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Market Watch

View: It's downright dangerous to equate banks and NBFCs

BY ET CONTRIBUTORS | UPDATED: NOV 04, 2019, 06.14 AM IST

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Last month, a business daily declared Bajaj Finserv MD-CEO Sanjiv Bajaj 'Banker of the Year'. Few will dispute the Bajaj scion's Midas touch, or contest his selection. Except that Bajaj is not a banker. And his company, Bajaj Finserv, the holding company of Bajaj Finance, is not a bank, but a non-banking finance company (NBFC).

But if no heads seemed to turn at the announcement, the reason is simple. The line between banks & NBFCs, always a fine one, has blurred to a point where few see a contradiction in a 'non-banker' being declared 'Banker of the Year'.

A Bank by Any Other Name

The confusion is understandable. Newspaper editorials often equate deposits in banks and NBFCs. A recent piece in ET ([The Unsafe Vaults: With the Financial System Hit by Defaults, Is It Time to Resurrect an Old Law?](#)) says, "At the peak of the global financial crisis, Ireland had to publicly declare its promise to repay every single bank depositor to prevent arun on the banking industry that would have shattered its economy." It then goes on to describe how depositors have not been repaid by NBFCs like Infrastructure Leasing & Financial Services (IL&FS), Dewan Housing Finance Corporation Ltd (DHFL), Altico Capital and Punjab & Maharashtra Cooperative (PMC) Bank, overlooking the subtle, but key, difference between banks and non-banks. And between deposits of banks and NBFCs.

This distinction is not a matter of semantics, but a key pillar on which the entire edifice of modern banking and the capitalist economy rests. At a time when government is reportedly toying with reviving the Financial Resolution and Deposit Insurance (FRDI) Bill (it was shelved last year following fears among bank depositors that the bail-in clause in the Bill would put their deposits at risk), it is important to understand the difference.

What makes banks special? Why would a bail-in clause be suicidal in the case of banks, even if it is not without merit in the context of NBFCs?

Let's start at the very beginning. Unlike NBFCs, banks are licensed by RBI to engage in the business of banking, that is, to take deposits from the public for the purpose of lending, with the caveat that these deposits are repayable on demand. NBFCs, too, might take public deposits. But these are not repayable on demand; they are repaid only after a specified period.

Since banks are licensed repositories of public savings, trust is paramount if the system is not to break down. Note, banking is a licensed activity not only in India where RBI is the licensing authority, but globally as well. Further, in keeping with global best practice, all applicants for a bank licence are required to meet the 'fit and proper' test, in addition to satisfying strict financial criteria.

Banks are unique in another respect. Unlike NBFCs, they issue cheques. These are considered as good as cash since they are backed by money in the bank. Banks, therefore, are part of the 'payments system' that underpins modern commerce.

At the same time, the fractional reserve system that underpins modern banking means they need keep only a fraction of their deposits and can lend out the rest. Yes, there is an inherent mismatch, since deposits are repayable on demand, and loans, understandably, cannot be repayable on demand. But provided banks manage the mismatch between their liabilities (deposits) and assets (loans) wisely and deploy deposits in sound assets, they will be able to pay their deposits as and when demanded, even if not immediately.

Sibling, But Less Privileged

To ensure banks live up to the trust reposed in them, they are subject to tough regulations like cash reserve ratio (CRR), statutory liquidity ratio (SLR), capital adequacy norms and a host of other regulations, including inspection — to ensure they are always able to

pay their depositors and in full. In return for submitting themselves to tough regulation, RBI acts as 'lender of last resort', in case of sudden liquidity problems or inability to meet withdrawals.

This is a crutch extended only to banks, not to NBFCs, to ensure trust in the banking system is not shaken. For the same reason, barring exceptional circumstances, banks are not allowed to fail, especially once they become large, as the collapse of a single large bank could have a domino effect and lead to the collapse of many others. Hence the phrase, 'too big to fail'.

NBFCs, in contrast, are not licensed by RBI. Large NBFCs are registered, especially if they are going to access public deposits. But RBI does not apply the globally sanctified 'fit and proper' yardstick, a highly selective, admittedly subjective, yardstick, to NBFCs. Unlike with banks, RBI is not a lender of last resort to NBFCs, even though it is their regulator and supervisory authority.

So, while it might be good to have a resolution mechanism for financial firms, especially deposit-taking NBFCs, it would be fatal to equate bank deposits with NBFC deposits. For the same reason, deposit insurance must remain a privilege extended only to bank deposits, given their unique position in the financial system and regulatory strictures to which they are subject. For non-bank depositors, it must be caveat emptor, backed by a functioning legal system, where the remedy for non-payment rests with courts.

A bail-in clause, appropriate for nonbanks, would be disastrous if extended to banks. Not unless we are willing to shake public faith in bank deposits and deprive banks of much-needed resources to finance economic activity.

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