ - “market-based financing”.
- Replaced with the term “non-bank financial intermediation” (NBFI) – FSB in Oct 2018
- In India, NBFCs, Mutual Funds, Pension Funds, Insurance Companies, etc. are considered as NBFIs by FSB.

Structure of NBFIs regulated by RBI

(As at the end of September 2019)



Asset size NBFCs and HFCs at Rs.40 - 45 trillion is 23% of banking sector assets

<u>Source</u>: Trend and Progress of Banking in India – Dec.2019

Definition of NBFC

(Sec.45-I(f) read with Sec.45-I(c) of RBI Act, 1934)

NBFC is a company engaged in business of

- ✓ Financing by way of loans and advances
- ✓ acquisition of shares / stocks / bonds/ debentures/ securities issued by Government or local authority
- ✓ Leasing & hire-purchase
- ✓ insurance business
- ✓ chit business
- ✓ collection of monies
- ✓ acceptance of deposits

but does not include

- x agriculture activity,
- x industrial activity
- x purchase or sale of any goods (other than securities)
- x providing any services and
- x sale/purchase/construction of immovable property.

- Non-Banking Institutions
- Financial Institutions
- NBFCs

Financial Activity as Principal Business

- Financial activity as “principal business” is when a company’s
  - financial assets > 50% of Total Assets and
  - income from financial assets > 50% of gross income.
- A company which fulfils both these criteria will be registered as NBFC by RBI.
- The term 'principal business' is not defined in RBI Act.
- RBI has defined it to ensure that only companies <u>predominantly engaged in financial activity</u> get registered with it and are regulated and supervised by it.

Regulation of NBFCs by RBI - Genesis

- Since 1963 - NBFCs regulated by RBI (Chapter III B of the RBI Act) (Primarily deposit directions)
- January 1998 - Amendment to Chapter III B, gave RBI powers to regulate NBFCs

  a) Requirement of registration – Section 45IA of RBI Act

  b) New regulatory framework for deposit accepting NBFCs (prudential framework)

  c) No fresh NBFC was permitted to raise deposits from public
- 2006 – Focus of regulation on Systematically important NBFCs
- 2011 – Regulation on Micro Finance Institutions
- 2014 – Revised regulatory framework aimed at harmonizing regulations with that of banks (asset classification, provisioning norms & corporate governance standards)
- 2018 – Ownership neutral regulations, Government NBFCs brought under the prudential regulations in a phased manner
- 2019 – Regulations of HFCs brought under the purview of RBI

Certain important amendments

- Compulsory registration with RBI and maintenance of minimum NOF for companies satisfying the 'principal business' criteria (Sec.45-IA of the RBI Act, 1934)
- Maintenance of liquid assets by NBFCs accepting public deposits (Sec.45- IB of the RBI Act, 1934)
- Creation of a Reserve Fund by all NBFCs by transfer of 20% of their net profit every year (Sec.45-IC of the RBI Act, 1934)
- Powers of RBI to determine Policy and issue directions to NBFCs (Sec.45JA of the RBI Act, 1934)
- Conduct of Special Audit of the accounts of NBFCs, if necessary (Sec.45MA of the RBI Act, 1934)
- Power of RBI to file winding up petition under Companies Act, 1956 (Sec.45MC of the RBI Act, 1934)

More Powers to RBI in Finance Act, 2019

- Sec.45-IA : Min. NOF between Rs.25 lakh to Rs.100 crore - Bank may notify different amount of NOF to different categories of NBFCs
- Sec.45-ID: Power of Bank to remove Directors of NBFC (other than Govt. NBFCs)
- Sec.45-IE: Power of Bank to supersede the BOD of NBFC (other than Govt. NBFCs)
- Sec.45MAA: Bank can remove or debar an auditor of NBFC for a max. period of 3 years at a time
- Sec.45MBA: Resolution of NBFCs through amalgamation, reconstruction, splitting into various activities, etc.
- Sec.45NAA: Power to call for information of Group Companies and inspection of Group Companies

NHB Act, 1987 amended to shift regulation of HFCs from NHB to RBI

Categorisation of NBFCs

- Based on liabilities
  - Deposit taking (NBFC-D) & Non-Deposit Taking (NBFC-ND)
- Based on size
  - Systemically Important (with asset size greater than Rs. 500 cr) – NBFC SI
  - Non-systemically important
- Customer interface & access to public funds
  - Type I – No interface and no access to public funds
  - Type II – any one of the two conditions or both

Activity based classification

No.	Type of NBFC	Activity
1	Investment and Credit Company (ICC)	Lending and investment
2	NBFC-Infrastructure Finance Company (NBFC-IFC)	Provision of infrastructure loans
3	NBFC-Systemically Important Core Investment Company (CIC-ND-SI)	Investment in equity shares, preference shares, debt or loans of group companies
4	Infrastructure Debt Fund-NBFC (IDF-NBFC)	Facilitation of flow of long-term debt into infrastructure projects
5	NBFC-Micro Finance Institution (NBFC-MFI)	Credit to economically disadvantaged groups
6	NBFC-Factor	Acquisition of receivables of an assignor or extending loans against the security interest of the receivables at a discount
7	NBFC-Non-Operative Financial Holding Company (NOFHC)	Facilitation of promoters/ promoter groups in setting up new banks
8	Mortgage Guarantee Company (MGC)	Undertaking of mortgage guarantee business
9	NBFC-Account Aggregator (NBFC-AA)	Collecting and providing information about a customer's financial assets in a consolidated, organised and retrievable manner to the customer or others as specified by the customer
10	NBFC–Peer to Peer Lending Platform (NBFC-P2P)	Providing an online platform to bring lenders and borrowers together to help mobilise funds
11	Housing Finance Companies (HFC)	Financing for housing

85.6% of total asset size

NBFCs regulated by other Regulators

Types of NBFCs	Regulated by
Mutual Funds Venture Capital Fund Merchant Banking companies Stock broking companies Collective Investment Schemes (CIS)	Securities and Exchange Board of India (SEBI)
Insurance Companies	Insurance Regulatory and Development Authority of India (IRDAI)
Nidhi Companies Mutual Benefit Companies	Registrar of Companies, Ministry of Corporate Affairs, Government of India
Chit Funds	Registrar of Chits of respective States

Supervision of NBFCs

MANDATE

- Depositor Protection
- Customer Protection
- Financial Stability

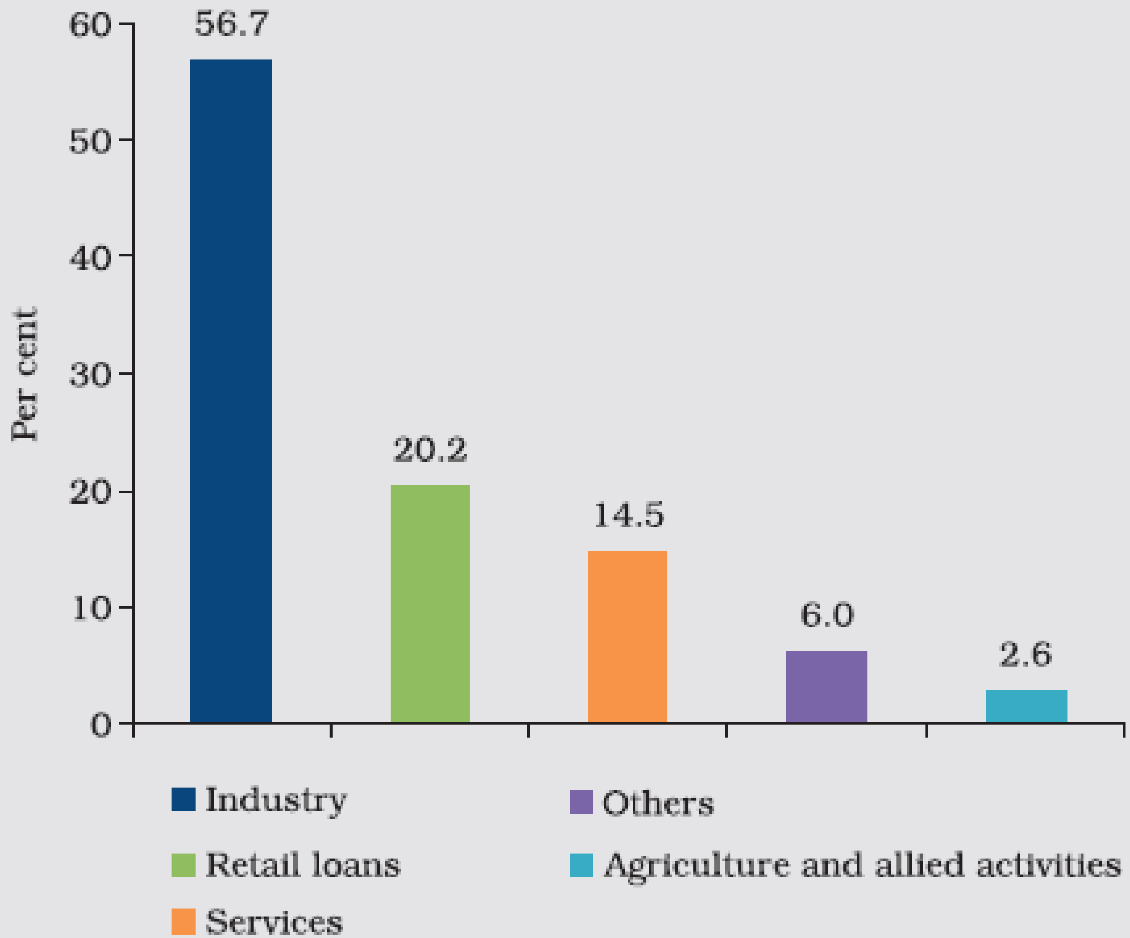
4 PILLARS OF SUPERVISON

- Onsite Inspection
- Off-site Surveillance
- Market Intelligence
- Exception Report by Statutory Auditors

Fifth pillar : Engagement with stakeholders

Chart VI.3: Distribution of NBFC Credit

(At end-September 2019)



Note: Data are provisional.

Source: Supervisory Returns, RBI.

Commercial Banks Vs. NBFCs

	Banks	NBFCs
Categories	3	11 (including HFC)
Regulation	Uniform for all banks	Varies as per category of NBFC
Demand Deposits	Can accept	Cannot accept
Capital Adequacy Ratio	11.5% (under Basel-III)	15% (Under Basel-I)
Cash Reserve Ratio	3%	NA
Statutory Liquidity Ratio	18%	15% (only for NBFC-D)
Payment & Settlement System	Yes	No
DICGC coverage	Yes	No
Priority Sector lending target	Yes – 40% of ANBC	No
Protection under LOLR of RBI	Yes	No
Supervision	RBS – all banks	CAMELS pattern – only certain NBFCs

NBFC deposits Vs. Bank deposits

NBFCs	Banks
They can accept deposits only upto 1.5 times of their Net Owned Funds	No such restriction is imposed on banks for mobilising deposits
They cannot accept Demand Deposits, i.e., they cannot open Savings Bank account and Current account	They can accept Demand deposits
The minimum tenure of the deposits is 1 year and maximum tenure of deposits is 5 years	The minimum tenure of deposits is 7 days and the maximum tenure is decided by the Boards of the banks
There is a lock-in period of 3 months for all the deposits of NBFCs	There is no lock-in period for deposits of banks.
They can offer a maximum interest rate of 12.5% only for the deposits	No such restriction is stipulated for banks. The interest rates on deposits are decided by their Boards
Insurance coverage under DICGC is not available for deposits of NBFCs	Insurance coverage up to Rs.5.00 lakh per depositor under DICGC is available for deposits of banks
They can accept only term deposits under NR(E) scheme from Non-Resident Indians for a period between 1 year to 3 years	Banks can open Savings deposits under NR(O) and NR(E) schemes and term deposits under NR(O), NR(E) and FCNR(B) schemes from Non-Resident Indians

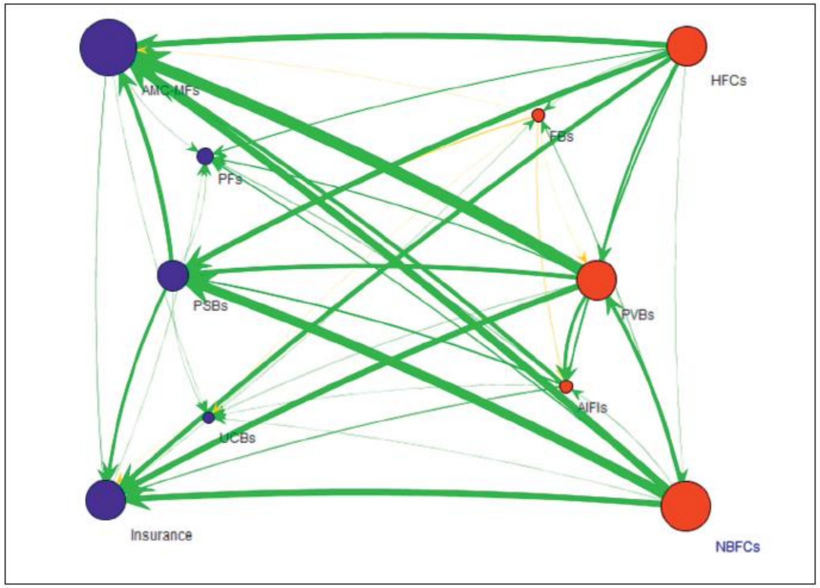
Comparative performance
Banks Vs. NBFCs

Parameters	Banks			NBFCs		
	Mar.2019	*Sep.2019*	*Mar.2020*	*Mar.2019*	*Sep.2019*	*Mar.2020*
CRAR	14.3%	15.1%	14.6%	20.0%	19.5%	19.6%
GNPA	9.3%	9.3%	8.5%	6.1%	5.6%	6.4%
NNPA	3.8%	3.7%	3.0%	3.3%	2.9%	3.2%
ROA (PAT)	-0.1%	0%	0.2%	1.7%	1.7%	

(Source: Financial Stability Report – June 2020)

Interconnectedness

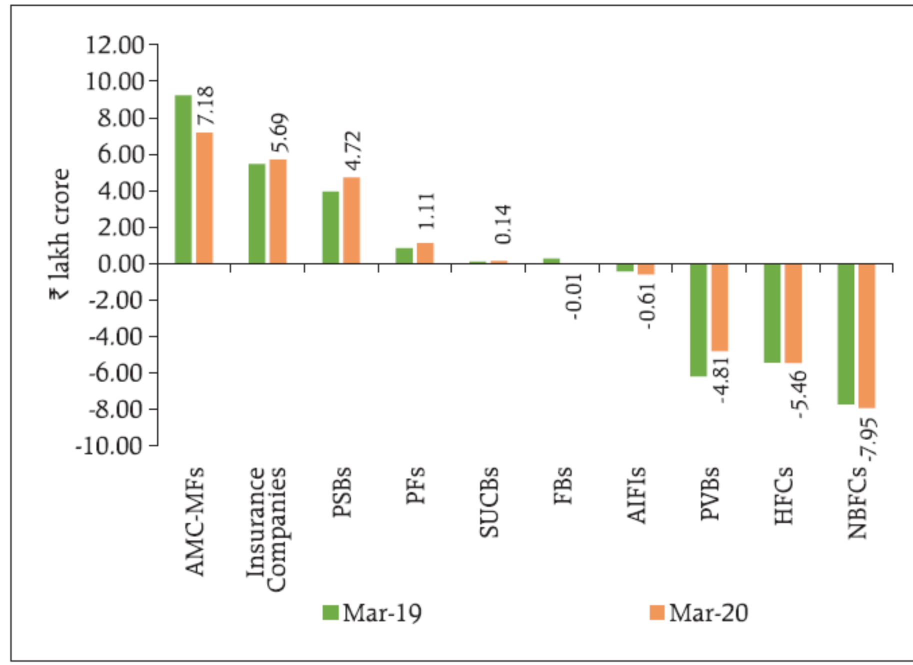
Chart 2.25: Network Plot of the Financial System, March 2020



Note: Receivables and payables do not include transactions among entities of the same group. Red circles are net payable institutions and the blue ones are net receivable institutions.

Source: RBI Supervisory Returns and Staff Calculations.

Chart 2.26: Net Receivables (+ve) / Payables (-ve) by Institutions



Source: RBI Supervisory Returns and Staff Calculations.

Regulation of systemic risk- financial stability

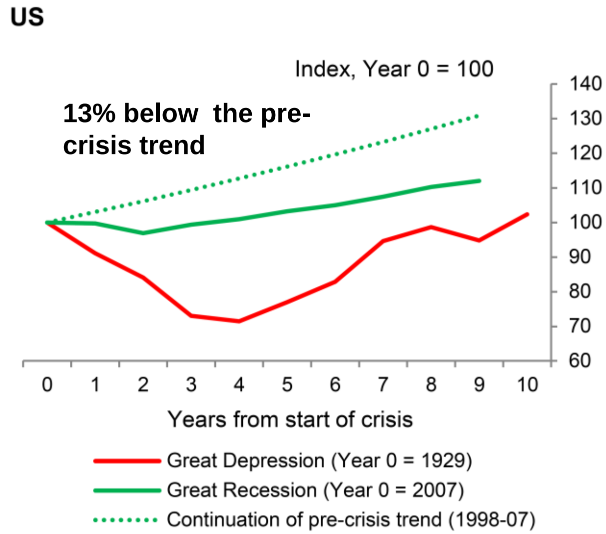
- Global Financial Crisis (GFC) – Lessons
  - The deficiencies of the prevailing regulations
  - Aggregate risk is higher than the sum of components
  - Systemic Risk - Risk of disruptions to the financial services that is caused by an <u>impairment of all or parts of the financial system</u>, and can have serious <u>negative consequences for the real economy</u>

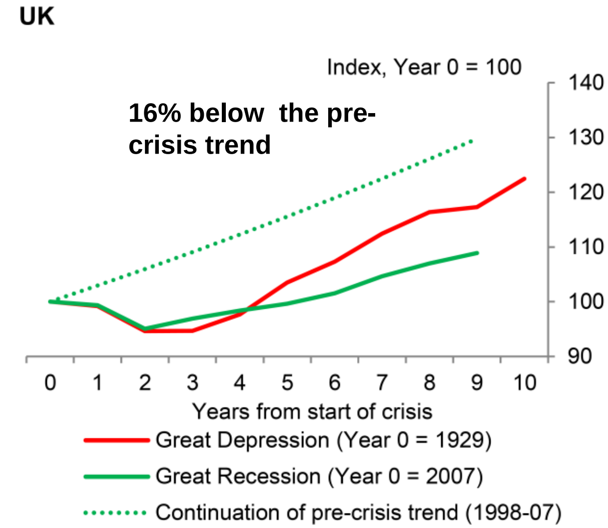
Systemic risk- implications

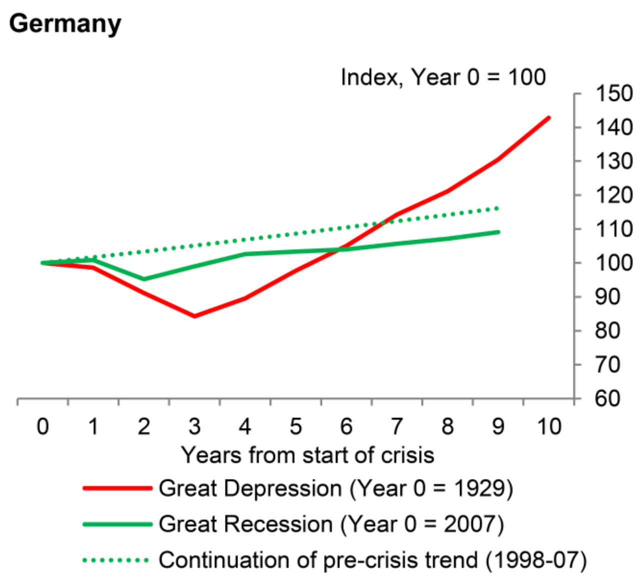
- Fiscal costs to resolve banking crises average about 7 per cent of GDP across 147 banking crises since 1970s
  - Cumulative output losses relative to trend GDP – staggering 23 per cent of GDP
- Crisis following credit booms are devastating
  - Debt overhang, deleveraging, credit crunch

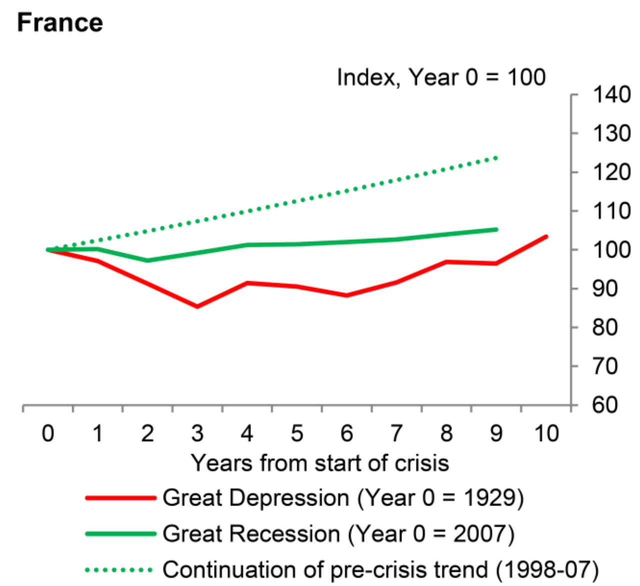
Costs of crises

US GDP dropped more than 5% and 8.8 million jobs were lost





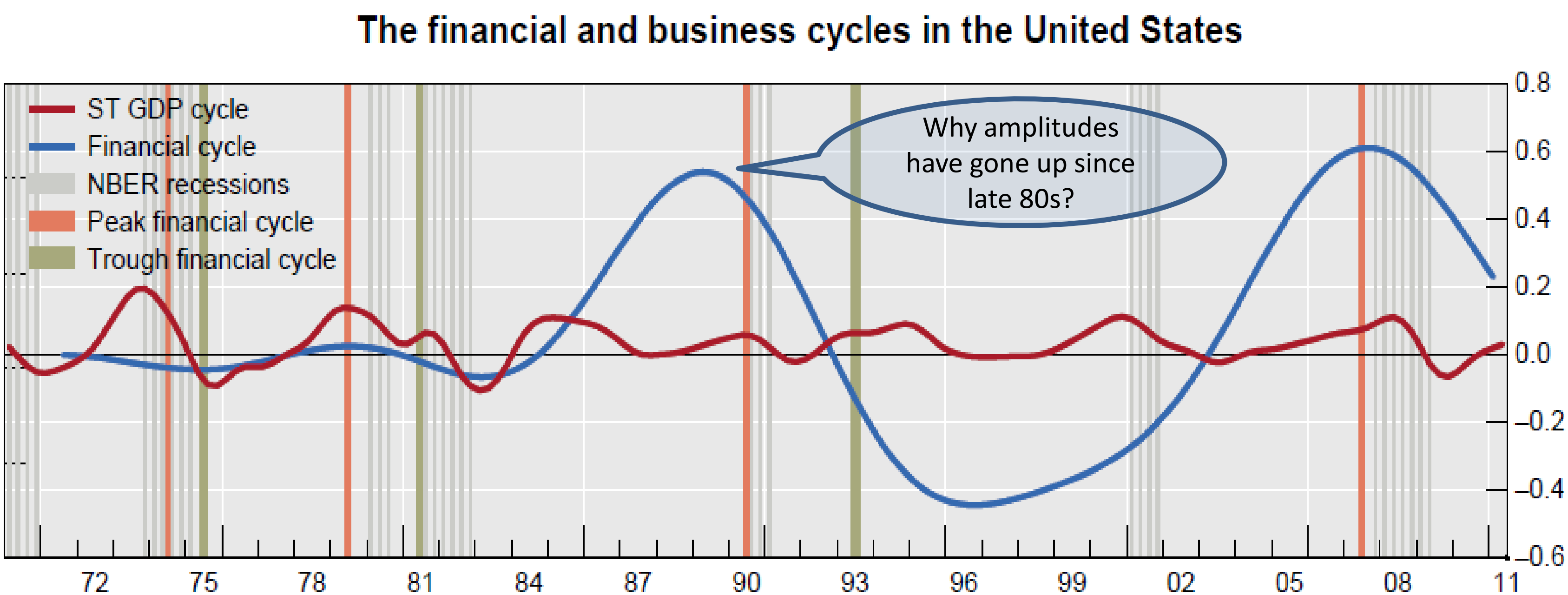




Systemic risk - nuances

- Dimensions
  - Cyclical (time) dimension
    - What goes up….
  - Structural (interconnectedness) dimension
    - Stability of individual entities does not guarantee systemic stability
    - Common exposures/information spillovers/contagion

Financial and business cycles



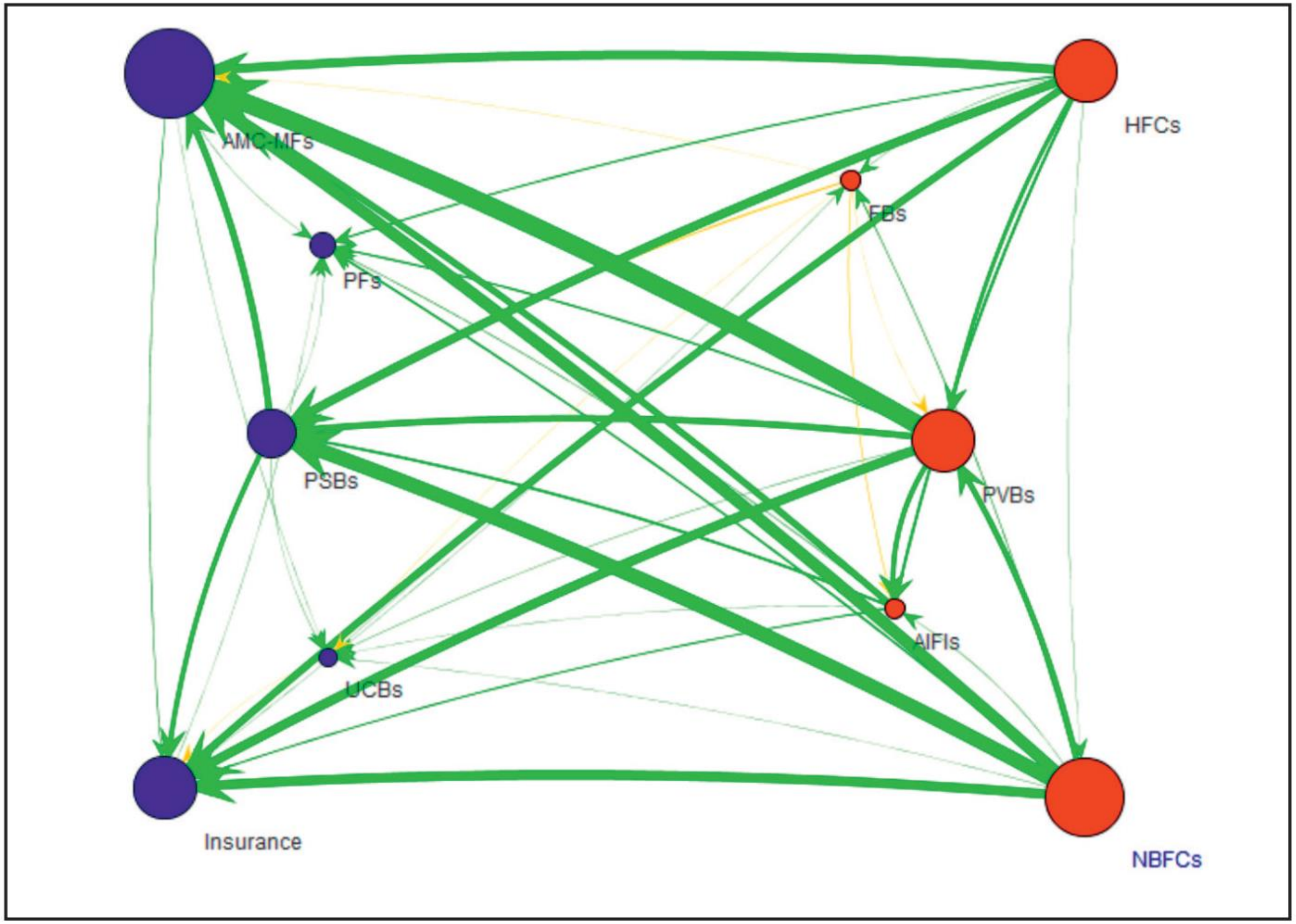
Note: Orange and green bars indicate peaks and troughs of the combined cycle using the turning-point (TP) method. The frequency-based cycle (blue line) is the average of the medium-term cycle in credit, the credit to GDP ratio and house prices (frequency based filters). The short term GDP cycle (red line) is the cycle identified by the short-term frequency filter.

Source: authors' estimates.

Financial Cycles are longer (15-20 yrs) than business cycles (8 yrs) – span more than one business cycle

Source: Characterising the financial cycle: Don't lose sight of the medium term – BIS Working Papers No 380 (June 2012)

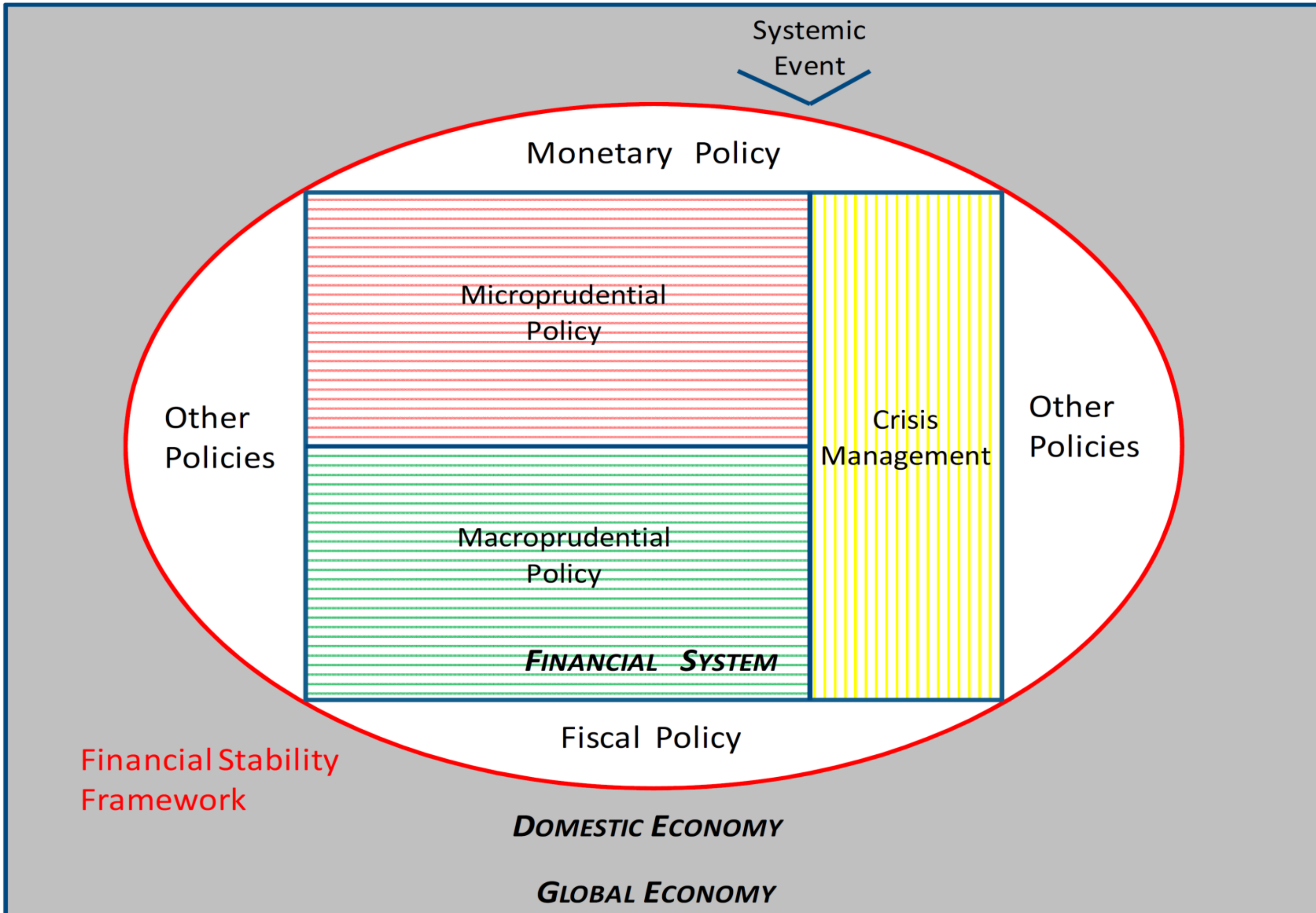
Network plot of the Indian Financial System – Mar 2020



Note: Receivables and payables do not include transactions among entities of the same group. Red circles are net payable institutions and the blue ones are net receivable institutions.

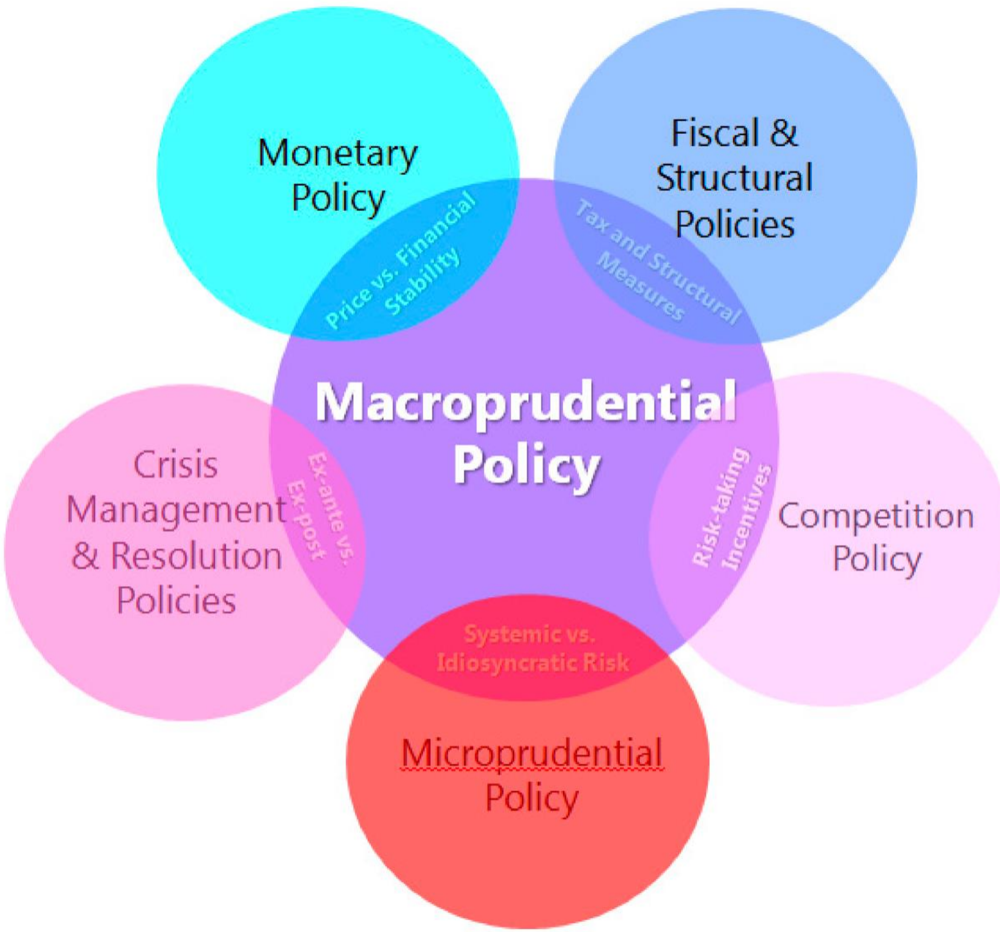
Source: Financial Stability Report – June 2020- RBI

Macroprudential policy to ensure financial stability



Source: IMF (2011): Macroprudential Policy: An Organizing Framework

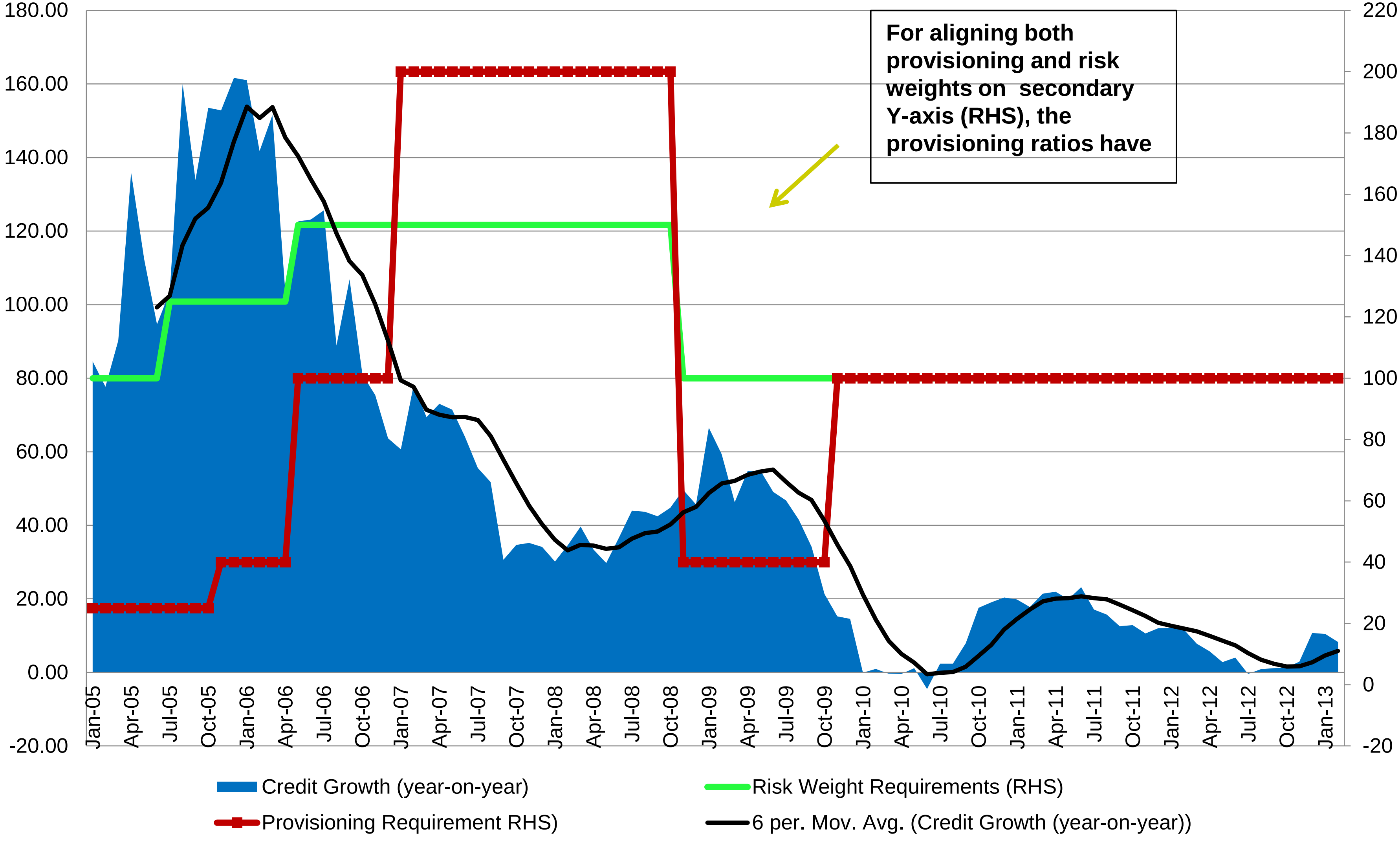
Interplay of various policies



Macroprudential Policy

- Countercyclical policies
- Policies to address the interconnectedness dimension

How macroprudential policies impact credit growth- Indian Example



Some parting thoughts

- Is regulation a costless exercise – is more always better?
- Does regulation need to be complex to be effective – The dog and the frisbee
- Limits of regulation
- Self regulation
- Nudging

Maintaining the balance – Regulator's job is never easy

Questions?

Thank you !