Reserve Bank of India sets eyes on non-bank lenders

India's central bank has tabled reforms to the funding practices of non-bank lenders in a move that some observers believe underlines its determination to limit the growth of a shadow-banking system.

Lending by non-banking financial companies has grown at an annual rate of around 28% over the last decade, while the banking sector's assets have been expanding at about 17% a year since 2010.

That expansion, and how it is funded, seems to be causing concern, and in recent weeks the central bank has announced changes to how these companies can raise money by issuing bonds.

The Reserve Bank of India on June 27 said it would introduce a "minimum set of guidelines" for all private placements from financial companies, previously a popular source of funding for the sector.

Among other restrictions, the notice limits how many times a year these companies can issue privately placed bonds, and caps the number of investors in private placements to 49.

Financial companies rely heavily on the institutional market to fund their loans, since most are not allowed to accept retail deposits. That means any action to restrict their access to the debt markets could have a big impact on the sector's expansion.

The backlash to the proposed rule change triggered an unusual climb-down, and the RBI withdrew the restriction on the frequency of private placements in a July 2 notice, promising a revision "in due course".

Some local market participants, however, see the RBI's recent interest in this alternative financial system as part of an ongoing effort to clean up the country's financial sector and prevent the growth of a less-regulated shadow banking system. That fits with recent regulatory actions against financial companies such as Sahara India.

"It could be the case that the RBI has concerns about fundraising by NBFCs from the public at large under the private placement route, and the case of Sahara India as well as the chit fund cases in West Bengal are likely to have contributed to the RBI initiating these changes" said Rahul Gulati, counsel at Talwar Thakore & Associates, a legal firm.

Conglomerate Sahara India has been at odds with local regulators since 2009 for selling convertible debt that found its way into the hands of high-net-worth individuals without first obtaining the approval of the securities board.

Sahara took the case to the Supreme Court, arguing it had not needed the approval because the deals were private placements, but in 2012 was ordered to return over US$3bn of investors' money.

In the new regulation for the non-bank lenders, the RBI clarified the definition of private placements, indicating that in certain instances financial companies have not made a clear distinction between private and public offerings.

It also said it would require every bond issued by a non-banking financial company to be backed by equivalent loans. It said financial companies should not extend loans against the security of their own debentures either and that all private bond placements should be fully secured.

INFRASTRUCTURE FUNDING

The drawback of the recent clampdown is that the RBI's proposed private placements rule risks crimping funding for some of India's biggest infrastructure lenders, such as Rural Electrification Corp and Power Finance Corp.

But the rapid growth of the sector, with more than 1,200 such companies now in operation, is adding to fears that regulation needs to be reformed to prevent a build-up of systemic risk.

Non-banking financial companies are subject to looser regulation than deposit-taking banks. They are allowed to fund land acquisitions, for example, and can provide loans backed by shares - both activities that are off limits to Indian banks.

Total assets of non-banking financial companies reached Rs10.4trn (US$170.5bn) in the financial year ending March 2012 according to India Ratings, the local arm of international rating agency Fitch.

That still represents only about 12.5% of the assets held in the banking sector. However, 15 years ago, non-banking financial companies held the equivalent to only 4.4% of total banking assets, according to the RBI.

The June 24 notice has therefore been seen as a signal that tighter regulation is on the way.

"RBI may act slow, but they are very, very smart and really have the pulse on the market," said a Mumbai-based investment banker with a local private bank.

(Economic Times)