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REPORTING ISSUES OF NON-BANKING FINANCIAL COMPANIES IN INDIA

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Abstract

The Non-Banking Financial Sector has developed considerably in terms of operations, variety of market products and instruments, technological sophistication, etc. there is large number of merger, acquisition, consolidation n the NBFC sector, leading to the emergence of larger companies with diversified activities. This consolidation and acquisition activity has contributed to growth in the number of NBFCs with an asset base in excess of Rs. 100 crore. The recent global financial crisis has however highlighted the importance of widening the focus of NBFC regulations to take particular account of risks arising from regulatory gaps, from arbitrage opportunities and from the inter-connectedness of various activities and entities comprising the financial system. The regulatory regime for NBFCs is lighter and different in many respects from that for the banks. There is increase in bank credit to NBFCs over recent years means that the possibility of risks being transferred from the more lightly regulated NBFC sector to the banking sector in India.RBI has made many changes from time to time for the strict control of NBFCs. In this paper researcher has attempted to evaluate the changes in legal framework, liquidity management and disclosure norms for non-banking financial companies, required to control and govern this sector.

INTRODUCTION

Non-Banking Financial Companies are a constituent of the institutional structure of the organized financial system in India. The financial systems of any country consist of financial markets, financial intermediation and financial instruments or financial products.

Finance sector in India can be divided into formal and informal finance.

The formal sector can be said to comprise of the formal and necessarily regulated channels of financing like finance provided by banks, financial Institutions, Non-Banking Financial Institutions and Micro finance Institutions. The informal sector can be said to comprise of the money lenders, some channel of micro finance and other not necessarily regulated sectors, landlords, local shopkeepers, traders, suppliers and professional money lenders and relatives are the informal sources of the micro finance for the poor both in rural and urban areas.

"A lot of the small NBFCs suffer from lack of funding support. If the government can set up a funding mechanism or a funding agency through which these NBFCs can borrow and they can lend in the smaller segments that will be a great help."

NBFC serving the segment ignored by banks are best suited to grow. NBFCs that have identified the niche markets, build strength and expertise, deep local knowledge of remote topographies would be able to build scale and size.

Mr.R. Thyagrajan called upon the government to set up an authority exclusively to take charge of the development of the NBFC industry, which he termed as "practically non-existence" today. he said that an exclusive authority would impart respectability and credibility to the industry and also ensure orderly growth of it."

Table no.01 and Figure no.01 depicts the share of various sources of financing the eleventh five year plan in percentage. The shares of Non-Banking Financial Companies are 10 per cent which is a considerable part of overall financing to the five year plans. It shows that NBFC sector is playing important role in Indian economy.

From the following table no._ it is observed that NBFCs have low share in sectoral flow of credit but cannot be ignored. NBFCs have Rs. 27549 crore credit flows in the year 2008 which is further decreased to Rs.22694 crore in the year 2009

Annual Sector Flow of Credit

SECTOR	AS ON 23/05/2008		AS ON 22/05/2009	
	AMOUNT(CRORES)	%	AMOUNT(CRORES)	%
AGRICULTURE	42745	10.1	64970	16.9
INDUSTRY	182857	43.2	181848	47.4
REAL ESTATE	17018	4.0	32321	8.4
HOUSING	31735	7.5	13028	3.4
NBFCs	**27549**	**6.5**	**22694**	**5.9**
TOTAL	423189	100	383483	100

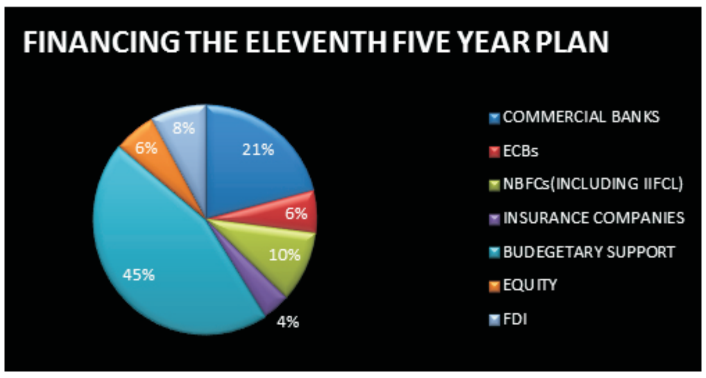
(Source: Adapted by researcher through RBI monthly bulletins)

Table no.01
Financing the 11th Five Year Plan (First Three Years)
(PER CENT)

Budgetary support	45
Commercial banks	21
NBFCs (including IIFCL)	10
FDI	08
Equity	06
ECBs	06
Insurance companies	04
Total	100

(Source: Planning Commission)

Figure no.01
Financing the eleventh five year plan



The Table no.04 and Table no.05 shows the number of NBFCs registered with Reserve Bank Of India yearwise and regionwise respectively.

Number of Non-Banking Financial Companies Registered with Reserve bank of India

NUMBER OF NON-BANKING FINANCIAL COMPANIES REGISTERED WITH RESERVE BANK OF INDIA			
END JUNE	NO. OF NBFC	NBFCs ACCEPTING PUBLIC DEPOSITS	Col.3 as a percentage of Col.2
01	02	03	04
2003	13849	710	5.1
2004	13764	604	4.4
2005	13261	507	3.8
2006	13014	428	3.3
2007	12968	401	3.1
2008	12809	364	2.8

(Source: Reserve Bank of India)

3. Objectives of this paper are:

a) To take the review of historical background of NBFCs in India.
b) To study the existing structure of NBFCs in India.
c) To study the legal provisions related to liquidity of NBFCs in India.
d) To analyse different issues related to corporate governance for NBFC's in India.

4. Research Methodology

The present paper is basically descriptive in nature. In the study, secondary sources of the data are used extensively. The required secondary data has been collected from various authentic sources such as published reports of various committees, working group framed by RBI, research papers and relevant websites.

5. Significance of the study:

a) This study will help to have a clear view about extant legal provisions to be followed by NBFCs for corporate governance in India.
b) This study might be a tool for the government while framing regulation regarding NBFC's.
c) This study might be a tool for investor, to identify potential investment.
d) This study will motivate the entire institutions towards performance improvement.

6. Limitation of the study

a) The study does not cover various other issues which s not mentioned n this paper.
b) Study covers only liquidity management and issues related to corporate governance mentioned in clause 49 for the NBFC's in India.

DEFINITIONS OF NBFC

The 'Reserve bank of India Act 1934' itself defines the term NBFC, there is a different definition of the same term viz. NBFC in the 'Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1988' that the RBI itself has issued under the aforesaid Act of 1934.

A. NBFC UNDER THE RBI ACT

Under section 45-I(a) of the RBI Act,1934 'business of non banking financial institution', is defined in terms of the business of a financial institution and NBFC.

NBFI - NON-BANKING FINANCIAL INSTITUTION

Sec: 45-I(a) : "business of a non-banking financial institution" means carrying on of the business of a financial institution referred to in clause (c) and includes business of a non-banking financial company referred to in clause (f);]

NBFC

'NBFC', itself is defined under sec. 45-I(f) of the Act, as under Sec. 45-I(f):) "non-banking financial company" means-
(i) A financial institution which is a company;
(ii) A non banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
(iii) Such other non-banking institution or class of such institutions, as the bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.

Wikipedia dictionary defines Non-Banking Financial Companies as Non-Banking Financial Companies (NBFCs) are financial institutions that provide banking services without meeting the legal definition of a bank, i.e. one that does not hold a banking license. Operations are regardless of this, still exercised under bank regulation. However this depends on the jurisdiction, as in some jurisdictions, such as New Zealand, any company can do business of banking, and there are no banking licences issued.

HISTORY AND BACKGROUND OF NON-BANKING FINANCIAL COMPANIES

Non-banking Financial Companies were permitted to function as financial intermediaries after 1970s i.e. the time of Indian Financial System nationalization, one such bank was the commercial chit fund2 .Companies that operate as registered chit funds have to satisfy a number of specific criteria. These criteria were first laid out in Section 2(2) of the Madras Chit Funds Act, 1961, which regulated the institution in the state of Tamil Nadu. Subsequently they were adopted in their entirety in the Miscellaneous Non-Banking Companies Directions, an interim regulatory document issued by the Reserve Bank of India in 1973, and ultimately in Section 2(b) of the central Chit Fund Act, 1982, which applies to the entire country: "Chit" means a transaction whether called chit fund, chit, kuri, or by any other name, by which its foreman [the company] enters into an agreement with a number of subscribers that every one of them shall subscribe a certain sum or a certain quantity of grain by installments for a definite period and that each subscriber in his turn as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement shall be entitled to a prize amount.

As long as the chit fund is organized precisely along the lines laid out above, the company can operate as a financial intermediary, regulated by the Registrar of Chit Funds in each state, rather than by the Reserve Bank of India. As discussed in the previous section, the chit funds were able to generate an implicit interest rate that was substantially higher than the rate offered by the government banks to depositors. Businesses, and borrowers in general, also

benefitted from this institution, since credit was severely rationed by the banks. Government regulators, and particularly the Reserve Bank of India, were quick to take note of the growth of the chit funds and other NBFCs, following the nationalization of the banking system.
Several committees were appointed to study the working of these companies, prominent among them being the Bhabatosh Datta Commission (1971) and the James Raj Commission (1975)

These committees felt that while many NBFCs frequently resorted to unfair methods, and therefore needed to be regulated; prohibiting them entirely would adversely affect certain sectors of the economy that had limited access to bank credit, or chose not to deposit their money with the banks. For the particular case of the commercial chit fund companies, these study groups recommended a Model Bill, to be enacted as a Central Act of Parliament, to ensure uniform regulation throughout the country. They also recommended that the administration of the legislation be left to the state governments. The Government of India acted on these recommendations and passed the Chit Fund Act in 1982, with implementation of the Act left to the Registrar of Chit Funds in each state.

Non-banking finance companies (NBFCs) have played an important role in the Indian financial system. Traditionally they have been the vehicle for financing individuals and corporate who had some difficulty in obtaining bank funding. Earlier, commercial banks tended to stay away from retail and small-to-medium sized corporate and the Non-banking finance companies saw opportunity in this void and built dominant positions in automobile financing, commercial vehicle financing, IPO funding and corporate leasing. Consequently, many NBFCs set up large countrywide distribution networks - often as large as those of consumer companies.

Non-banking financial companies (NBFCs) form an integral part of the Indian financial system. The history of the NBFC Industry in India is a story of under-regulation followed by over-regulation. Policy makers have swung from one extreme position to another in their attempt to set controls and then restrain them so that they do not curb the growth of the industry.

The Indian economy is going through a period of rapid `financial isation'. Today, the `intermediation' is being conducted by a wide range of financial institution through plethora of customer friendly financial products. The segment consisting of Non-Banking Financial Companies (NBFCs), such as equipment leasing/hire purchase finance companies have made great strides in recent years and are meeting the diverse financial needs of the economy. In this process, they have influenced the direction of savings and investment. The resultant capital formation is important for our economic growth and development. Thus, from both the macroeconomic perspective and the structure of the Indian financial system, the role of NBFCs has become increasingly important. It is interesting to note that as at the end of March 1996 the regulated deposits (deposits which RBI regulates) of 10194 NBFCs amounted to Rs.45, 439 crore. The borrowing of these companies stood at Rs.62, 995 crore. One of the most important components of these deposits/ borrowings is deposits from public in which RBI is more concerned. Such deposits stood at Rs.17, 883 crore (excluding HFCs) which comes out to 4.25 per cent of the total deposits of scheduled commercial banks.

The momentum of recent developments in non-banking financial sector has evinced considerable debate. While there is a class in the industry strongly opposing the strengthening of regulatory framework and focusing closer supervisory attention, ostensibly in support of principle of free market, the another urging Reserve Bank to intervene and enhance the image quotient of the industry so that a moderate level of sustainable growth is as sured of. To appreciate and understand the present predicament, it is better to look back to the history of the regulation of NBFCs.

To briefly recapitulate, the scheme of regulation of NBFCs originated in mid-sixties when sudden upsurge in deposit mobilisation by Non-Banking Companies was noticed. However, the focus of regulation was mainly intended to ensure that it serves as an adjunct to monetary and credit policy and also provides an indirect protection to the depositors. The focus continued to be the same till early 90s. Over a period of time, especially during late 80s and early 90s, NBFCs have penetrated into the main stream of financial sector and have established themselves as complements of banking industry.

At the dawn of liberalisation era, the Narasimham Committee (1991) had broadly touched upon the role of NBFCs in the emerging financial sector and made certain valuable recommendations for their healthy growth. The general tone of the committee was that these companies should be encouraged to grow with corresponding reinforcement of regulatory and supervisory frame work. As a sequel to Narasimham Committee, Reserve Bank had appointed a Working Group on Financial Companies (Chairman, Dr. A.C. Shah) to make an in-depth study of the role of NBFCs and suggest regulatory and control measures to ensure healthy growth and operation of these companies. The Committee had made several recommendations with far reaching implications. Accepting most of the recommendations of the Committee, Reserve Bank had considered the Report as an Approach Document for furtherance of the NBFCs sector. Some of the major recommendations of the Group were relating to shift of regulatory approach from the liability to the asset side, introduction of scheme of registration and entry point norm with minimum net owned fund (NOF) of Rs.50 lakhs for existing/new NBFCs, issue of prudential norms for income recognition, provisioning, capital adequacy etc., and amendments to RBI Act, 1934 giving enhanced power to RBI for better regulation of NBFCs. The recommendations of the committee were implemented in a phased manner. While the scheme of registration was introduced in April 1993 for all NBFCs having NOF of Rs.50 lakhs and above, prudential norms/ guidelines were issued in June 1994 for all registered NBFCs. These norms were more in the nature of guide lines which were not mandatory in the absence of necessary statutory powers. Subsequent to this, in April 1995, underscoring the importance of setting out a effective supervisory frame work, an expert group under the Chairmanship of Shri P.R. Khanna, Member of the Advisory Council for the Board for Financial Supervision was appointed to design an effective and comprehensive supervisory framework for NBFC sector. Most of the recommendations of the Committee have been accepted and a supervisory framework comprising on-site inspection for bigger companies and off-site surveillance system for other companies has been designed and the same is being implemented in a phased manner.

As mentioned earlier, since mid 60s legislative frame work was structured mainly to regulate the deposit acceptance activities of NBFCs. However, in the changed scenario and in the light of the recommendation of the Shah Working Group so also the observations of the Joint Parliamentary Committee a comprehensive draft legislation was prepared in 1994 which however, required extensive discussion with Ministry of Finance and Law. Finally, an Ordinance was promulgated by the Government in January 1997, effecting comprehensive changes in the provisions of RBI Act.

The ordinance has since been replaced by an Act in March 1997. The amended Act, among other things, provide for entry point norm of a minimum NOF of Rs.25 lakhs (even though the Ordinance provided for the minimum limit at Rs.50 lakhs) and mandatory registration for new NBFCs for commencing business, maintenance of liquid asset ranging from 5 to 25 per cent of deposit liabilities, creation of reserve fund by transferring not less than 20 per cent of the net profit every year, power to the Bank to issue directions relating to prudential norms, capital adequacy, deployment of funds, etc. power to issue prohibitory order and filing of winding-up petition for non-compliance of Directions/Act. The above legislative changes would enable Reserve Bank to better regulate the NBFCs.

While the amendments have been mostly welcomed by the industry and the others concerned, it was alleged by a section of people that the amendments are reflection of RBI's expansionist attitude which would negate the true spirits of the current liberalisation programme. For a more complete understanding, one should keep in mind that economic liberalisation is about bringing market closer to the participants so that they have the freedom to make economic decisions. Obviously, this means better regulatory interference. A well functioning market does not suddenly emerge devoid of deliberate acts of the Regulators. Many economic historians have noted a complex interaction between State regulation and growth of the market as an institution. One of them, Karl Polyani 2 called it a `double-movement'. To simply state "every time the market widens its scope of operation, new regulations by the State are needed to make the market function well. Such double movement is a complex process of adaptive interaction where both must learn to co-operate." Therefore, the legislative changes should be seen as a conscientious act of regulatory response. In fact, this response emerged with an intention to act as facilitator for the industry which has established itself in the emerging market and surely not as an ovenrkill. Moreover, the changes have the following objectives;

i. to ensure healthy growth of NBFC sector;
ii. to ensure that they function on prudential lines;
iii. to quickly remove bad ones in the industry to avoid contamination effect through regulatory intervention

Another dimension to the legislative changes is the presence of heterogeneous and some time questionable accounting practices being followed by NBFCs and the imperative need to bring uniformity in the accounting practices which would enable inter firm and inter-industry comparison. It is beyond doubt that a well knit accounting practices in conformity with international standards are a pre-requisite to repose faith in the industry. There are several instances where NBFCs have capitalised from the absence or inadequacies of the standard accounting practices. One such example is `Leasing'. It is commonly noticed that `Leasing' route has been used mainly as a tool for deferring tax liability. The sale and lease back transaction was rampant supposedly on the items of 100 per cent depreciable category, which has prompted Government to come out with amendments to I.T. Act recently.

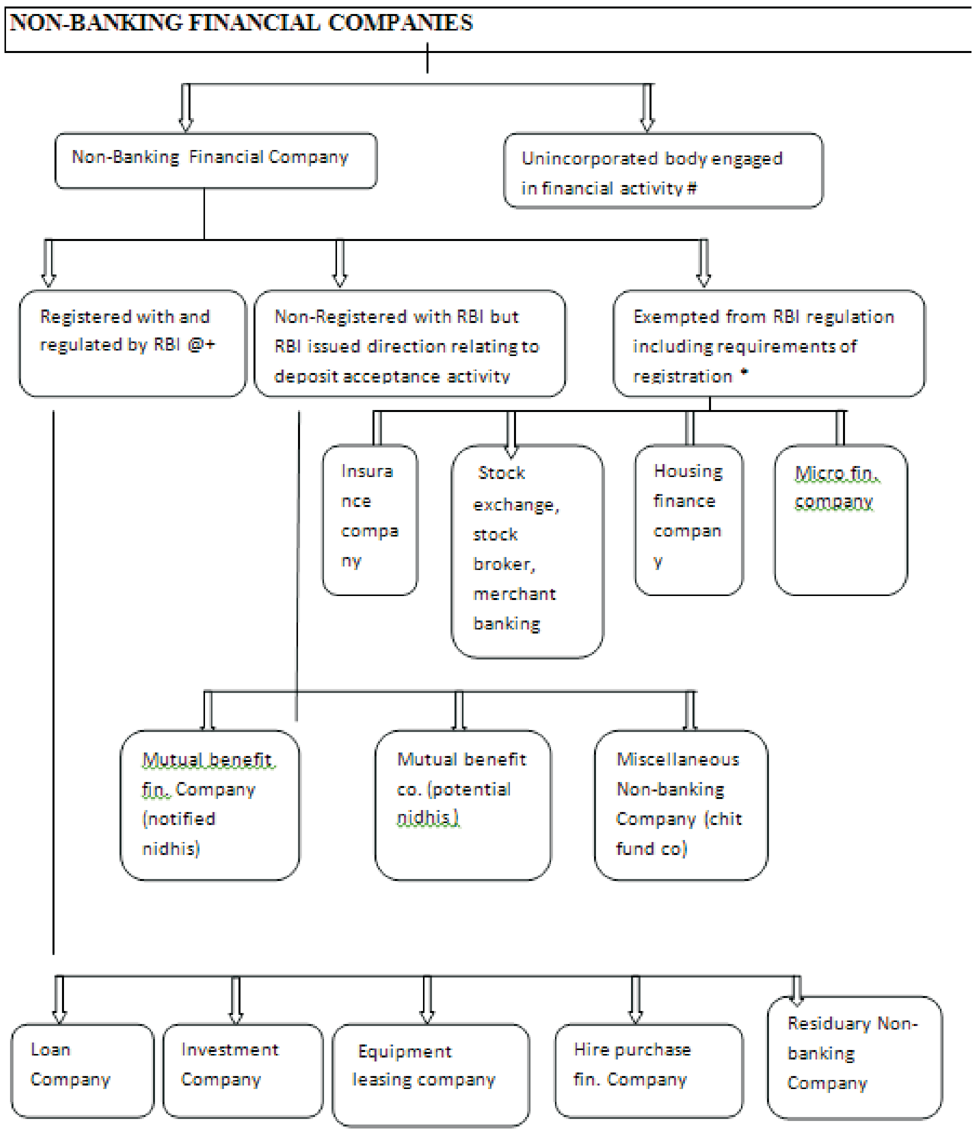
3.4 STRUCTURE OF NON-BANKING FINANCIAL COMPANIES

Structure of Non-Banking Financial Companies is showing different forms of Non-Banking Financial Companies working in India and playing indispensable role in the growth of financial market for development of the country. Structure of Non-Banking Financial Companies are given in Figure no.03.

unincorporated bodies cannot receive deposits except from relatives as specified in section 45-S of the RBI act and such institution as specified under section 45 I (66) (iv) of the act,

@ Primary dealer are registered with RBI and regulated by RBI as such irrespective of whether they accept public deposits or not.
* As they regulated by other regulatory authorities
+ NBFCs who accept public deposits are subject to a regulatory framework prescribed for the purpose

Structure Of Non-Banking Financial Companies



(Source: Recasted by researcher through various sources

Liquidity Management of NBFCs

Liquidity is the ability of financial institutions to meet their payment obligations by quickly realizing value from their assets. As financial institutions are involved in maturity transformation, liquidity risks are endemic to them, with assets being mostly illiquid and of longer tenure than their liabilities. A variant of liquidity risk is funding risk, or the difficulty experienced by financial institutions in their ability to raise funds from market and other sources. One of the important hallmarks of the 2008 financial crisis, across jurisdictions, was the inability of financial institutions to roll over or obtain new short-term funding. Supervisors also failed to recognize the degree to which providers of wholesale funding had changed from banks to money market mutual funds. The heightened volumes in over-the-counter (OTC) derivatives also added to the demands on liquidity.

The Basel Committee on Banking Supervision has developed two internationally consistent regulatory standards for liquidity risk supervision, which are the Liquidity Coverage Ratio and the Net Stable Funding Ratio. The Liquidity Coverage Ratio stipulates that an institution should maintain adequate levels of liquid assets which can be converted to cash at very short notice to enable it to survive a 30 day time horizon. The objective is to promote short-term resilience of the liquidity risk profile of institutions by ensuring that they have sufficient high-quality liquid assets to survive a significant stress scenario lasting 30 calendar days. The Liquidity Coverage Ratio has two components: (a) value of the stock of high-quality liquid assets in stressed conditions; and (b) total net cash outflows. The stock of liquid assets should enable the institution to survive until Day 30 of the stress scenario, by which time it is assumed that appropriate corrective actions would be taken by management and/or the supervisory authorities for an orderly resolution of the situation. The second objective of the Basel Committee recommendations is to promote resilience over a longer time horizon by creating additional incentives for institutions to fund their activities with more stable sources of financing on an ongoing basis. The Net Stable Funding Ratio has a time horizon of one year and has been developed to capture structural issues to provide a sustainable maturity structure of assets and liabilities should there be: a significant downgrade of the institution's credit rating, a partial loss of its deposits, a sharp reduction in its secured or unsecured wholesale funding, and/or an increase in its derivative collateral calls or its contractual off-balance sheet exposures. The Net Stable Funding ratio seeks to calculate the proportion of long term assets which are funded by long term stable funding which it prescribes should be greater than 100 percent.

The tightening of liquidity in the immediate wake of the global crisis of 2008-09 impacted the Indian NBFC sector which largely funded itself in the wholesale markets from banks and mutual funds. NBFCs that were more leveraged, more dependent on CPs and short term bank borrowing with little flexibility in shedding assets faced more stress. There were several pockets of stress in the sector. Sanctioned credit lines from banks were frozen. In response, several NBFC businesses either downsized their balance sheets or rationalized their branches and deferred their expansion plans. Business activities of NBFCs decelerated with loan book and investment growth slowing down considerably.

NBFCs that had overseas parents were able to mobilize some temporary liquidity support. The Reserve Bank had to step in with a series of measures to provide respite to financially stressed NBFCs in 2008-2009. They were allowed to raise short term foreign currency borrowings under certain conditions and borrow from the central bank liquidity adjustment facility through the commercial banks as a temporary measure. NBFCs were given access, against collateral of CPs of good quality issued by them, to an indirect lender of last resort facility (traditionally available only to banks) through an SPV structure. They were also allowed further time to comply with the increased capital adequacy requirements. Risk weights on bank exposure to NBFCs were brought down. Systemically important non deposit taking NBFCs were permitted to augment their capital by issuing perpetual debt instruments qualifying as capital.

The crisis of 2008 more than emphasized the need for effective liquidity management to cope during times of stress. Hence there is a need for additional regulatory measures on liquidity maintenance.

Extant Regulatory Requirements on liquidity for the NBFC Sector

Having recognized the liquidity risks that NBFCs-D could face, RBI has stipulated maintenance of a statutory liquidity requirement (SLR) at 15 percent of aggregate deposits on a daily basis. This percentage is lower than what the banks are required to hold because NBFCs do not have access to current account or savings deposits. ALM guidelines have been made applicable to NBFC-Ds with deposits of Rs. 20 crore and above. The ALM guidelines monitor structural liquidity, short term dynamic liquidity and interest rate sensitivity. Gap analysis is used to measure the mismatches over various time intervals. The main focus is on the short term mismatches of up to 30/31 days. Under these guidelines NBFC-Ds are required to ensure that the negative gap in the 1-30/31 day bucket does not exceed 15 percent of the cash outflows under normal circumstances.

The crisis of 2008 brought home the realization that the norms relating to ALM and liquidity risk management are of equal importance to NBFCs-ND, as they do not have access to low cost deposits, nor are they permitted to operate in the call money market. Their fund raising capabilities are mostly restricted to raising commercial papers, non-convertible debentures with maturities between 3 months to one year, inter-corporate deposits and borrowings from banks, which are typically all of shorter maturity than their assets. Asset Liability Management (ALM) guidelines have been mandated for NBFC-ND-SIs with assets of Rs. 100 crore and above and for deposit taking NBFCs with deposits more than Rs. 20 crore. Such NBFCs are required to maintain a gap not exceeding 15% of their net cash outflows in the 1-30/31 day bucket. There is no such requirement for smaller NBFCs with asset sizes below Rs. 100 crore that do not hold public deposits.

The liquidity issues facing NBFCs were debated by the members of the Working Group. Members noted that while minimum CRAR for NBFCs is higher than that for banks, in times of turbulence this may not be sufficient to deal with potential liquidity stress. Hence, the issue of liquidity risk for NBFCs remains inadequately addressed. Apart from a quarterly return, no other regulatory requirements have been stipulated for NBFCs-ND below asset sizes of Rs. 100 crore.

However, liquidity issues are different for different subsets of NBFCs. A one-size-fits-all approach may not be appropriate. The large NBFCs, especially IFCs, have very long term assets and comparatively short term liabilities, thus carrying ALM mismatches and possible refinancing risk in their balance sheets. ALM mismatches for NBFCs which are into retail financing may not be as marked as in the case of IFCs. Retail focused NBFCs are often able to reduce the maturity of their assets through securitization and bilateral assignments. An analysis of the liquidity mismatches for 177 large NBFC-ND-SIs shows that more than 60 percent have positive mismatches in their ALM in the first two buckets.

Under the new liquidity related stipulations of Basel lll, banks are categorized as wholesale banks and retail banks, and the new norms are applicable to both. Taking all aspects into consideration, the Working Group is of the view that all NBFCs should have a liquidity cushion for any stress faced up to the 30 day period. All NBFCs, both deposit taking and non deposit taking should hold Government securities equal to the gap between their total inflows and outflows up to the 30 day period. While some members of the Group felt that NBFCs being in the nature of wholesale banks (at least on the liabilities side of the balance sheet) should have access to the RBI repo window, it was acknowledged that the LOLR facility is normally reserved for banks which are subject to a much tighter regulatory regime than NBFCs. It was noted that NBFCs would in any event have the opportunity to use committed credit lines or government securities maintained by them as part of a liquidity buffer for repos in the market in the event of stress.

Issues in Corporate Governance

The need for adopting good corporate governance practices has been the focus of attention of all financial entities. This is critical from the perspective of investors and stake holder confidence more generally. In recognition of this, RBI has prescribed a governance code for NBFCs as part of best practices. Corporate governance guidelines have been prescribed for all deposit taking companies with deposits above Rs. 20 crore and above and systemically important non-deposit taking NBFCs. These entail constitution of Risk Management, Audit and Nomination Committees as well as some regulations on disclosure and transparency. Listed NBFCs are also expected to adhere to the corporate governance rules under the Clause 49 Listing Agreement of SEBI. While due diligence is undertaken on significant shareholders and directors at the time of registration there are no prescriptions for qualifications for directors or a system for continuing due diligence as in case of banks. Further in the event the RBI feels that any director is not fit or proper there are no powers for removal of such a person. In addition, there are no guidelines on connected lending or remuneration practices which are engaging regulators universally.

With the increasing size, interconnectedness and systemic significance of NBFCs, it is important that the directors and share holders who are responsible for steering the company are fit and proper and have the necessary qualifications. At the time of granting CoR to a company, RBI is required to satisfy itself that the conditions specified in Section 45IA(4) of the Act are fulfilled. Those conditions include, (a) that the affairs of the NBFCS are not being or not likely to be conducted in a manner detrimental to the interest of its present or future depositors and (b) that the general character of the management or the proposed management of the NBFC shall not be prejudicial to public interest or the interest of its depositors. In order to satisfy itself about the general character of the management of an NBFC and how its affairs are conducted, it will be necessary for RBI to know as to who are or will be managing the company. As such, due diligence is conducted with respect to significant shareholders and the directors. However, there is no specific provision in the Act which requires an NBFC to take the approval of RBI for any change in the management of NBFC.

the Working Group has recommended that any change in control or change in shareholding, directly or indirectly above 25% should be with the prior approval of RBI. It has also recommended prior approval of RBI for any mergers of NBFCs under Section 391-394 of the Companies Act, 1956 or acquisitions by or of an NBFC, which are governed by the SEBI Regulations for Substantial Acquisitions of Shares and Takeover. As a long term measure, the Working Group recommends that suitable amendments may be carried out in the RBI Act giving powers to RBI over management of NBFCs similar to that available and proposed in the case of banks.

The restrictions on the number of directorships with respect to NBFCs are governed by the provisions of sections 275 and 278 of the Companies Act, 1956. As regards NBFCs, there are no restrictions on the number of directorships on the lines of the restrictions set forth in section

16 of BR Act for banking companies. Because under section 278 of Companies Act, the directorships in private companies are not counted for the purposes of section 275 of that Act (under which a person cannot be a director of more than fifteen companies), persons who are directors in more than fifteen companies also become directors of NBFCs. It is observed that directors of many companies applying for Certificate of Registration are on the Boards of a large number of companies, including NBFC group companies and foreign companies. Instances of as many as 24 directorships have been observed. Multiple directorships are inconsistent with principles of good governance.

It is equally important to extend the due diligence and fit and proper norms to the principal shareholders of the companies. In small privately held businesses shareholders play an active role in the affairs of the company. The same principle is applicable to large, professionally managed NBFCs where the Board of Directors is different from the shareholders, and where the shareholders are represented in the Boards and hence play an active part in shaping the policies of the NBFCs. It may be mentioned that at present, under the acknowledgement procedure put in place by RBI, any change in shareholders beyond 5 percent in banking companies invites a due diligence exercise on the new shareholders by the RBI. Appropriate statutory provisions8 in this regard are proposed to be inserted in the BR Act. The Working Group is satisfied that similar statutory provisions should be made for NBFCs also.

An equally important corporate governance issue not addressed by regulation is adoption of appropriate measures to contain connected lending in NBFCs. In view of their growing systemic significance and professionalization of management, many large NBFCs have themselves adopted such measures. Nevertheless, there is need to put appropriate regulation in place to avoid instances of diversion of funds, including borrowed funds, to Directors, their relatives, or to firms that the Directors are associated with or have substantial or beneficial interest in. The Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision in September 1997 state that in order to prevent a contagion risk, and to prevent abuses arising from connected lending, banking supervisors must ensure that lending to related companies and individuals are on an arm's length basis, and that such credits are clearly identifiable, effectively monitored and appropriate steps are taken to control (in terms of quantitative limits) or mitigate risks.

The global financial crisis of 2008 has demonstrated the risks from ill designed incentive based compensation packages being offered to the management. The remuneration packages encouraged short term performance goal setting at the cost of long term success of companies resulting in excessive risk taking by the management of companies. The disconnect between performance based compensation and actual value added to companies has been one of the core issues of the financial crisis and has prompted the Financial Services Board to recommend that sound compensation principles must be embedded in any financial reform. These include risk alignment and variable pay structures, claw back clauses besides appropriate disclosures. While these issues are being debated for suitable adaptability in the Indian context, they are nevertheless pertinent from a governance perspective.

The Working Group in their deliberations on corporate governance in the NBFC sector agreed that due diligence of Directors is important. The Joint Parliamentary Committee (JPC) on the Stock Market Scam has also observed in their report that it is imperative for the banks to follow strategies and techniques which are basic to the tenets of sound corporate governance, which include capable and experienced Directors, efficient management, coherent strategy and business plan and clear lines of responsibility and accountability. The Working Group is of the view that all NBFCs with asset size of Rs. 1000 crore and above whether listed or not should comply with clause 49 of SEBI's listing agreement. These requirements ought to be mandatory for all NBFCs with asset size of Rs. 1000 crore and above and could be advised but not mandatory for those below it. The uniform application of clause 49 of SEBI's Listing Agreement stipulations should result in the necessary improvement in the qualification, professionalism, and independence of NBFCs Directors, impose appropriate limitations on the number of directorships that can be held by one person, and induce greater disclosure.

Clause 49 mandates that there should be an independent and qualified audit committee in which all members are to be financially literate and at least one to have expertise in accounting or financial management. It also requires that a Director shall not be a member in more than 10 committees across all companies in which he is a director. There is also the requirement of submission of quarterly reports, disclosure of compensation to its non-executive directors, disclosure of all related party transactions, remuneration to directors etc.

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