FIDC NEWS

Finance Industry Development Council

(A Self-Regulatory Organisation for Non-Banking Finance Companies (NBFCs) registered with RBI)

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NBFC-AFCs' Robust performance in the middle of a slowdown

After a prolonged period of disheartening economic indices of inflation, exchange rates, GDP and CAD (current account deficit), we could see the beginnings of a silver lining within these dark clouds in the form of slight shrinkages in CAD and inflation. It could be too pre-mature for us to decode this as early signs of revival but there is a positive change that is good for us. The FY 12-13 results of almost all the major players in the financial services industry has been encouragingly robust and to perform so well in the middle of a slowdown is in itself a feather in the Industry's cap which highlights the intrinsic strength of the fraternity to be able to do well even during turbulent times.

The fresh bank licensing framework looks more and more incompatible with the core competencies of the NBFCs when one sees the guidelines. With the most likely names withdrawing or wanting to convert themselves as a bank with conditions clearly indicates the lack of alignment with the prospects in framing the norms for issue of fresh licences. FIDC will have to engage itself more intensely with the regulator in the coming days and ensure that the norms laid don't strait jacket the banks from delivering efficiently to the credit starved community which was the intent in the first place. We will need active support from all of you in making our wish list implementable and well thought out.

We had floods in Uttarkhand because the State was dragging its feet on decisions regarding land and we had a near draught in Maharashtra because the state there was delaying decision regarding water. Delays in implementing reforms in the financial sector will have similar disastrous effects and from FIDC we will be pushing the entire system to see that all the systemic changes initiated like the Usha Thorat Committee report and bank licensing etc. are taken to their logical conclusion in good time and in a manner which gives us as an industry and the community at large a win - win status.

R Sridhar, Chairman, FIDC

REGULATORY PERIMETER

RBI NOTIFICATIONS & CIRCULARS :

NBFCs/RNBCs - Implementation of Section 51-A of UAPA, 1967 - Updates of the UNSCR 1267 (1999) /1989 (2011) Committee's Al Qaida Sanctions List and Consolidated List : RBI/2012-13/482-DNBS (PD).CC. No 324/03.10.42/2012-13: May 2, 2013.

KYC Norms/AML Standards / Combating Financing of Terrorism - Unique Customer Identification Code for NBFC Customers in India : RBI/2012-13/489- DNBS (PD).CC. No. 325/03.10.42/2012-13; May 03, 2013.

Lending against Gold : RBI/2012-13/509 -DBOD. No. Dir. BC. 96 /13.03.00/ 2012-13: May 27, 2013.

NBFCs finance for Purchase of Gold : RBI/2012-13/510-DNBS . CC . PD . No. 326/03.10.01/2012-13 May 27, 2013.

NBFC-MFIs – Directions – Modifications in Pricing of Credit - Margin cap : RBI/2012-13/517 DNBS (PD) CC.No.327/03.10.038/2012-13: May

AT A GLANCE

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31, 2013.
RBI's Fraud Monitoring Cell to function from Bengaluru from July 01, 2013 : RBI/2012-13/ 532 DNBS (PD) CC.No.329 /03.10.42/2012-13 June 13, 2013
Raising Money through Private Placement by NBFCs-Debentures etc: RBI/2012-13/560; DNBD(PD) CC No. 330 /03.10.001/2012-13, June 27, 2013.
Raising Money through Private Placement by NBFCs-Non-Convertible Debentures (NCDs) –Clarification: RBI/2013-14/115 DNBS(PD) CC No.349/03.10.001/2013-14, July 02, 2013

RBI tightens norms for NBFCs raising money via private placement

Tightening norms, the RBI on 27 June said NBFCs raising money through private placement of debt "The minimum subscription amount for a single investor shall be Rs 25 lakh and in multiples of Rs 10 lakh thereafter... Private placement by all NBFCs shall be restricted to not more than 49 investors," it said in a notification. There should be a minimum time-gap of at least six months between two private placements and the NBFCs should not extend loans against the security of its own debentures, it said. NBFCs are allowed to raise money by issuing capital/debt securities including debentures by way of public issue or private placement. For public issue of such securities, institutions and retail investors are allowed to participate. [Economic Times/PTI, 27 June]

RBI puts on hold private debt placement rules for NBFCs

The RBI on July 2 said it would hold off implementing a notification issued last week that mandated a minimum wait of six months between two private placements from a non-bank financial firm. Instead, the RBI said a decision on "the appropriate minimum time gap" would be taken by the central bank "in due course," after the industry raised some concerns about the measures. The clarification could allay the concerns of NBFCs, which rely heavily on capital markets to fund their businesses but have attracted less regulatory oversight than banks. The RBI said NBFCs would be further given time until the end of September to put in place clear plans for raising funds.
The central bank added that its previous notification would not be applicable for primary dealers, while defining private placements as "non-public" issuances of non-convertible debt by NBFCs, clearing doubts if last week's provisions would have applied to convertible bonds.
In another key clarification, the RBI said the earlier provisions would not apply to core investment companies, or special investment vehicles that are created by some NBFC groups to raise funds on behalf of the group. However, the RBI kept other provisions such as the mandate that debt issues must be fully secured by underlying assets, and that only up to 49 investors can buy into a private placement. [Reuters/Deccan Herald, July 3]

RBI nod may be must for NBFCs takeover

The takeover of shell NBFCs will have to pass through a new and high obstacle as the Reserve Bank of India moves to implement a plan to empower itself to approve the acquisition and transfer of licence of such companies to new buyers. The plan follows allegations of misuse of licence by the acquirers and flipping of licences by many defunct NBFCs. It may take as long as a year for companies taking over to start operations, said a person familiar with the regulator's thinking. Now, it takes a month after intimating RBI. Stricter due diligence for the takeover of finance companies comes in the backdrop of the plan to issue new banking licences where many finance companies could apply after a management change. Though the RBI reserves the right to issue a banking licence, it aims to avoid frivolous issues, said the person who did not want to be identified.
"New entrants may prefer to apply for a new licence from RBI over buying a small NBFC at a premium since the due diligence and process around a takeover case are likely to be similar to those in the case of a new licence," said Shinjini Kumar, partner, PwC. [Economic Times, April 11]

NBFCs finance for Purchase of Gold

RBI has directed the NBFCs on May 27 that "no advances should be granted by NBFCs for purchase of gold in any form, including

Dr Subba Rao,Governor, RBI released knowledge paper at the 7th International Banking and Finance Conference organised by Indian Merchants' Chamber (IMC) on 5th June 2013.

primary gold, gold bullion, gold jewellery, gold coins, units of gold Exchange Traded Funds (ETF) and units of gold Mutual Funds". It may be recalled that the annual monetary policy statement made by the RBI governor on May 13 said that RBI proposes to issue guidelines to NBFCs in view of recommendations in final Report of the Working Group on Gold.

Core investment companies can now set up insurance biz

The RBI has unveiled guidelines for core investment companies (CICs) to set up a joint venture company for undertaking insurance business with risk participation. CICs, which are in the nature of non-banking finance companies (NBFCs), invest primarily in group entities in different sectors of the economy. Being holding companies, they invest in both financial and non-financial activities.
In its guidelines, the RBI has specified that for floating an insurance venture, the CIC's owned funds should not be less than Rs 500 crore and it should have earned net profit for three consecutive years. Further, the CIC's non-performing assets should not be more than one per cent of the total advances; and the track record of the performance of the subsidiaries, if any, should be satisfactory. [Business Line, April 2]

Large NBFC-MFIs can lend at 12% margin this fiscal

A NBFC that predominantly operates as a microfinance institution (MFI) can extend credit at 12 per cent over its cost of borrowing during this fiscal, according to a notification issued by RBI. However, with effect from April 1, 2014, RBI said the 12 per cent cap for large MFIs and 10 per cent for others will be restored. [Business Line, June 3]

RBI asks NBFCs to give customers unique ID code

The Reserve Bank on May 3 asked NBFCs to allot customers unique identification code to avoid multiple identities. "The increasing complexity and volume of financial transactions necessitate that customers do not have multiple identities within a financial institution or across the financial system," RBI said in a notification. It has asked NBFCs to initiate steps for allotting Unique Customer Identification Code (UCIC) to all their customers while entering into any new relationships. Existing individual customers may also be allotted UCIC by end-June 2013, it added.
A Working Group by the government has proposed introduction of unique identifiers for customers across different financial institutions for setting up a centralised know your customer (KYC) registry, it said. However, setting up such as system for the entire financial system is likely to take time, NBFCs can make an immediate beginning in this regard by putting in place such identification code for their own customers, it said. "The UCIC will help NBFCs to identify customers, track the facilities availed, monitor financial transactions in a holistic manner and enable NBFCs to have a better approach to risk profiling of customers. It would also smoothen NBFC's operations for the customers," it added further. [Economic Times/PTI, May 3]

In-principle nod for new bank licences will be valid longer

The RBI made a few concessions to aspirants intending to float banks. One, it extended the validity period of the in-principle approval to promoter/promoter groups for setting up a bank from 12 to 18 months. Two, it decided to grant the new entities more time to meet priority sector lending norms. [Business Line, June 3]

Governance in Banks and Financial Institutions

Mr. Anand Sinha,
Deputy Governor,
Reserve Bank of India

"Effective regulation furthers corporate governance and effective corporate governance ensures that the objectives of the regulation are met, with minimal regulatory intervention."

"Over the years, the NBFC sector has not only grown in size but also in terms of interconnectedness and systemic importance"

Governance issues have been engaging the attention of policy makers, more intensely in the aftermath of the global financial crisis. Many instances of governance failures have come to the fore as the contributory factors that had exacerbated the crisis. With lessons learnt from the crisis, the framework is being revisited so as to strengthen the governance standards.

What is Governance?

What exactly is Governance? Governance, in general terms, means the process of decision making and the process by which decisions are implemented (or not implemented), involving multiple actors. Good governance is one which is accountable, transparent, responsive, equitable and inclusive, effective and efficient, participatory and which is consensus oriented and which follows the rule of law...

Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring....

The whole gamut of corporate governance could be considered as a blend of various segments namely, regulatory governance, market governance, stake holder governance and internal governance. For an economy to perform well and for the financial system to be stable, good corporate governance would be required across all these segments. Regulatory governance refers to control exercised by regulators over firms through statutes, policies and regulations. Market governance denotes the use of market based controls which discipline the corporate behaviour. While stakeholder governance alludes to the direct or indirect control by various stakeholder groups having direct or indirect interest in the corporations, internal governance refers to the institutional arrangement of checks and balances within the corporation.

Why is corporate governance important for financial institutions?

While good governance is essential for any entity, it has deeper significance for financial institutions. There are many compelling reasons, some of which are:

a. Financial institutions are central to economic activity – banks and a large part of the non-banking financial system (the shadow banking system) undertake credit intermediation. Failures of financial institutions would thus impede the economic growth and would cause serious damage to the system. Economies take longer time to rebound from financial crisis than the business cycle recessions.

b. Financial institutions operate on a higher leverage. As per a study by the Bank for International Settlement (BIS) for the period 1995-2009, compared to non-financial institutions that had a leverage of about 3, banks operated at a leverage of 18.3 while non-bank financial firms had a leverage of 12.1. Higher leverage makes financial intermediaries more vulnerable to shocks. From a systemic perspective, the inherent procyclicality of the financial system leads to the build up of high leverage during upturn phase of the economy which amplifies booms and busts. Therefore, while the procyclicality issues need to be dealt with from a financial stability perspective, it is apparent that these financial institutions must be well governed for achieving financial stability.

c. Financial institutions, especially banks, deal in people's savings and trust of customers forms the cornerstone of their existence. Any breach of trust leading to loss of confidence is bound to lead to a *run,* not just on a particular bank but on others too who are perceived to have weakness or even similar business models. The non bank financial intermediaries who lose the trust of their lenders would not be able to raise resources at a reasonable cost making it hard for them to operate efficiently and profitably. All these can lead to snowballing effect impairing the functioning of the entire financial system due to interconnectedness. Good governance ensures customers' and other stakeholders' trust in banks and non-banking financial intermediaries.

d. Among the financial intermediaries, banks occupy a special place due to their centrality in the transmission of monetary policy and the functioning of the payment and settlement systems. They also are the beneficiaries of deposit insurance which may weaken their incentive for strong management monitoring as well as monitoring by other stakeholders including depositors. Good corporate governance would ensure strong internal controls which would offset the weakened incentive for monitoring. A robust and stable banking system is an absolute necessity for a well functioning economy.

* * *

Governance and Ethics

Lack of ethics too played a significant part in the erosion of governance standards in institutions. Values and culture define ethics. Ethics are principles that recommend proper conduct, help distinguish right from wrong and drive people to do the right thing even when no one is looking. While ethical behaviour is a minimum requirement for any dealing or transaction, it becomes all the more essential for financial intermediaries, and particularly for banks, for whom trust is the cornerstone. Honest and prudent behaviour by banks and other financial intermediaries is integral to their reputation and public confidence in the system. However, the conduct of financial institutions that caused the crisis does not suggest any measure of enduring interaction between ethics and banking. In fact, financial markets and entities displayed significant moral bankruptcy through the period spanning pre-crisis, crisis year and beyond. Some of the recent high profile events have emphatically highlighted the complete lack of ethics in some financial institutions. London interbank offered rate (LIBOR) rigging episode wherein a few financial institutions colluded in rigging the LIBOR so as to profit from the trades or to give an inflated impression about their creditworthiness shook the world. LIBOR is one of the most important interest rates and is used for pricing of about US$ 800 trillion worth of financial instruments (reportedly 11 times the GDPs of all nations on earth). There are several such episodes. Closer home too, in India, we have witnessed a few high profile cases which have shaken the public trust in the financial system. Satyam, once regarded as having good corporate governance, was found to have been deeply involved in one of India's biggest corporate frauds. The 1992

securities scam which brought out the nexus between bankers and brokers led to massive overhaul of the financial system in India. The unethical practices adopted by some banks in recent past in selling inappropriate financial products (exotic derivatives) to their corporate customers and the unfair and unscrupulous methods adopted by some microfinance institutions (MFIs) in their operations are some recent reminders of erosion of ethics in the financial system.

Causes of governance failure

A systemic failure of corporate governance means the failure of the whole set of regulatory, market, stakeholder and internal governance, which has largely contributed to the on-going financial crisis.

a. Regulatory governance failure :

The regulatory framework in the pre-crisis period was veering more towards deregulation and liberalisation. The Chinese wall that separated investment banking from retail banking was brought down with the repeal of Glass-Steagall Act of 1933 which led to the proliferation of universal banks. While this enabled the institutions to achieve economies of scale and scope, it also led to transmission of risks of investment banking into retail banking. The exemption from regulation of OTC derivatives enabled by the passage of Commodity Futures Modernisation Act 2000 is alleged to have encouraged excessive trading in Credit Default Swaps which were an important feature of the global crisis. Other regulatory dispensations such as permitting banks to move massive amounts of assets and liabilities off balance sheet through structured investment vehicles also fuelled the crisis. Further, the regulatory gaps which led to proliferation of shadow banking entities have also been significantly instrumental in exacerbating the crisis. There were lapses in the supervisory framework also. In the run-up to the crisis, it was observed that the supervisors were staying on the sidelines and not intruding sufficiently into the affairs of participants. They were not being proactive in dealing with the emerging risks and in adapting to changing environment. There was a lack of capacity to identify, or to act on identification. For example, supervisors could not see the risks building up when banks started dealing in very complex products or when banks started relying excessively on short term funding sources for their operations. Supervision was not comprehensive and even when supervisors found some anomaly, it was not taken to conclusion.

b. Market Governance failure :

The prevailing dogma prior to the crisis was that markets were always right and will find their own balance, left to themselves. There was unflinching faith in the invisible hand of markets, despite the well known fat tails in statistical distributions representing herd behaviour of markets signifying irrationality driven by excessive optimism or pessimism. However, the crisis established that markets are indeed fallible. As observed by Joseph E. Stiglitz, a Nobel laureate in economics, when information is imperfect, markets do not often work well and information imperfections are central in finance.

c. Stakeholder governance failure :

The crisis has also highlighted the failure on the part of various stakeholders who did not have active involvement in corporate governance.

d. Internal Governance failure :

It is observed that the lapses in internal systems and controls such as Board oversight, managerial competence, compensation policies, audit etc. were instrumental in exacerbating the crisisLet me now briefly touch upon some of the specific internal governance failures in the financial institutions that have contributed to and/or exacerbated the crisis.

a. Complex and opaque Organisational structures :

There was a massive growth in the complexity of Organisational structures in the pre-crisis period, with a view to taking advantage of regulatory arbitrage and also of gaps in regulations. Regulators found it difficult to look through the structures and enforce regulation. Many times, such complex structures fell in the gaps between regulatory jurisdictions and escaped regulations.

b. Inadequate Oversight by Board :

Boards were found to be not actively involved in formulating risk appetite framework of firms. Incomplete risk information due to gaps in MIS coupled with inadequate understanding of risk due to the lack of expertise among the directors, hampered effective and timely decision making. Improper pricing of risk led to suboptimal allocation of capital and inadequate preparation for the tail events eventually leading to the precipitation of the crisis.

c. Weaknesses in the Senior Management :

Senior management failed to adopt and integrate necessary systems to identify, manage and report risk. The misalignment of incentives also resulted in the management pursuing objectives which, at times, were at cross purposes to those of the firm.

d. Proliferation of complex products :

There was a significant spurt in the complexity of financial products in the run-up to the crisis. Abundance of cheap liquidity prodded the participants to innovate ways to deploy the funds and earn a return. Complexity and opacity led to inadequate understanding and mispricing of risk. The long chain of transactions also obfuscated the true risks inherent in the transactions and led to a false sense of comfort.

e. Flawed remuneration policies :

Compensation structures which focussed excessively on short term performance incentivised managers to take excessive risks in order to meet the short term objectives at the expense of long term sustainability of the firm. Further, the framework where the participants get to keep the gains while the losses are assured to be borne by the society (either explicitly by the government guarantee or implicitly due to the inevitable governments' intervention to bail out due to systemic concerns), was an incentive for participants to take-up risky activities. Equity incentives, put in place with the objective to align managers' incentives with those of shareholders, may also have induced managers to take excessive risks.

f. Weak risk management systems and internal controls :

With significant developments in technology, risk management in the run up to the crisis became highly quantitative on the lines of an exact science. Models proliferated with a false assurance to capture and measure every kind of risk. It is said that economists suffered from a syndrome of Physics *envy*. The models tried to anticipate the future based on assumptions of normality and on the basis of past data. In their exuberance, quants, however, forgot that the assumption of normality does not correspond to reality, particularly, in highly stressed situations. For example, the probability of a 5-sigma loss on any given day would mean that such an occurrence should happen once in about 14,000 years (assuming 250 trading days in a year) that is much longer than the period of time that has elapsed since civilisation evolved. During the crisis the Wall Street Journal (2007) reported that events that models predicted would happen only once in 10,000 years, happened everyday for 3 days. Further, the assumption, or rather the dogma, which was the basis of many models, that future could be predicted on the basis of past data, led to disastrous outcomes. With the rapid development of technology, increased integration of markets and entry of sophisticated players, the present and the future are much different from the past and it would be very naïve to predict the future based on the past data.

g. Inadequate emphasis on financial literacy and consumer protection :

While the complexity of financial products was increasing, inadequate attention was paid to imparting financial education to the public. Financial literacy would not only to enable customers to make use of the available products but, more importantly, help them understand the inherent risks in the products and to guard themselves if the financial institutions indulged in mis-selling and other unfair practices.

International initiatives in strengthening corporate governance

Global crisis has highlighted the significance of good corporate governance for the survival and well functioning of financial institutions. The Senior Supervisors' Group's Report '*Observations on Risk Management Practices during the Recent Market Turbulence*' (March 2008) confirms that the financial institutions which survived the crisis better were those who had, among others,

informative and responsive risk measurement and management reporting and practices. The blend of qualitative and quantitative analysis provided a high level of insight and consistent communication to management of evolving conditions, enabling the firm to respond effectively to emerging opportunities and risks.With lessons drawn from the crisis, policy makers have revisited the extant corporate governance framework and have issued guidance with a view to addressing the gaps witnessed and strengthening the governance framework. The OECD Steering Group on Corporate Governance, which examined the governance failures, observed that while the corporate governance weaknesses in remuneration, risk management, board practices and the exercise of shareholder rights had played an important role in the development of global crisis, the OECD Principles of Corporate Governance issued in 2004, nevertheless, provided a good basis to adequately address the key concerns that have been raised and that there was no urgent need for them to be revisited. The Group opined that the more urgent challenge was to encourage and support the implementation of already agreed international and national standards including the OECD Principles of Corporate Governance. Basel Committee on Banking Supervision (BCBS) has revisited its 2006 guidance on corporate governance and brought out Principles for enhancing corporate governance (October 2010). The Financial Stability Board (FSB) has, in its progress report to the G20 Ministers and Governors (November 2012) also made recommendations relating to the corporate governance issues of systemically important financial institutions (SIFIs).

Risk Governance

There is an enhanced realisation that the risk governance demands a holistic approach and that risk appreciation should start at the top. A strengthened management information system (MIS) supported by robust information technology platform is a necessary pre-condition for enhancing Board efficiency in oversight and decision making. Similarly, augmented skill sets and experience at the level of independent directors would go a long way in enhancing the Board capacity. Strong MIS facilitates risk reporting to the boards in an effective and comprehensive manner, which in turn enhances transparency and causes informed decision taking. Robust information technology systems are a necessary condition for supporting the MIS framework as the quality of risk information that the Boards and the top management receive depends largely on the quality and robustness of the information technology systems. In addition to prescribing the risk appetite for the institution, the board also needs to lay down appropriate risk strategy and ensure that this is institutionalised throughout the Organisation. This would entail, aligning risk management processes with the overall business strategy, clearly defining the roles and responsibilities down the hierarchy, establishing accountability and reinforcing change with communication and training. The Board and the senior management oversight must be supplemented with effective leadership by the Chairman and the chief executive officer (CEO), and informed non-executive directors. The Boards must get much more intimately involved in risk matters and have a firmer understanding of the key risks faced by the business. Effective risk governance also demands that each director is aware of the breadth of risks faced by the bank. Directors add value to the Board when they have financial expertise, are aware of risk fundamentals and techniques, and are able to manage dynamics with executives. Board level risk committees have an important role to play in the overall risk governance framework. Apart from monitoring the firm's strategic-risk profile on an on-going basis, such committees would also be responsible for defining the firm's overall risk appetite; approving major transactions above a firm's risk threshold, and; establishing limit structures and risk policies for use within individual businesses. Presence of a Chief Risk Officer (CRO) is expected to strengthen the risk management framework. However, independence of the CRO, with necessary stature to influence decisions, would be a critical element in ensuring the effectiveness of the post in risk management process as also the strategic risk management related decisions. The CRO must report directly to the CEO and the Board and be responsible for all risks, risk management and control functions. Another important requirement is integrating risk with business strategy and compensation. Risk – and return on risk – need to be core component of any performance measure, and should be explicitly factored into incentive and compensation schemes. Compensation must be formally aligned with actual performance, such as through adding more rigorous risk-based measures to scorecards. This would also involve moving to longer vesting periods, and increasing deferred compensation. The fragmented organisation of risk data into separate silos slows down risk management process and hinders the capability to respond to new regulatory requirements. The financial crisis has pushed both supervisors and market players to move towards an integrated approach to risk data that brings down the silos in organisation. Only by integrating data models, processes and methodologies can a bank achieve higher performance in terms of data quality. The risk management systems must take into account the technical limitations of risk models, such as Value at Risk (VaR). Stress testing and scenario analysis need to be established as truly effective management tools and should be integrated and standardised across business lines, types of risk and asset classes.

Financial Stability Board (FSB)'s thematic review on risk governance

The Financial Stability Board (FSB) in its Thematic Review on Risk Governance has observed that since crisis, national authorities have taken several measures to improve regulatory and supervisory oversight of risk governance at financial institutions such as developing or strengthening existing regulation or guidance, raising supervisory expectations for the risk management function, engaging more frequently with the board and the management, and assessing the accuracy and usefulness of the information provided to the Board to enable effective discharge of responsibilities. The evaluation also found that in many jurisdictions, the governance practices are more advanced that those prescribed under national guidance. This, the report opined, may have been motivated by firms' need to regain market confidence rather than regulatory requirements. The results of the Review support the finding that the firms in the regions hardest hit by the financial crisis have made the most progress. However, there are significant gaps relative to the criteria developed, particularly in risk management. The report points to the differences in progress across regions. While firms in advanced economies have adopted more of the desirable risk governance practices, nearly 65 per cent of the firms that reside in emerging market and developing economies (EMDEs) did not meet all of the criteria for the risk management function. The report notes that more work needs to be done in the areas such as elevation of CRO position, establishment of an effective risk appetite framework (RAF), improving the chief audit executive (CAE)'s access to directors beyond those on the audit committee, etc.

II. Indian Scenario

Corporate Governance of Banks

Banking regulation in India shifted from prescriptive mode to prudential mode in 1990s, which implied a shift in balance away from regulation and towards corporate governance. Banks are accorded greater freedom and flexibility to draw up their own business plans and implementation strategies consistent with their comparative advantage. This freedom necessitated tighter governance standards requiring bank boards to assume the primary responsibility and the directors to be more knowledgeable and aware and also exercise informed judgement on various strategies and policy choices. With a view to strengthen corporate governance, over a period of time, various guidelines have been issued in matters relating to the role to be played by the Board, fit and proper criteria for the directors of banks, bifurcation of the post of Chairman and Managing Director (CMD), remuneration etc. Recognising that ownership of banks by one or few individuals could be detrimental to the public interest, especially, depositors' interests, it is stipulated that, in India, banks should have a diversified ownership model. To ensure that ownership and control of banks are well diversified, guidelines on ownership and governance in private sector banks were issued by the Reserve Bank in February 2005. Another important regulatory prescription in this regard is the requirement of Reserve Bank's prior approval for any acquisition of shares in

private sector banks resulting in a shareholding of 5 per cent or more of the total paid up capital of the bank. The importance of diversified ownership is also underlined in the recent guidelines on new bank licenses wherein it is stipulated that Non-Operative Financial Holding Companies (NOFHC) which set up new banks should, after the initial lock in period of five years, bring down their equity capital of the bank from the minimum 40 per cent while setting up to 15 per cent within 12 years. To ensure 'Fit and Proper' status of the groups that would set up new banks, it is also stipulated that entities / groups should have a past record of sound credentials and integrity, be financially sound with a successful track record of 10 years.

Corporate Governance of Non-Banking Finance Companies (NBFCs)

Traditionally, Non-Banking Finance Companies (NBFCs) in India were small family run businesses some of which accepted deposits and engaged mainly in activities such as lending. Over the years, the NBFC sector has not only grown in size but also in terms of interconnectedness and systemic importance. Today, even though the sector has a total asset size constituting just above 12 per cent of that of scheduled commercial banks, some of the NBFCs have grown very big and are operating as conglomerates with business interests spread across insurance, broking, mutual fund, real estate etc. Keeping in consideration the growing significance of NBFCs in the financial system and their interconnectedness with the banking sector there is a strong case for strengthening their governance framework so as to not only protect the individual institutions and their depositors, but also to ensure the stability of the entire financial system. Further, NBFCs have exposures to sensitive sectors such as real estate and capital markets and they also rely on wholesale funding, all of which point to the requirement of robust internal controls and governance framework to ensure their stability. During the crisis, while none of the shortcomings as observed globally during the GFC manifested in any significant way in the Indian NBFC sector, a temporary crisis of confidence did emanate which affected some of the NBFCs. The lack of confidence exposed the shortcomings in the funding model and consequent problems in the overall risk management framework of these NBFCs which were relying heavily on short term wholesale sources such as mutual funds to fund long term assets. Further, certain shortcomings in the corporate governance were observed in a section of NBFCs viz; those in the microfinance institutions (MFI) sector, leading to near collapse of the sector. Distorted financial incentives such as short term profit maximisation / undue profiteering and excessive managerial compensation that were the hallmarks of the GFC were the leading contributors to the MFI crisis. The corporate governance issues in the MFI sector were exacerbated by some of the '*for profit*' MFIs, dominated and controlled by promoter shareholders which led to inadequate internal checks and balances over executive decision making and conflict of interests at various levels. Other undesirable practices such as connected lending, excessively generous compensation for senior management and founders/ directors and the failure of internal controls leading to frauds, precipitated the crisis. Some of the MFIs are also alleged to have chased high growth trajectory at the expense of corporate best practices. While drawing comparisons between the US subprime crisis and Indian MFI crisis, in an article titled '*Microfinance Industry in India: Some thoughts*' in Economic and Political Weekly (EPW) (October 8, 2011), Dr. Y.V.Reddy, former Governor, RBI, had observed that opaque practices, high salaries and commissions including unethical business and leverage were prevalent in MFIs. Recognising the significance of NBFCs in the overall financial system, measures were undertaken to strengthen the regulatory framework in terms of stipulation of capital adequacy and exposure norms in 2006. Subsequentlyin2007, guidelines on corporate governance for NBFCs were issued by the Reserve Bank of India. The listed NBFCs were already required to comply with the provisions of the Listing Agreement of the Securities and Exchange Board of India (SEBI), others being governed by the relevant provisions in the Companies Act, 1956.While the frameworks laid down by the various regulators / Companies Act may appear similar and over lapping in some areas, there are a few differences. Companies Act does not differentiate between financial, non-financial companies and SEBI Guidelines are generally from the perspective of investor protection with emphasis on disclosure and transparency. Therefore, RBI being the prudential regulator of NBFCs, additionally lays emphasis on risk management framework and the business practices etc. and its framework is mainly from the angle of depositor / customer protection. Reserve Bank's guidelines on corporate governance are applicable to only NBFCs with certain threshold of business i.e. with a certain deposit base or asset size.

Recent developments in NBFC sector

Reserve Bank has recently issued draft guidelines on corporate governance of NBFCs based on the recommendations of the Working Group on the issues and concerns in the NBFC sector (Chair: Ms. Usha Thorat). The guidelines aim to fine tune the framework for NBFCs by aligning the same with the businesses that they deal in and the growth in size, interconnectedness and systemic importance of the sector. The Guidelines address issues such as multiple directorships, continuing due diligence process with a reporting requirement to RBI, self certified '*fit and proper*' criteria and disclosures that are specific to NBFCs' business, such as disclosures on provision coverage ratio, Asset Liability profile, movement of NPAs, off-balance sheet exposures, structured products issued by them etc. Other requirements include prior approval of RBI for change in control of any registered NBFCs. It is indicated that big NBFCs with asset size of Rs. 1000 crore and above would require prior approval of RBI for appointment of CEO and would need to comply with Clause 49 provisions (of SEBI listing agreement) even if unlisted. NBFCs with asset size of Rs. 100 crore and above would be required to comply with the disclosure requirements specified in Clause 49 and of certain financial indicators. Given the recent episodes in the MFI sector, the corporate governance guidelines for MFIs have also been revamped. Measures are aimed at checking undesirable business practices like multiple lending, alleged coercive practices and charging excessive interest rates, etc. The guidelines are aimed at enhancing the 'self discipline principle' in these NBFCs. Measures include pricing of credit, restricting lending to a borrower by not more than two MFIs, sharing credit information with a Credit Information Bureau, review of Fair Practices Code (FPC) etc. A Self Regulatory Organisation (SRO) also is envisaged for the sector as a watchdog. While the final framework is still being evolved, the role envisaged for the present, inter alia, is to ensure good governance in the industry by way of client protection with enforcement powers to check violations to codes of conduct / regulations.

Conclusion

Governance, like regulation, is an evolving concept and is continuously fine tuned to suit the dynamic economic and business environment. Global financial crisis has given us an opportunity for strengthening both the regulatory as well as governance frameworks, by highlighting gaps that exacerbated the crisis. There is an interesting debate over whether and how much regulation can substitute board level governance. While regulation is imposed from outside, corporate governance is internal and is more in the nature of self regulation which ensures that the principles and rules laid down by the regulations are scrupulously adhered to. Prior to the crisis, the emphasis was increasingly on self regulation through robust corporate governance so that the regulation could remain largely principle based and less prescriptive. However, serious lapses observed in governance framework during the crisis, tilted the balance in favour of more rigorous regulation. I am of the view that both regulation and corporate governance have to complement each other. Effective regulation furthers corporate governance and effective corporate governance ensures that the objectives of the regulation are met, with minimal regulatory intervention.***[Address by Anand Sinha, Deputy Governor, Reserve Bank of India, delivered on his behalf, at the L & T Management Development Centre, Lonavla on March 19, 2013.]***

Welcome
Mr. N. S. Vishwanathan
Principal Chief General Manager,
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Body to deal with financial distress on the cards: RBI

The RBI said that a proposal is afoot to set up a resolution authority to deal with the widespread distress caused by failure of financial institutions. "Within India we are coming up with a resolution authority for what can be done when institutions come under stress," RBI governor D Subbarao said in response to a query as to whether it was right to impose 'sin tax' to bailout distressed investors of Saradha Group in West Bengal. Resolution authority provides an official framework to deal with the problems in the aftermath of the failure of large financial institutions. Citing examples of developed nations, he said, it was done in the US when the government used tax payer money to bailout many financial institutions that came under stress due to global meltdown in 2008. [Financial Chronicle/PTI, May 09]

Financial Sector Legislative Reforms Commission has recommended in its report for setting up of Resolution Corporation, a specialised 'resolution mechanism'." A 'resolution corporation' would watch all financial firms that have made intense promises to households, and intervene when the networth of the firm is near zero(but not yet negative). It would force the closure or sale of the financial firm, and protect small consumers either by transferring them to a solvent firm or by paying them".[Source : Report of Commission]

Rs 150-cr service tax claims from NBFCs on securitisation

Several major NBFCs have dodged at least Rs 150 crore of service tax due in the process of securitizing their loans with top new-generation private banks. Service tax authorities, who are zeroing in on frontline NBFCs based in Kerala, Mumbai, Chennai and Kolkata, which together have over 10,000 branches across the country, have found that the evasion has been going on for years. The NBFCs had securitised their loans –mainly gold, vehicle and home – with some of the country's most successful new-generation private banks.

Securitisation means the selling of loans by NBFCs to banks or other financial institutions in order to get immediate liquidity. The NBFCs take care of the paperwork, loan repayment and administrative tasks of the securitised loan, for which it receives a huge sum from the banks as service charge. This entails a service tax of 12.36 per cent. The actual value of the service, instead of being marked separately, has been loaded onto the purchase price of the loan, facilitating evasion of tax.

Tax sleuths believe the evasion might run into several hundreds of crores as they suspect several other NBFCs, and micro-finance companies, have been manipulating accounts to dodge tax obligation. "We checked the securitization records of nine prominent NBFCs relating to the past five years," Aneish P. Rajan, assistant director, Directorate-General of Central Excise Intelligence, told *Business Line*. "Our initial estimate shows there has been a service tax evasion of more than Rs 150 crore." Two NBFCs, one based in Kerala and the other in Mumbai, have already paid up Rs 22 crore, and the tax authorities are hopeful of retrieving the rest. "The investigation is a long-drawn process as we have to sift through thousands of documents and digital records," said Rajan. [Business Line, June 3]

'Surveillance' of NBFCs needs to be strengthened

There is need to review the regulatory supervision of the non-banking financial sector in the backdrop of the recent meltdown of a few finance companies (read: chit funds) in the country, said RBI Governor D. Subbarao. India's non-bank financial sector is very large, diverse and complex. Some of it is in the corporate sector, but much of it is unincorporated. The Governor observed that the different segments are controlled by different regulators. While some of the deposits raised by these companies are legal, some are illegal.

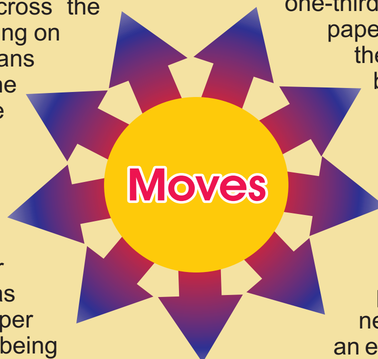
"While tightening regulation is important, it is not sufficient. What is to be noted is that much of the fraud in the non-bank sector happens through unlawful and fraudulent schemes, which should not be operating. "This reinforces the importance of surveillance and enforcement, especially by the State governments," said Subbarao at a banking and finance conference organised by the Indian Merchants' Chamber.

In the Reserve Bank's view, deposit taking should eventually be restricted only to banks which are tightly regulated. Deposit collection by non-banking companies should be gradually minimised, and eventually eliminated. Towards this endeavour, the Reserve Bank has been quite restrictive in authorising (NBFCs) to collect deposits. The number of NBFCs allowed to collect deposits has come down from 1,420 in 1998 to less than a fifth, 257, by 2013. [Business Line, June 5]

'Barring NBFCs from taking deposits will cripple them'

The RBI Governor D. Subbarao's remark on June 5 that NBFCs will be eventually kept out of deposit-taking has caused apprehension in the NBFC sector. V.P. Nandakumar, executive chairman of Manappuram Finance Ltd, one of the top gold-loan NBFCs, "If the RBI thinks that NBFCs should not raise funds through deposits, the companies will have a really tough time," he said. "Without access to this avenue of fund-raising, the companies will be totally dependent on the banks," he said. "Relying on just one credit channel will be a huge risk." Moreover, since small NBFCs did not enjoy credit rating, bank finance would be inaccessible to them. The current uncertainty over whether the NBFCs would be allowed to continue to access non-convertible deposits [NCD] was a major cause of worry, particularly after the Rao Committee report. The NCD was a key channel of receiving public deposits; it also helped broad-base borrowing, thus limiting risks.

The entire NBFC sector was concerned about the RBI governor's statement, he noted. In Nandakumar's view, ideally, the RBI should allow NBFCs to raise one-third of their funds from retail, another one-third from the banks and the rest from commercial papers and institutions. Allow NBFCs to raise one-third of their funds from retail, another one-third from the banks and the rest from commercial papers and institutions. [Business Line, June 6]



Stamp papers may come with 1-yr validity

Stamp papers may soon come with only one-year validity, as the finance ministry is planning amendments to the over a century-old Indian Stamps Act. The validity period is being proposed to address the issue of forgery. Besides, electronic payment of stamp duty may be allowed under the new Bill. Officials said the purpose behind prescribing an expiry date for the use of the stamp paper was to stop its misuse, as many people bought backdated papers to stake their claim on properties in the future when no such deal would have actually happened on that date.

The finance ministry is also considering various other changes to the Indian Stamps Act, with major ones including amendments pertaining to a uniform stamp duty on stock market transactions across the states, against the current practice of multiple rates. Stamp duty may be collected by stock exchanges from the seller and then passed on to the states where the seller is based.

Section 54 of the Act provides that a person possessing a stamp paper for which he has no immediate use can seek refund of the value by surrendering it to the collector within six months of purchasing it. This validity is only for the purpose of seeking refund of unused stamp paper and not for using it. A Supreme Court judgment in 2008 had clarified there was no impediment for a stamp paper, purchased more than six months prior to the proposed date of execution, being used for a document.

The Bill, which is in the works for the last few years now, may be taken in the monsoon session of Parliament if all approvals are in place. [Business Standard, 12 April]

NBFCs mull fund raising to meet new RBI norms

Major NBFCs are gearing up to raise funds as the RBI is expected to shortly release the operational guidelines for NBFCs which may prescribe a higher capital requirements and stricter bad loan provisioning. Fund raising is essential to fuel growth and also to meet the regulatory prescription for higher capital. Three large NBFCs told Financial Chronicle that they plan to raise funds for growth and other requirement that would add up to about Rs 10,000 crore.[Financial Chronicle, April 21]

FIDC to approach the Apex court for uniform guidelines for enforcement of the arbitral awards

FIDC decided to file a reference application to Supreme Court on behalf of NBFCs for laying down uniform guidelines on enforcing the arbitral awards, which will bind all the High Courts in view of conflicting judgments of various High Courts. NBFCs generally have arbitration clauses in their agreements with the parties. As per Sec.36 of The Arbitration and Conciliation Act, 1996, the award can be enforced after expiry of 3 months from the date of receipt of the award by the parties to the arbitration proceedings.

Originally, after the expiry of 3 months, NBFCs were filing Execution Petitions in the appropriate court of jurisdiction after getting transmission orders from the High Court within whose jurisdiction the arbitration proceedings were conducted. However, the Madras High Court in its judgment dated 26.08.2011 (Kotak Mahindra Bank Ltd. V. Sivakama Sundari & Other, 2011 (6) CTC 11), had held that such transmission order is not necessary for filing execution petition. The High Courts of Delhi, Bombay and Kerala concurred with this view. However, the High Courts of Madhya Pradesh and Karnataka insist for transmission orders. FIDC as a body of NBFCs has therefore decided to approach the Apex court for laying down uniform guidelines for enforcement of the arbitral awards.

Interest on delayed payment

The Bombay High Court has dismissed the appeal of the Maharashtra Small Scale Industries Development Corporation against the award of interest by an arbitrator in its dispute with Snehadeep Structures. The construction firm, which supplied materials for a slurry pipeline for the Chandrapur thermal power station, alleged that the payments were not made on time and therefore it was entitled to interest on delayed payment. When the claim was disputed, the matter went to an arbitrator. He awarded interest from the date of statement of claim till the date of award and future interest at the same rate till the payment or realisation. The corporation appealed to the high court, which rejected it stating that the order of interest was justified and it would not interfere in arbitration awards.[Business Standard, May 12]

Guidelines on compensation

In road accident claims under the Motor Vehicles Act, the statutory schedule for calculating compensation need not be scrupulously followed by tribunals and courts, the Supreme Court stated in the judgment, Reshma Kumari vs Madan Mohan.

There were differing views among Supreme Court judges for over a decade about the second schedule of the Act. Some judgements held the view that the table for calculating damages was "unworkable". Some other decisions maintained that the schedule was a good guide for computing compensation. Despite this raging controversy, Parliament had failed to make amendments in the law for two decades. In view of the differences, this case was referred to a larger bench for a final view. In this judgment, the three-judge bench analysed earlier judgments of the Supreme Court and laid down a set of guidelines for arriving at a fair figure for damages under various situations, like when the accident was caused by negligence (Section 166) and when 'no-fault liability' is invoked (Section 163-A). The court asked all forums below to follow the new guidelines and those laid down in its 2009 judgment in Sarla Verma vs Delhi Transport Corporation, setting to rest the contrary views.[Business Standard, April 7]

Cheque bounce offence likely to go

The government will soon bring an amendment in the Negotiable Instruments (NI) Act that will restrict banks from dragging a person to court for an offence like cheque bounce. All such cases, after the changes are effected, will have to be decided only through arbitration , conciliation or settlement by Lok Adalats.

It is estimated that more than 30% of all the pending cases in courts across the country are either related to cheque bounce or traffic challans. The proposed amendment has been recently suggested by an inter-ministerial group (IMG), which was set up last year to make suggestions for necessary policy and legislative changes to deal with a large number of cases pending in various courts.

The law ministry is working closely with the finance and surface transport ministries to make suitable changes in the law and cases falling under both categories (cheque bounce and traffic challans) will be ineligible to be taken to courts unless some other criminal intent is alleged. The changes in the NI Act will make it compulsory for the disputing parties to resolve the matter through alternative dispute resolution mechanism. Amendments in the Motor Vehicles Act are suggested for cases related to traffic challans.

The IMG report, being implemented by the finance ministry, said a summary procedure for dealing with cheque bounce cases as a schedule of procedure may be codified, and developed by the department of financial services. The same may suitably be incorporated in the Negotiable Instruments Act, it added. The existing rules for court fees do not take into account the amount involved in the cheque or volume of complaint cases. "The court fee may be made Ad-valorem to act as a deterrent for indiscreet and vexatious complaints ," the IMG has said. Provision may also be made for defaulting party to bear the cost of litigation in cheque bounce cases, it added. [Economic Times/TNN, 4 June]

Washington sought rights to invoke Sarfaesi Act to recover bad loans

Just ahead of Secretary of State John Kerry's India visit, Washington had sought rights for the US Exim Bank to invoke India's Sarfaesi Act to recover its bad loans. Sources said the finance ministry asked for the RBI's opinion on the matter, given that if the US demand is met, it could set a precedent as no foreign lender except multilateral funding agencies such as ADB and IFC currently have recourse to Sarfesi Act to recover their loans. For any lender to invoke Sarfesi provisions, the government needs to notify it as a financial institution under the Act. [Financial Express, June 25]

Entities funding India Inc's litigation costs see good business opportunity

Leading litigation funds are exploring the possibility of doing business with Indian companies and some have discussed the subject with local law firms. Many Indian businessmen discover the travails of joint ventures with foreign partners when they find themselves in international courts of law, writing out fat cheques to men in black and Queen's Counsels in wigs. Such expenses can burn a hole in balance sheets, and more and more Indian companies will have to shell it out as cross-border litigations surge. But a breed of specialised financiers is sensing this as a new business opportunity. These are the litigation funds, which bet on the outcome of high-stakes court battles.

Organised like private equity houses, they don't invest in stocks that traditional asset managers do, but instead fund the litigation costs of a company in return for a share of the proceeds. If a client loses, the fund receives nothing - like a bet that has gone sour. Leading litigation funds like Burford, Harbour and Fulbrook are exploring the possibility of doing business with Indian companies and some have discussed the subject with local law firms.

"Litigation funding as a concept is very attractive to Indian clients and their lawyers. We know this from a recent visit to Mumbai during which we met with 10 law firms where we had an overwhelmingly positive response to our funding solution," said Susan Dunn, head of litigation funding at the London-based Harbour, one of the most experienced financiers. The attraction largely stems from the fact that the budget is agreed and payments are made every month throughout the life of a case - a structure that minimises cash flow uncertainty. [ET Bureau, 22 April]

Taxman sends notices to MFs on securitised product income

The income tax (I-T) department has sent fresh notices to mutual funds, asking them to pay taxes on income from pass through certificates (PTCs), a securitised product. The move comes less than two months after the Union Budget clarified that returns from PTCs were tax-exempt. In March 2012, the Bombay High Court had quashed the I-T department's demand for tax on income from mutual funds' investments in securitised instruments such as PTCs, in response to an appeal filed by UTI Mutual Fund. The court also dismissed the department's demand to freeze accounts of mutual funds.

The I-T department has maintained that income from securities instruments such as PTCs is taxable. Mutual funds are arguing they are exempt from taxes on investment income as these are held on behalf of unitholders. Mutual fund industry officials allege tax authorities are giving an impression that the trusts have been formed to avoid taxes. "When fund houses are exempt from taxes, why would we form a body like this just to avoid taxes?" said the chief executive officer of a mutual fund.

Following the confusion, the mutual fund industry had approached the finance ministry last year seeking clarity on the matter. "At that time, the minister understood the matter and it got plugged in the Budget," said an official of the Association of Mutual Funds in India (Amfi). The change in the tax rules will take effect only after the Finance Bill is introduced. According to mutual fund officials, the matter is not retrospective. [Business Standard, April 25]

SEBI clubs FIIs, QFIs as FPIs, eases entry norms for them

The SEBI has decided to tighten regulations for buyback of securities. It will also allow start-ups and SMEs to get listed without making an initial public offer (IPO) on an institutional trading platform (ITP) to be created.. The board of SEBI, which met on 25 June, has approved simplified and uniform entry norms for foreign investors by clubbing FIIs, sub-accounts and QFIs (qualified foreign investors) into a new investor class called FPIs (foreign portfolio investors). SEBI also decided to do away with the requirement of prior direct registration of FIIs and sub-accounts. Instead, designated depository participants (DDPs) will register FPIs on behalf of SEBI, subject to KYC compliance.

SEBI will double the mandatory minimum buyback of shares to 50 per cent from 25 per cent. Companies will have to create escrow accounts for at least 25 per cent of the amount earmarked for buyback. They will forfeit this money if they fail to buy back the mandatory minimum. The maximum buyback period has been halved from 12 to six months. Also a company cannot make a buyback offer within a year of the closure of a previous offer. Company promoters cannot make any share transaction, on-market or off-market, during the buyback period. For the buyback of odd lots of physical shares, a separate window in the trading system for tendering these shares and requirement of PAN/Aadhaar for verification have been recommended.

SEBI's 2009 regulations on disclosure requirements relating to preferential issues and lock-in have been amended to enhance transparency and ensure adequate audit trail. [Financial Chronicle, June 25]

IDFs can extend schemes' tenure by up to 2 year: SEBI

Infrastructure Debt Funds (IDFs) can now extend the tenure of their schemes by up to two years with the consent of two-third investors, with market regulator SEBI notifying the changes in its IDF regulations. The IDFs, which can be set up like mutual funds, can also invest funds collected for their schemes in bonds of public financial institutions and infrastructure finance companies. Notifying various amendments to its IDF regulations, SEBI said that such investments can be done only if the Asset Management Company (AMC) is unable to find the core assets such as debt assets or securitised debt of infrastructure firms, bank loans related to infrastructure for deployment of the amounts of principal.

Extending the time-frame for subscription, SEBI said that the New Fund Offer (NFO) period has been increased to up to 45 days (from up to 15 days) and the Specified Transaction Period (STP) to up to 45 days (from up to 30 days), SEBI said in a notification dated April 16, 2013.

The regulator has also widened the definition of strategic investors to include systemically important non- banking finance companies registered with the Reserve Bank and Foreign Institutional Investors (FIIs) registered with SEBI. [Financial Chronicle/PTI, April 17]

SEBI to get powers to summon call data, email, SMS records

The SEBI, will soon get powers to summon phone call records, emails and SMSes of persons it is probing for insider trading and other market manipulations. With these powers, SEBI aims to prevent black money coming into the market, as well as to keep an eye on insider trading. SEBI's plea for such powers has been endorsed by the finance ministry which late last month wrote to the ministry of home affairs for designating the capital market regulator as an agency authorised to receive call data records (CDR) under the Indian Telegraph Act, 1885. This followed a meeting Finance Minister P Chidambaram took on May 15 to discuss how SEBI could be enabled to requisition and receive CDRs of calls, SMSes and emails available with telecom/other service providers. However, the regulator is not asking for powers to snoop on telephonic conversations. [Business Standard/PTI, 12 June]

Govt proposes stronger powers to SEBI to tackle ponzi schemes

With an aim to provide stronger powers to SEBI for taking on perpetrators of ponzi schemes and other fraudulent activities, the government has proposed to arm the market watchdog with direct powers to carry out search and seizure operations and for attachment of assets. Besides, it has also been proposed to provide SEBI with powers to seek information, such as telephone call data records, from any persons or entities in respect to any securities transaction being probed by it.

SEBI has been seeking an overhaul of regulations governing its powers and mandate for a long time, given the changing nature of the securities market in general, and newer tools being used by manipulators to take gullible investors for a ride, in particular. The government has decided to accept most of the proposals made by SEBI in this regard and the amendments would be carried out after the Cabinet approves the move and the required amendment bill is passed by the Parliament, he added.

With regard to the regulation of Collective Investment Schemes (CIS), the proposal calls for Sebi being empowered to deal with all kinds of investment schemes involving pooling of funds totalling Rs 100 crore or more. Also, any investment scheme floated by a 'person' and not only a 'company', has been proposed to be brought under SEBI's jurisdiction for CIS activities.

The proposed amendment seeks to bring all kinds of ponzi schemes, which are thriving in various semi urban and rural areas at the expense of gullible investors, are brought under SEBI's oversight, which itself would be made much more effective to safeguard investors from being defrauded. Besides, the government has also proposed to provide SEBI with direct powers to conduct search and seizure with authorisation from its Chairman. [Financial Chronicle/PTI, May 20]

SEBI seeks new laws to deal with deposit-taking firms

Capital market regulator SEBI has urged the Centre to come up with a new set of laws providing for a single regulator for deposit taking companies. "The type of promises some of these companies are giving are such that no legitimate business activity can provide that sort of returns. We have, therefore, requested the government to come up with a new set of laws providing for a single regulator for these companies," Sebi chairman U K Sinha said. [Financial Chronicle, Mar 26]

SEBI removes physical filing of KYC documents

To streamline the process of know-your-customer (KYC) procedures, market regulator SEBI has done away with the submission of physical documents by investors to the KYC registration agencies (KRAs) in favour of the electronic format only. The intermediaries, including mutual funds, would need to submit scanned copies of investor documents to the KRAs and retain the physical documents with themselves. However, the physical documents will need to be submitted,wheneverKRAsdemandthem.

So far, KRAs – which are responsible for maintaining KYC records across all SEBI-regulated entities – were required to maintain the original KYC documents, both in physical as well as electronic formats. To minimise the physical paperwork, SEBI has now amended its KRA regulations, allowing the market intermediaries to keep the original investor documents in physical form with them and submit only the scanned copies to the KRAs. [Financial Chronicle/PTI, Mar 25]

SEBI lifts vigil on corp bonds, will release daily figures

The SEBI has taken the initiative to collate all key data on corporate bonds issued domestically but is finding it difficult to get one key set of data — on defaults. All intermediaries in corporate bonds and SEBI representatives met to discuss the issue and agreed to create a comprehensive database of all corporate bonds issued in the country. The data will be disseminated to help regulators and investors in the corporate bond market ahead of the launch of the dedicated debt platform by the stock exchanges, expected shortly. Corporate bonds worth Rs 1,81,070 crore were March 31. Every year such bonds worth Rs 50,000 crore are issued. But there was no consensus on who would provide the information on defaults. The issuer is not willing to give the information for obvious reasons; the stock exchanges and depositories may not have knowledge of this. [Financial Chronicle, April 11]

Asia facing daunting challenge in financing infrastructure projects: Indian official

Asia is facing a daunting challenge in financing physical infrastructure projects in the next decade, where a funding of from 8 to 10 trillion U.S. dollars is needed, said a senior Indian official. Indian Finance Minister P. Chidambaram said that Asia is seeing a serious shortage of financial resources for its infrastructure projects and has looked for various financial resources to fund its infrastructure boom. Addressing an Asian Development Bank (ADB) annual meeting, Chidambaram said due to low interest rates globally, it has become more difficult to raise fund for infrastructure projects. Meanwhile, the ADB lending will decline from 10 billion U.S. dollars to 8 billion U.S. dollars. Indian Prime Minister Manmohan Singh also suggested at the meeting that ADB and other institutions might channel the savings of Asian countries into funds for financing infrastructure projects. [May 4 (Xinhua)]

ECB trims key lending rate to record-low 0.5%

The European Central Bank has indicated that more stimulus is possible as it reduced its main lending rate by one-quarter percentage point. President Mario Draghi says central bank officials "stand ready to act if needed" and that he is keeping an "open mind" about negative interest rates. The ECB says its special liquidity facilities will remain open.[EFLA SMARTBRIEF, May 2]

China, India seek to create new economic engine

China and India, both with a billion-plus population and emerging as the world's two rising powers, are seeking to join efforts to create a new engine of the global economy. "I am confident that we will view bilateral relations from a strategic height..., jointly nurture new bright spots in cooperation among Asian countries, and create a new engine of economic growth of the world," Chinese Premier Li Keqiang said during his visit to India, the first leg of his maiden foreign tour after taking office in March.

Against the backdrop of a faltering global economy dulled by the lengthy recession in the EU and lukewarm recovery in the U.S., analysts expect cooperation between the two populous emerging economies, especially in trade and investment, to help paint a brighter picture. Zhang Yansheng, a foreign trade expert with the National Development and Reform Commission, said the two countries' economies are broadly complimentary with each other, with China strong in manufacturing and India good at outsourcing, indicating room for further cooperation.

In 2012, two-way trade between the nations amounted to 66.5 billion U.S. dollars. China is now India's second largest trade partner, while India is China's biggest partner in South Asia. The two countries aim for bilateral trade to reach 100 billion U.S. dollars by 2015. While the growing trade has brought concrete benefits to both countries amid sluggish markets elsewhere, some Indians may find it disconcerting as the trade is heavily skewed in China's favor, a particularly sensitive issue for India with its ballooning current account gap. "China never had the intention to pursue a trade surplus. Only a dynamic trade balance is a sustainable trade relation," Premier Li stressed in India.Liu Xiaoxue, an expert on Sino-India trade from the Asia-Pacific Institute under the Chinese Academy of Social Sciences, attributed the persisting imbalance mainly to India's less sophisticated production lines. India's exports to China are mainly cotton and minerals, while China offered manufactured goods such as industrial equipment. During Li's stay in India, the two sides agreed to take measures to address the issue of the trade imbalance, including cooperation on pharmaceutical supervision, stronger links between Chinese enterprises and the Indian IT industry, and completion of negotiations on agro-products. As long as trade keeps flowing, the two sides can gradually resolve the imbalances in the process, said Liu. [BEIJING, May 21 (Xinhua)]

Fed adopts rule clarifying steps to tag nonbanks for oversight

The U.S. Federal Reserve said that it had approved a final rule to clarify the process the new U.S. risk council will follow when it begins designating nonbank financial firms for heightened oversight. A group of regulators known as the Financial Stability Oversight Council is responsible for determining which nonbank firms are so critical that their failure could threaten the financial system. The rule sets requirements for determining when a company is "predominantly engaged in financial activities," part of the process laid out by the 2010 Dodd-Frank financial oversight law. The final rule largely mirrors an earlier proposal, with the change that engaging in physically settled derivatives transactions will not count as a financial activity, the Fed said. [Reuters,WASHINGTON, April 3]

American International Group Inc. (AIG), Prudential Financial Inc. (PRU) and a unit of General Electric Co. (GE) were identified by U.S. regulators as potential risks to the financial system in a step toward putting the firms under tighter government scrutiny.[Bloomberg, June 4]

High-cost borrowing is a new American norm, research finds

High-cost borrowing through payday loans, pawn shops, auto title loans and others is no longer on the margins of U.S. consumer behavior — about 1 in 4 Americans have tapped this kind of financing, new research shows. A new study by the National Bureau of Economic Research finds high-cost lending is now firmly rooted in the American financial system after two decades of strong growth. It is firmly rooted in the American financial system and is common even for households who are generally referred to as 'middle-class families.

The new research comes amid a renewed regulatory focus on this type of lending, particularly the payday loan industry. A recent report by the Consumer Financial Protection Bureau found that payday loans were essentially a “debt trap.” The average payday-loan consumer took out 11 loans during a 12-month period, paying a total of $574 in fees -- not including loan principal, according to the study by that federal agency. A quarter of borrowers paid $781 or more in fees. [Los Angeles Times, April 26]

Default risks in S. Korea rise among low-credit companies, households

Default risks in South Korea rose fast among low-credit companies and households, boosting concerns over the deepening bi-polarization in funding, central bank report showed. Small businesses, which heavily depend on non-bank institutions for funding due to their low-credit worthiness, saw their borrowing from secondary institutions drop 7.6 percent in 2012 after tumbling 7.5 percent in the prior year, according to the financial stability report submitted by the Bank of Korea (BOK) to the National Assembly. Banks expanded their lending to small companies in the cited period, but funding conditions for small firms were worsening due to tight credit by non-bank institutions, the central bank said.

Default risks among low-credit, low-income households increased after financial institutions sought to strengthen risk management, leading those who have troubles in borrowing from banks to rely on non-bank institutions and loan sharks that demand super-high lending rates.

Delinquency rate of loans extended by mutual savings to households rose sharply to 15 percent as of the end of 2012. [SEOUL, April 30 (Xinhua)]

World Bank ready to pitch in if Fed move uncaps borrowing costs

The World Bank says it will step in if an eventual U.S. Federal Reserve tapering suddenly causes borrowing costs to soar. "If the United States does back off ... and slows down its quantitative easing, borrowing costs will go up, and we think they will also go up for developing countries. And that's a real concern," bank President Jim Yong Kim said. [Reuters, June19]

China growth seen decelerating in 2014

Although China should finish this year with 7.7% growth, next year the gain in gross domestic product should ease to 7.3%, forecasts China International Capital Corp. CCIC also predicted the government will lower its 2014 growth forecast to 7.0%. [China Daily-Beijing]

Bank borrowings of NBFCs slow down due to higher rates, lower demand

With banks' lending rate remaining high, NBFCs are increasingly look for alternative ways to meet their funding requirement. As a result, bank credit growth to NBFC sector has dropped to single digit level [5.2 percent] in April as compared to 35 per cent growth in the same period of the previous year. According to market participants, NBFCs are increasingly borrowing money through privately placed non-convertible debentures (NCDs) which are of long term in nature and short-term commercial paper (CP).

This has clearly reflected in sectoral credit deployment data of RBI for the month of April. According to the data credit to NBFCs increased just by 5.2 per cent in April compared with the increase of 34.4 per cent in the same month last year. [Business standard, June 8]

Securitisation to turn costlier for banks with new distribution tax

The Rs 30,000-crore securitisation market is up for a fresh challenge, after seeing a 40 per cent drop in volumes last year, owing to lack of clarity on taxation issues. Securitisation, a key route for private and foreign banks to meet priority sector commitments, will turn costlier for them as the government has imposed additional tax on investors from June this year.

Non-banking finance companies, which raise funds by securitising their loan portfolio in favour of these banks, may have to shell out a higher interest rate as banks will try to pass on the additional tax burden on the issuer. If banks want to pass on the entire burden on issuers, they have to invest at about 270 basis point higher interest rate. "The industry will go through a difficult phase again," said Vinod Kothari, chartered accountant and an expert in securitisation. "Who will ultimately bear the additional burden and to what extent will depend upon the bargaining power of the issuer and the investor?" he asked.

The Lok Sabha has passed the Finance Bill 2013, on April 30, with the proposal to levy a 30 per cent distribution tax on investors in securitisation deals through SPVs. "Earlier, banks, which are the principal investors in securitisation deals through SPVs, used to pay tax on their net income from the deal. Now, they will be taxed on gross income, making it costly for them," Kothari said.

A forum called Indian Securitisation Foundation has convened a meeting on May 22-23 in Mumbai to discuss this emerging situation. After the new securitisation guidelines issued in May last year, the volume of fresh issue dipped to Rs 28,400 crore from Rs 44,500 crore in the preceding fiscal. A senior official with a leading NBFC said the securitisation route may turn more costly for them as banks would try to pass on the burden. "The issuers and investors can avoid the additional burden through bilateral deals. But in case of direct buyout of loan portfolios, banks will have to bear the credit risk fully as RBI does not allow credit enhancement under bilateral arrangements," he said.

RBI said it will issue the final guidelines on reset of credit enhancement in securitisation by end-June 2013. Magma Fincorp CFO Lakshmi Narasimhan, does not expect any change in pricing of the deals. "Mutual funds are exempted from the tax. So, they can again emerge as the buyer in this market without any change in pricing," he said. Many like him said banks will any way be under pressure to buy pass-through certificates issued by the originator of the loans through an SPV.

NBFCs and MFIs get bank fund through securitisation at rates lower than those prevalent for bank loans. "We understand that the distribution tax will not be deducted by securitisation trusts if the instruments are invested in by MFs, and therefore, MFs will find it attractive to invest in pass-through certificates issued in securitisation deals," said Sandeep Singh, senior director at India Ratings & Research. [ET Bureau, April 18 & May 9]

Indian rupee's crash casts shadow over ECBs nearing maturity

The near 2% fall of the Indian rupee [to over Rs. 58] spells trouble for the stock of external commercial borrowings coming up for repayment over the next six months. Analysts estimate that over $20 billion worth of ECBs are due for repayment in 2013-14. Data from the government also show that as on September 30, 2012, repayments of such loans, including interest scheduled in 2013-14, was $20.12 billion.[FE BUREAU, JUNE 11]

Credit penetration in the country growing: CIBIL

Credit penetration in India has deepened considerably in the last seven years, with the share of first-time borrowers growing from 32% in 2006 to 50% in 2012, said Credit Information Bureau (India) Ltd, or CIBIL. "Out of this, 62% of these new-to-credit borrowers have obtained secured loans like home and auto, while 28% have availed unsecured loans like credit card and personal loans," the CIBIL analysis stated.

Moreover, the number of applications for new credit is also on the rise. "After the lull post-2008 global crisis, credit-offtake is on an upswing in the last few months. Non-banking financial companies and public sector banks are increasing their focus on auto loans and credit cards respectively," said Arun Thukral, managing director, CIBIL. The number of new credit applications has increased by 200% since January-March 2010. Similarly, the number of loan accounts opened grew by 80% between January-March 2010 and October-December 2012. "The increase in the number of new credit applications and loans booked indicate an increase demand for credit and bounce-back by lending institutions in sanctioning new credit after the 2008 downturn," the analysis noted.

Largely, it's secured credit like auto and home loans that have driven this increase in credit offtake, collectively accounting for more than 40% of all new credit applications. In the first three months of 2013, however, credit card was the most enquired product, making up 20% of all enquiries, followed by auto loans at 17%, the report said. [ET Bureau, April 19] ■

NBFCs in robust financial conditions, shows RBI stress test

A stress test carried out for the period ended December 2013 on credit risk for NBFCs (includes both deposit taking and ND-SI sectors] at system level by the Reserve Bank is released on June 27, 2013. It was carried out under two scenarios: (i) where gross NPA increased two times and (ii) gross NPA increased 5 times from the current level. It was observed that in the first scenario, CRAR dropped by 1.1 percentage points from 21.7 per cent to 20.6 per cent while in the second scenario CRAR dropped by 4.4 percentage points (CRAR dropped from 21.7 per cent to 17.3 per cent). It may be concluded that even though there will be a decline in CRAR under both the scenarios, it will remain above the minimum required level of 15 per cent.

Stress tests on credit risk for individual NBFCs for this period was also carried out under the above two scenarios as used for system level stress tests. Under the first scenario, it was observed that CRAR in respect of only 3.5 per cent companies was less than minimum regulatory requirement of 15 per cent while in the second scenario, CRAR in respect of 8.9 per cent companies went under 15 per cent.

The report further revealed that the aggregate CRAR of the NBFCs-ND-SI sector stood at 26.8 per cent for the quarter ended December 2012 as against 27.4 per cent in the previous quarter ended September 2012. However, GNPA ratio of the NBFCs-ND-SI sector stood at 3.2 per cent for the quarter ended December 2012 as against 2.5 per cent for the same quarter in the preceding year reflecting deterioration in the country's economy.

Despite this, ROAs (net profit as a percentage of total assets) of the NBFCs-ND-SI sector went up at 2.1 per cent for the quarter ended December 2012 as compared with 1.8 per cent for the same quarter in the previous year showing distinct improvement in profitability.

Their exposure to sensitive sectors like real estate sector stood at 4.5 per cent of total advances and capital market exposure on an average accounted for 8.8 per cent of their total assets. However, the capital market exposure to own funds of the NBFCs-ND-SI sector accounted for 34.0 per cent.

The business models of Non-Banking Financial Companies (NBFCs) make them largely reliant on banks for their liquidity requirements, observes the RBI report.. Within the financial system of the country, they are the second largest borrowing sector, after the banking sector. Total borrowing by this sector is close to Rs.3 trillion, while the investment/ lending by NBFCs stood at around Rs.1.2 trillion. The bulk of these exposures are fund based. The reliance of the NBFCs to banks makes them vulnerable to liquidity shocks arising from any instability in the banking system. [*Financial Stability Report issued by the RBI on 27 June*]. ■

Put Thorat panel norms on hold:

NBFCs would urge the RBI not to implement the draft guidelines based on the Usha Thorat committee's report till loan growth revives and regulatory changes on loan recovery are announced. Market players say falling automobile sales have hit growth in their vehicle finance portfolios. The Society of Indian Automobile Manufacturers (SIAM) had lowered the growth forecast of 2012-13 to 0-1 per cent.
Vehicle financing is one of the major businesses of NBFCs. Most NBFCs showed flat growth due to the slowdown in the automobile sector. Growth in NBFCs' commercial vehicle and construction equipment businesses has also declined.
In their representation to RBI before Budget 2013-14, NBFCs had requested the asset classification norm be kept at 180 days and the tier-I capital requirement of 7.5 per cent be continued. In its draft guidelines based on the Thorat committee report, RBI had brought NBFCs on a par with banks, in terms of the 90-day asset classification norm. It had also raised the tier-I capital requirement for NBFCs from 7.5 per cent to 10 per cent. In their representation, NBFCs had said if these norms were to be implemented, they should be granted tax benefits on provisioning books, as was the case with banks, and be allowed to recover dues through the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (Sarfaesi) Act, 2002. These requests were also conveyed to and taken up with the finance ministry and other authorities by FIDC top brass from time to time. [Business Standard, April 4]

FIDC to take up issues affecting NBFCs

Managing Committee of FIDC met on 29 June at Chennai. Several issues and moves of authorities affecting/likely to affect the sector came up. It was felt that there is a need to talk to RBI on Governor's statement that NBFCs may not be allowed to take Public Deposits.[See item titled 'Surveillance' of NBFCs needs to be strengthened on page-7]. It was also objected that NBFCs are referred as 'Shadow Banks' by RBI Governor and other officials and media. Members also stressed the need to change the negative perception of Regulator and its officials towards NBFCs and their functioning. It was suggested that the issues of service tax on securitisation deals and VAT on repossessed vehicles is needed to be taken up with appropriate authorities. The difficulty in getting investment grade rating for small NBFCs from credit rating agencies was voiced pleading the need to represent to RBI to remove mandatory rating requirement. The need to regulate the premium on third party insurance on vehicles was discussed at the meeting suggesting that the FIDC should talk to the relevant authorities to limit unwarranted hikes in third party premium by insurance companies.
Since the report of the Financial Sector Legislative Reforms Commission **(**FSLRC**)** a body set up by the Government of India, Ministry of Finance [MoF] on 24 March 2011 has now come out, there is a need to take a view on the recommendations affecting NBFC-AFCs and if required take up the issues related to it with Regulator and MoF.

Restrictions on raising fund

RBI has put several restrictions on raising money through private placement by NBFCs- Debentures vide circular dated 27th June 2013 [see item titled 'RBI tightens norms for NBFCs raising money via private placement 'on page-2] and a clarification thereto was issued by RBI on July 2, 2013 [See item titled 'RBI puts on hold private debt placement rules for NBFCs' on page-2]. That clearly brings NCDs under the ambit of the circular. Private placement of NCDs by NBFCs can now be made only to 49 investors. Though RBI has withdrawn the minimum 6 month gap between 2 issues for the time being, but clearly, the route to raise funds through privately placed NCDs has been blocked. In view of these restrictions affecting severely NBFCs FIDC has decided to strongly take up with the RBI the matter and meet the higher authorities in this regard.

Mr. Mahesh Thakkar, Director General, FIDC proposing vote of thanks to Mr. Rajiv Takru, Secretary, Dept. of Financial Services, Ministry of Finance, Govt. of India at the 7th International Banking and Finance Conference organised by Indian Merchants' Chamber (IMC) on 5th June 2013.

FIDC In Action

Mode of intimating local police station on repossession of vehicles

NBFCs as a normal practice and as laid down by FIDC's Handbook on Repossession intimate local police stations by 'Telegram' as the normal mode while taking repossession of vehicles. Now that the system of Telegram has been permanently closed by Postal Department, FIDC suggests as an alternate system to all members to use 'Registered Speed Post' as the recommended mode of intimation to local police. In addition, members may use any other modes like email, SMS etc.as they deem fit

Pre-policy meeting with RBI Governor

NBFC heads met the RBI brass on April 10 as a part of the customary pre-policy round of meetings for annual monetary policy review scheduled for May 3. Top executives from Shriram Capital, Mahindra Finance, L&T Finance Holdings and Kotak Mahindra Prime were among those who attended. "We discussed monetary issues, funding and liquidity problems," Mahesh Thakkar, director general, FIDC, the umbrella body of asset financing companies, said after the meeting. Main issues taken up were :

- Concerns on the Usha Thorat committee report, which had recommended stricter provisioning and capital norms for NBFCs.
- Liberalisation of fund-raising norms to tide over the tight liquidity situation. Opening ECB window for AFCs.
- Relaxation of norms on securitisation and for priority sector.
- Risk weight norms on certain lines of business, such as lending to trucks, to be brought at a par with banks.
- NBFCs should be made part of the corporate debt-restructuring programme.
- Have a stable policy for the decade that will bring investment in NBFCs in a big way from foreign cos.

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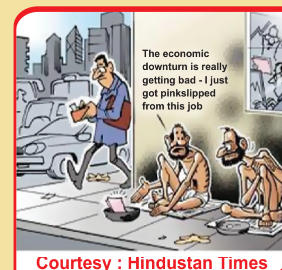

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