Chapter VI
Non-Banking Financial Companies*

6.1 Non-banking financial companies (NBFCs) encompass an extremely heterogeneous group of intermediaries. They differ in various attributes, such as, size, nature of incorporation and regulation, as well as the basic functionality of financial intermediation. Notwithstanding their diversity, NBFCs are characterised by their ability to provide *niche* financial services in the Indian economy. Because of their relative organisational flexibility leading to a better response mechanism, they are often able to provide tailor-made services relatively faster than banks and financial institutions. This enables them to build up a *clientele* that ranges from small borrowers to established corporates. While NBFCs have often been leaders in financial innovations, which are capable of enhancing the functional efficiency of the financial system, instances of unsustainability, often on account of high rates of interest on their deposits and periodic bankruptcies, underscore the need for reinforcing their financial viability. The regulatory challenge is, thus, to design a supervisory framework that is able to ensure financial stability without dampening the very spirit of maneuverability and innovativeness that sustains the sector.

6.2 NBFCs proliferated by the early 1990s. This rapid expansion was driven by the scope created by the process of financial liberalisation in fresh avenues of operations in areas, such as, hire purchase, housing, equipment leasing and investment. The business of asset reconstruction has recently emerged as a greenfield within this sector following the passage of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002.

6.3 In view of their rapid growth and in response to certain disconcerting developments, the Reserve Bank strengthened the supervisory framework in January 1998, consequent to amendments to the Reserve Bank of India Act, 1934 in March 1997. In supervisory terms, fiscal 2002-03 saw the completion of the process of compulsory registration of NBFCs, existing at the point of the amendment of the Reserve Bank of India Act, 1934 with the Reserve Bank. Besides, a system of asset-liability management has also been put in place. In the interest of greater transparency, the Reserve Bank also instituted a system of balance sheet disclosures, effective March 2003.

6.4 The health of the NBFCs continues to show a distinct improvement in recent years facilitated by prudential nurturing. Most of the reporting NBFCs recorded a capital to risk-weighted assets ratio (CRAR) of at least the stipulated minimum of 12 per cent, with almost three-fourth reporting a CRAR of above 30 per cent. Similarly, the non-performing assets of NBFCs, in both gross and net terms, as a percentage of credit exposure, have been declining in recent years. Nevertheless, the NBFCs, as a sector, recorded losses for the second year in succession during 2001-02.

2. Non-Banking Financial Entities Regulated by the Reserve Bank

6.5 Non-banking financial entities which were either partially or wholly regulated / supervised by the Reserve Bank include the following:

- NBFCs, comprising equipment leasing, hire purchase finance, loan, investment and residuary non-banking companies;
- mutual benefit financial companies**, *i.e.*, *nidhi* companies;
- mutual benefit companies**, *i.e.*, potential *nidhi* companies; and,
- miscellaneous non-banking companies, *i.e., chit* fund companies (to the extent of their deposit-taking activity) (Table VI.1).

6.6 Certain types of financial companies, *viz.*, insurance companies, housing finance companies, stock broking companies, *chit* fund companies, companies notified as '*nidhis*' under Section 620A of the Companies Act, 1956 and companies engaged in merchant banking activities (subject to certain conditions), however, have been exempted from the Reserve Bank's registration as they are regulated by other agencies.

3. Registration

6.7 The Reserve Bank of India (Amendment) Act, 1997 made it obligatory for NBFCs to apply to the Reserve Bank for a certificate of registration (CoR). The minimum net owned fund[1] (NOF) for registration, was stipulated at Rs.25 lakh for the then existing NBFCs and Rs.2 crore for new NBFCs seeking grant of CoR on or after April 21, 1999. The three-year period provided in the Reserve Bank of India (Amendment) Act, 1997 for the NBFCs to attain the minimum NOF necessary for registration expired on January 9, 2000.

Table VI.1: Select Types of Non-Banking Financial Entities

Non-Banking Financial Entity	Principal Business
1	2
I. Non-banking financial company	In terms of the Section 45I(f) [read with Section 45I(c)] of the Reserve Bank of India Act, 1934, as amended in 1997, the principal business is that of receiving deposits or that of a financial institution, such as, lending, investment in securities, hire purchase finance or equipment leasing.
(a) Equipment leasing company (EL)	Equipment leasing or financing of such activity.
(b) Hire purchase finance company (HP)	Hire purchase transactions or financing of such transactions.
(c) Investment company (IC)	Acquisition of securities; includes primary dealers (PDs) which, *inter alia*, deal in underwriting and market-making for government securities.
(d) Loan company (LC)	Providing finance by making loans or advances, or otherwise for any activity other than its own; excludes EL/HP/ Housing Finance Companies (HFCs).
(e) Residuary non-banking company (RNBC)	Receiving deposits under any scheme or arrangement, by whatever name called, in one lump-sum or in instalments by way of contributions or subscriptions or by sale of units or certificates or other instruments,

		or in any manner. These companies do not belong to any of the categories as stated above.
II.	Mutual benefit financial company (MBFC), *i.e.*, *nidhi* company	Notified by the Central Government as a *nidhi* company under Section 620A of the Companies Act, 1956.
III.	Mutual benefit company (MBC), *i.e.*, potential *nidhi* company	A company which is working on the lines of a *nidhi* company but has not yet been so declared by the Central Government, has minimum net owned fund (NOF) of Rs.10 lakh, has applied to the Reserve Bank for CoR and also to the Department of Company Affairs (DCA) for being notified as a *nidhi* company and has not contravened directions/ regulations of the Reserve Bank /DCA.
IV.	Miscellaneous non-banking company (MNBC), *i.e.*, *chit* fund company	Managing, conducting or supervising as a promoter, foreman or agent of any transaction or arrangement by which the company enters into an agreement with a specified number of subscribers that every one of them shall subscribe a certain sum in instalments over a definite period and that every one of such subscribers shall in turn, as determined by tender or in such manner as may be provided for in the arrangement, be entitled to the prize amount.

Table VI.2: Certificates of Registration of NBFCs

End-June	All NBFCs	NBFCs accepting Public Deposits
1	2	3
1999	7,855	624
2000	8,451	679
2001	13,815	776
2002	14,077	784
2003	13,849	710

The further three-year period granted by the Reserve Bank, at its discretion, also came to a close on January 9, 2003. The Reserve Bank approved about one-third of the applications received, permitting only 710 NBFCs to accept / hold public deposits[2] as at end-June 2003 (Table VI.2). All NBFCs holding public deposits whose CoRs have been either rejected or cancelled have to continue repaying the deposits on due dates and dispose off their financial assets within three years from the date of application / cancellation of the certificate or convert themselves into non-banking non-financial companies. Thus, there has been a fall in the number of operating NBFCs reflecting mergers, closures and cancellation of licenses. Besides, the number of public deposit-accepting companies also came down because of conversion to non-public deposit-accepting activities.

4. Supervision

6.8 The Reserve Bank has been strengthening the supervisory framework for NBFCs to ensure sound and healthy functioning and to avoid excessive risk taking. The degree of supervisory oversight is based on the following three criteria, *viz.*, a) size of the NBFC, b) the type of activity performed, and c) the acceptance (or otherwise) of public deposits. The NBFC supervisory framework rests on a four-pronged strategy encompassing the following, *viz.*, a) on-site inspection, based on the CAMELS methodology, b) off-site monitoring supported by state-of-the art technology, c) market intelligence, and d) exception reports of statutory auditors of NBFCs.

6.9 The Reserve Bank inspected a total of 918 registered NBFCs, including 255 public deposit-accepting companies during 2002-03 (July-June). The Reserve Bank also conducted 685 snap scrutiny exercises relating to NBFCs.

6.10 Notwithstanding the differences between banks and NBFCs, there are areas of operational convergence due to their engagement in similar types of activities in the broad product space of deposit mobilisation and lending. A critical issue is the desirable degree of regulatory convergence between banks and NBFCs in view of the complex set of similarities and differences in their functions (Box VI.1). It is in this context, that the Reserve Bank's regulatory framework for NBFCs, by and large, follows the regulations for banks but also differs in a number of cases (Table VI.3). The regulations are relatively more stringent in case of public deposit-accepting companies in order to protect depositors' interest. Since NBFCs are not directly part of the process of credit creation, reserve requirements apply exclusively to banks. Finally, as NBFCs have sometimes promised unsustainable returns to investors - often to small depositors - there is a ceiling on rates offered on NBFC deposits to avoid such past experience.

5. Policy Developments

6.11 The Reserve Bank introduced a number of measures to enhance the regulatory and supervisory standards of NBFCs during 2002-03, especially in order to bring them at par with commercial banks, in select operations, over a period of time. Regulatory measures adopted during the year include aligning interest rates in this sector with the rates prevalent in the rest of the economy, tightening prudential norms, standardising operating procedures and harmonising supervisory directions with the requirements of the amended Companies Act, in respect of, *inter alia*, registration, reporting requirements and constitution of audit committees.

Box VI.1: Regulatory Design for Banks and Non-Banking Financial Intermediaries

Banks and NBFCs essentially perform the function of financial intermediation in the economy. Their regulatory design has serious implications for the efficiency of the financial system, as well as for financial stability. Gaps often create the scope for regulatory arbitrage that impact on the process of price discovery and efficient allocation of resources, or result in regulatory repression of the various segments of the financial sector. Banks and public deposit-accepting NBFCs compete for deposits. Besides, banks and NBFCs are also competing sources of funds in certain sections of the credit markets. These two factors provide the basic case for regulatory convergence in terms of licensing (and entry), capital adequacy, loan loss provisioning and risk management. At the same time, a large number of NBFCs do not mobilise public deposits and therefore, do not fund their activities through deposit money, as in the case of banks. This implies that the case for regulatory convergence based on depositors' protection between banks and NBFCs does not apply uniformly to the latter.

The differences in regulation of banks and NBFCs reflect their unique characteristics and the fundamental differences in their operations. First, while both bank and non-bank deposits reflect investor choice, bank accounts -current and / or savings - are necessary to settle financial transactions since banks exclusively have the power of issuing cheques as constituents of the payments system. Secondly, transactions put through banks and NBFCs carry very different macroeconomic implications. A deposit with a bank sets off a process of credit creation while a deposit with an NBFC typically results in a transfer of ownership of bank deposits without any immediate monetary impact. This implies that certain regulatory measures, such as, the imposition of cash reserve requirements, apply uniquely to banks.

The impact of NBFC activity on bank soundness is also complex. First, a shift of term deposits from banks to NBFCs could ease the interest expenditure in the bank balance sheets, since NBFCs are more likely to place funds in non-interest bearing current accounts. Second, in case of individual banks, there would also be the cost of variability of cash flows as NBFCs transact their business. The net effect on banking soundness would, thus, primarily depend on the relative strength of the two factors. Finally, insofar as banks lend to NBFCs, their performance directly impinges on the health of banks.

Reference:

Carmichael, Jeffrey and Michael Pomerleano (2002), *The Development and Regulation of Non-Bank Financial Institutions*, World Bank, Washington DC.

Interest Rates

6.12 In view of the softening of interest rates in the financial markets, the maximum rate of interest that NBFCs (including *nidhi* companies and *chit* fund companies) could pay on their public deposits was reduced from 12.5 per cent per annum to 11.0 per cent per annum with effect from March 4, 2003. Similarly, the minimum rate of interest payable by RNBCs was reduced from 4.0 per cent to 3.5 per cent per annum on daily deposit schemes, and from 6.0 per cent to 5.0 per cent per annum on other types of deposits. In order to ensure that rates on non-resident Indian (NRI) deposits are uniform in the entire financial system, NBFCs, including RNBCs, have been directed that interest payable on such deposits accepted by them would be the same as that payable by scheduled commercial banks (SCBs), *i.e.*, 25 basis points above the London Inter-Bank Offer Rate (LIBOR) / SWAP rate for US dollars of corresponding maturity.

Asset Liability Management

6.13 The asset-liability management (ALM) guidelines for NBFCs, issued in June 2001, became fully operational from March 31, 2002. A system of half-yearly reporting has been put in place in this regard beginning September 30, 2002 in respect of NBFCs with public deposits of Rs.20 crore and above, or an asset size of Rs.100 crore and above, within a month of close of the relevant half-year.

Transactions in Government Securities

6.14 All NBFCs were directed to invariably hold their investments in Government securities in either of the following ways: a) the Constituents' Subsidiary General Ledger Account (CSGL) with a SCB, or the Stock Holding Corporation of India Limited (SHCIL), or b) in a dematerialised account with depositories, [*e.g.*, the National Securities Depository Limited (NSDL) and the Central Depository Services Limited (CDSL)] through a depository participant registered with the Securities and Exchange Board of India (SEBI).

Disclosure for Depositor Education

6.15 NBFC deposits are not covered under any insurance scheme. In the interest of transparency and public awareness, NBFCs were instructed to include a clause in any advertisement / statement issued by them for inviting public deposits that the deposits placed with them are not insured.

Table VI.3: Regulatory Norms for Banks and Non-Banking Financial Companies

Particular	Bank	NBFC
1	2	3
Minimum capital/ Net Owned Fund	Minimum capital requirements of Rs.200 crore, to be raised to Rs. 300 crore within three years of operation, in case of new banks. Promoters' minimum contribution is 49 per cent of the paid-up capital.	Net owned fund of not less than Rs. two crore is a pre-requisite for grant of CoR for commencing the business of a non-banking financial institution.
Statutory Liquidity Requirement	Maintain in India, in either, (i) cash, (ii) gold (at up to current market price), (iii) unencumbered approved securities valued at a price specified by the Reserve Bank, or (iv) net balances in current accounts with nationalised banks in India, at close of business on any day, an amount not less than 25 per cent of total of demand and time liabilities in India on fortnightly basis, or such other percentage not exceeding 40 per cent, as the Reserve Bank, by way of notice, specifies from time to time.	To maintain in India in unencumbered approved securities, valued at current market price, an amount at the close of business on any day which shall not be less than 15 per cent of the public deposits outstanding as at the last working day of the second preceding quarter.
Cash Reserve Ratio	Applicable.	No such requirement.
Reserve Fund	Applicable. Transfer out of the profit of each year before dividend is declared, to such reserve fund a sum, not less than 20 per cent of such profit.	Same as in the case of banks.
Prior approval of Reserve Bank for appointment of the managing directors.	Necessary. Applicable in case of amendment to the terms and conditions of the appointment of managing directors, *etc*.	No such requirement.

Prohibition of common directors	Applicable.	No such requirement.
Powers for appointment of additional directors	The Reserve Bank may appoint one or more persons to hold office as additional directors of a banking company.	No such powers in case of NBFCs.
Control over appointment of auditors	Prior approval of the Reserve Bank for appointment, re-appointment or removal of the auditor required.	No such requirement for NBFCs. These companies have freedom to appoint their auditors as per the Companies Act, 1956.
Deposit directions	Acceptance of deposits from the public, repayable on demand, allowed. Interest rate payable on saving accounts prescribed by the Reserve Bank.	Detailed directions on acceptance of public deposits relating to, *inter alia*, minimum eligibility criteria, quantum, minimum and maximum period, rate of interest, and advertisement.
Payment system	Member of payment and settlement system.	Cannot accept deposits withdrawable by cheque.
Deposit insurance	Deposits insured by the Deposit Insurance and Credit Guarantee Corporation of India up to Rs.1 lakh for each depositor in respect of his /her deposit in an insured bank in the same capacity and in the same right.	Deposits are uninsured and no official agency guarantees the payment of principal or the interest on such deposits.
Refinance facility	The Reserve Bank may grant refinance, rediscounting facilities and demand loans.	No such provision in the Reserve Bank of India Act, 1934.
Powers of amalgamation, and scheme of arrangement	The Reserve Bank has powers to sanction schemes of amalgamation, reconstruction, and arrangement approved by the requisite majority of shareholders of the bank.	No such provision.
Winding up proceedings	Special provisions for winding up of a banking company under certain circumstances.	Winding up, subject to the general provisions contained in the Companies Act, 1956.

Exposure of NBFCs to the Capital Market

6.16 The exposure of NBFCs to the capital market has important ramifications for their depositors' interest. The NBFCs, holding public deposits of Rs.50 crore and above and RNBCs having aggregate liabilities to the depositors of Rs.50 crore and above as on March 31, 2002 or thereafter, have been directed to furnish to the Reserve Bank, information relating to their exposure to the capital market, at quarterly intervals, within a month of the close of the relevant quarter.

Exemptions

6.17 The basic philosophy of regulatory guidelines is to protect depositors' interest and not to discourage the basic function of genuine risk taking. Accordingly, venture capital fund companies and the stock broking companies, which do not hold public deposits as defined under the Reserve Bank regulations and possess a certificate of registration from the SEBI, have been exempted from the core provisions of sections of the Reserve Bank of India Act, 1934 relating to CoR requirements, maintenance of liquid assets and creation of reserve fund.

Investments by RNBCs in UTI units

6.18 In order to avoid disproportionately large exposures to any mutual fund, investments of RNBCs in mutual funds are subject to certain restrictions. In view of the bifurcation of the Unit Trust of India (UTI) and the fact that mutual fund activities of UTI presently fall under the purview of the SEBI (Mutual Funds) Regulations, 1996, the dispensation to RNBCs to invest in the units of UTI up to the entire sub-limit of 10 per cent of the aggregate liabilities to the depositors, was withdrawn. The permission to the RNBCs to invest in the mutual funds, including the UTI, would, however, continue within the ceiling of 10 per cent of the aggregate liabilities. The sub-ceiling of 2 per cent of such liabilities for any one mutual fund is now extended to the investments in the units of UTI.

Primary Dealers (PDs)

6.19 The regulatory framework for PDs reflects their unique position in the financial markets. While they are essentially non-bank financial intermediaries operating in the money and government securities markets, PDs also channelise central bank liquidity to banks so that their lendings to banks in the call money market are reckoned as part of inter-bank liabilities. Besides being investors, along with banks in the money and government securities markets, PDs also perform a market-making function, in course of which they are allowed access to the Reserve Bank's liquidity window in the form of the Liquidity Adjustment Facility and assured liquidity support in consonance with their commitments in primary auctions. In consonance with their special role in financial markets, the Reserve Bank has instituted a regulatory framework for primary dealers which reflects their functional similarities as well as differences with banks (Table VI.4). In view of their essential function as dealers in money market instruments and government securities, PDs, unlike banks, are not subject to several regulations in respect of asset classification, income recognition, non-performing assets, provisioning and exposure norms. The scale, scope and regulation of the primary dealer network in the Indian case is, more or less, in consonance with cross-country experiences (Table VI.5).

6.20 PDs have been brought under the purview of the Board for Financial Supervision (BFS) in 2002-03 in view of their growing systemic importance in terms of the following attributes: (a) their large number, (b) highly leveraged portfolios with short-term funds, (c) substantial share in the Government securities market, and (d) a significant position in the money market, comparable with banks. The Reserve Bank also undertakes on-site inspection of each PD besides the off-site supervision through prescribed periodic returns.

6.21 In January 2002, PDs were advised to follow a prudent dividend distribution policy. This is expected to build up sufficient reserves (even in excess of regulatory requirements), which can act as a cushion against any adverse interest rate movements in the future. The financial strength of the PDs is being monitored at regular intervals.

6.22 With a view to enlarging the funding avenues for their operations, PDs were allowed to avail of FCNR(B) loans from banks within an overall limit of 25 per cent of their NOF to supplement their funding sources. The foreign exchange risk on such loans would need to be hedged at all times at least to the extent of 50 per cent of exposure.

Table VI.4: Comparative Position of Banks and Primary Dealers with respect to Select Regulatory Parameters

Norm	Bank	Primary Dealer
1	**2**	**3**
CRAR	9 per cent of total risk-weighted assets (RWA).	15 per cent. Tier-I and Tier-II capital defined as in case of banks for credit risk. Tier-III capital for market risk subject to the constraints as per BIS standards. Capital adequacy for subsidiaries not applicable.
Investments	SLR securities and non-SLR securities (*i.e.*, total investment portfolio) classified into three categories, *viz.*, Held to Maturity (HTM) (up to 25.0 per cent of total investments), Available for Sale (AFS) and Held for Trading (HFT) categories, with progressively regular mark-to-market norms .However as per the balance sheet format, investments continue to be disclosed as per six existing classifications.	The government and non-government securities portfolio, to the extent the holding period and defeasance period stipulations can be satisfied, treated as trading and marked to market.
Disclosure Requirements	Number of items[3].	a) Net borrowings in call (average and peak during the period); b) Basis of valuation at lower of cost and market (LOCOM) / mark to market (MTM); c) Leverage Ratio (average and peak); and, d) CRAR (quarterly figures). Besides, PDs may also furnish more information by way of additional disclosures.
ALM Guidelines	Introduced February 1999. Banks to ensure coverage of 60 per cent of their liabilities and assets initially, and subsequently cover 100 per cent of their business by April 1, 2000. Prudential norms prescribed only for negative liquidity mismatches in the first two time buckets (*viz.*, 1- 14 days and 15-29 days) at 20 per cent each of the cash outflows in these time buckets.	ALM guidelines to NBFCs applicable to PDs with necessary modifications in tune with their nature of operations from January 2002. • The entire government securities portfolio treated as liquid and put in the first time bucket for liquidity risk management. Non-government securities treated as trading portfolio to the extent that holding period and defeasance period stipulations are satisfied. • PDs have been advised to continue with duration gap, present value of a basis point (PVBP), daily earnings at risk (DeaR), value at risk (VaR), *etc.* in relation to interest rate risk management measures rather than simple maturity / repricing gap method.

Resource Raising	Not applicable for banks.	PDs may raise resources by means of i) Call/term borrowing; ii) Borrowing from the Reserve Bank under normal/ backstop/LAF facility; iii) Repo borrowings from market; iv) Borrowings under credit line from banks/ financial institutions; v) Borrowings through ICDs/CP/ bonds; and, vi) Borrowing under FCNR(B) loans scheme of banks.

Table VI.5: Primary Dealer Systems - Cross-country Experience

Economy	Start Date	Number of Dealers	Number of Primary Dealers	Access to Central Bank facilities: Liquidity support	Access to Central Bank facilities: Open Market Operations	Supervision
1	2	3	4	5	6	7
Brazil	1974	338	22	No	Yes	Central bank.
Canada	1998	44	12	Yes	Yes	Central bank, ministry of finance, Investment Dealer Association.
France	1987	40 *plus*	18	No	No	Ministry of finance.
Mexico	2000	20-25	5	Yes	No	Central bank, ministry of finance.
UK	1986	NA	17	No	No	Financial Services Authority, ministry of finance.
USA	1960	NA	25	Yes	Yes	Central bank, ministry of finance.

NA: Not available.
Source: Arnone, Marco and George Iden (2003), "Primary Dealers in Government Securities: Policy Issues and Selected Countries' Experience", *IMF Working Paper* , No.WP/03/45.

6.23 Following representations received from some PDs, the Reserve Bank issued operational guidelines enabling them to undertake Portfolio Management Services (PMS) for entities other than those regulated by the Reserve Bank. Besides compliance with the above operational guidelines, the PMS undertaken by PDs, requires prior approval of the Reserve Bank and registration with the SEBI.

Guidelines and Directions to Securitisation and Reconstruction Companies

6.24 Several countries have set up asset reconstruction companies (ARCs) - in both the public and private sectors, specialising in recovery and liquidation of banks' non-performing assets (Table VI.6). This reinforces the earlier experiment of rapid asset disposition attempted in Mexico, Philippines, Spain and the USA. The Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham) recommended the transfer of sticky assets to an asset reconstruction company. The recent SARFAESI Act provides for sale of financial assets by banks/FIs to securitisation companies (SCs)/ reconstruction companies (RCs).[4]

6.25 The basic operation of asset reconstruction is easily captured by a simple hypothetical example (Table VI.7). A bank could sell its non-performing assets to an ARC at a commission / discount (say, marked to collateral valuation), which is charged to the profit and loss account in return for bonds issued by the ARC, without loss of generality, to clean up their balance sheet. The ARC, which buys the asset, with bonds issued to the bank (or the public) can make a profit if it is able to reconstruct it or dispose it off at a higher price.

Table VI.6: Restructuring Agencies - International Experience in Select Countries

Country	Agency	Ownership	Asset Transfer criteria	Transfer Price	Share of Assets disposed
1	2	3	4	5	6
China	Four agencies matched with banks (1999-)	Public	Non-performing loans	Book value	
Finland	Arsenal (1993-)	Public	Non-performing loans	Book value	Substantial
Ghana	NPART (1990-97)	Public	Mostly non-performing loans	Book value, excluding accrued interest	Turned into collection agency
Sweden	Securum (1992-97), Retriva (1993-,merged with Securum, 1995)	Public	Size and complexity of loans	Book value	Substantial

Source:
1.Klingebiel, D. (1999), “The Use of Asset Management Companies in the Resolution of Banking Crises”, *World Bank Policy Research Working Paper*.
2. Ma, Guonan and Ben S.C. Fung (2002), “China’s asset management corporations”, *BIS Working Paper*, No.115.

Table VI.7: Transactions in Asset Reconstruction: A Hypothetical Example

Flows in Bank Balance Sheet				Flows in ARC Balance Sheet			
Liabilities		Assets		Liabilities		Assets	
1	2	3	4	5	6	7	8
Deposits		Loan transferred to ARC	-100	Bonds	50	Bank loan valued at transfer price	50
Profit	(-)50	Payment received (ARC Bonds at transfer price)	50	Profit	10	Value addition during reconstruction	10
Total	**-50**		**-50**	**Total**	**60**		**60**

6.26 The Reserve Bank issued guidelines and directions to SCs and RCs seeking registration from it under Section 3 of the SARFAESI Act, 2002 (Box VI.2). The Reserve Bank has so far received 15 applications from SCs / RCs for the issue of CoR. An external Advisory Committee on the registration of SCs / RCs has been constituted to screen applications and advise the Reserve Bank on the registration of these companies. Two applications have been approved so far for grant of CoR to commence the business of SCs / RCs subject to certain conditions. Two asset reconstruction companies, *viz.*, Asset Reconstruction Company (India) Limited and Asset Care Enterprises Limited, have been issued certificates of registration to commence the business of securitisation and asset-reconstruction.

Design of New Balance Sheet Format

6.27 In pursuance of the recommendations of the Expert Group for Designing a Supervisory Framework for Non-Banking Financial Companies (Chairman: Shri P.R. Khanna), the Reserve Bank stipulated that, effective March 31, 2003 onwards, all NBFCs (irrespective of whether they hold public deposits or not) should attach a schedule to the balance sheet containing some additional prescribed particulars (Box VI.3). These requirements are applicable to the NBFCs in the category of equipment leasing, hire purchase finance, loan and investment and RNBCs.

Mutual Benefit Financial Companies (MBFC or Nidhis)

6.28 Mutual Benefit Financial Companies (*nidhis*) have been exempted from the core provisions of the Reserve Bank of India Act, 1934 and directions except those relating to the ceiling on interest rates, maintenance of register of deposits, issue of deposit receipt to depositors, and submission of annual return on deposits. However, as part of the implementation of the recommendations of an Expert Group (Chairman: Shri Sabanayagam), the Central Government has prescribed certain prudential norms for the MBFCs, such as, entry point norms, NOF to deposits ratio, stipulated liquid asset requirement, acceptance of deposits and its methodology (as in the case of NBFCs prescribed by the Reserve Bank), and prudential norms in July 2001. These norms were further amended in April 2002. These measures are expected to strengthen the functioning of these companies. The Central Government notified, on September 29, 2003, that interest rate payable on deposits accepted by these companies would be the same as NBFCs. With the above prescriptions, the entire regulation of these companies has been taken over by the DCA.

Mutual Benefit Companies (MBCs/ Potential Nidhis)

6.29 The NBFCs working on the lines of *nidhi* companies are categorised as Mutual Benefit Companies (MBCs) by the Reserve Bank and as potential *nidhi* companies by the DCA. Such companies are defined as those desirous of *nidhi* status under section 620A of the Companies Act, 1956. It may be pertinent to note that there were 206 companies (as on January 9, 2003) whose applications were awaiting notification as *nidhis* by DCA. However, a large number of MBCs awaiting *nidhi* status, including the companies mentioned above, applied to the Reserve Bank for grant of CoR as NBFCs.

Box VI.2: Asset Reconstruction Companies

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 was enacted by the Government of India on June 21, 2002 for regulation of securitisation and reconstruction of financial assets and enforcement of security interest by secured creditors, including securitisation companies (SCs) and reconstruction companies (RCs). The Act vests the Reserve Bank with the powers to register such companies and frame regulations for their functioning, covering areas, such as, registration, owned fund, prudential norms, capital adequacy, aggregate value and type of assets to be acquired. Based on the recommendations of the two working groups constituted by the Reserve Bank to address the above issues, guidelines and directions have been issued to securitisation or reconstruction companies on April 23, 2003. Following are the main features of the SCs / RCs:

- SCs / RCs seeking registration with the Reserve Bank are required to have a minimum owned fund of Rs.2 crore.
- Such SCs / RCs can undertake both securitisation and asset reconstruction activities. While

SCs / RCs not registered with the Reserve Bank can carry out the business of securitisation and asset reconstruction outside the purview of the SARFAESI Act, they would not be able to exercise the powers of enforcement provided for in the SARFAESI Act.

- SCs / RCs registered with the Reserve Bank would confine their activities to the business of securitisation and asset reconstruction and such other activities as permitted under the SARFAESI Act. Carrying out any other business would require Reserve Bank approval. Companies carrying out any other business are to cease to undertake such activities by June 20, 2003.
- SCs / RCs should not accept deposits (as defined under Section 58 A of the Companies Act, 1956).
- While change or take-over of management / sale or lease of business of the borrower is provided for in the SARFAESI Act, SCs/RCs cannot exercise these powers until the Reserve Bank issues necessary guidelines in this regard.
- Every SC / RC shall frame an asset acquisition policy with the approval of their board within 90 days of grant of CoR by the Reserve Bank. This should, *inter alia*, provide norms and procedure for acquisition of financial assets, types and desirable profile of the assets, valuation of assets and delegation of powers.
- SCs / RCs may reschedule and settle the debts payable by the borrower in terms of a policy framed by their boards in regard thereto.
- SCs / RCs should formulate a plan for realisation of assets, which clearly spell out the steps proposed to reconstruct the assets and realise the same within a specified time frame, which shall not in any case exceed five years from the date of acquisition.
- SCs / RCs may raise funds from Qualified Institutional Buyers (QIBs) by way of issue of security receipts, as per policy framed in this regard, through one or more trusts set up for this purpose. The security receipts, to be issued on private placement basis, can be transferred only amongst QIBs.
- SCs / RCs, may, as a sponsor or for the purpose of establishing a joint venture, invest in the equity share capital of another SC / RC for the purpose of asset reconstruction. Surplus funds available may be deployed in government securities and deposits with scheduled commercial banks in terms of a policy framed in this regard by their board. Investments in land and buildings can be made only out of funds borrowed and/ or owned funds in excess of the minimum prescribed owned fund of Rs.2 crore.
- Prudential norms covering capital adequacy, income recognition, asset classification, valuation of investments and provisioning, shall be applicable to the assets borne on the balance sheet of such companies.
- Every SC / RC should classify the assets on its balance sheet into standard and non-performing assets, and the non-performing assets further into sub-standard assets, doubtful assets and loss assets. Provisioning is to be made at the rate of 10 per cent and 50 per cent (100 per cent to the extent the asset is not covered by the estimated value of the security) in respect of substandard assets and doubtful assets, respectively. Loss assets are to be written off. If loss assets are retained in the books for any reason, provisions are to be made to the full extent.
- All investments made by the SCs / RCs are to be valued at the lower of cost or realisable value.
- SCs / RCs should maintain, on an ongoing basis, a capital adequacy ratio, which shall not be less than 15 per cent of its total risk-weighted assets.

- SCs / RCs are, *inter alia* to make disclosures in the balance sheet and offer document in the form of financial details, interest rate / probable yield, redemption details including servicing arrangements, credit rating, if any, description of assets backing the security receipts.

Keeping in view that the six-year period provided in the Reserve Bank Act to attain the minimum NOF expired on January 9, 2003, the Reserve Bank has to decide all the pending applications of all NBFCs based on their individual merits and fulfillment of eligibility criteria. In view of the fact that the regulation of all *nidhis* and potential *nidhis* has been taken over by DCA and as the Government concurred with the Reserve Bank's proposal to exempt from the Reserve Bank Regulations only those potential *nidhis* which were existing on January 9, 1997 and have applied to DCA for *nidhi* status on or before January 9, 2003, the Reserve Bank is dealing with the pending applications for grant of CoR on the above basis. The companies which have not applied to DCA for *nidhi* status, or which do not comply with DCA regulations and those whose application for *nidhi* status have been rejected by DCA would be dealt with as NBFCs.

Box VI.3: Balance Sheet Disclosures by NBFCs

The Expert Group for Designing a Supervisory Framework for Non-Banking Financial Companies (Chairman: Shri P.R. Khanna) recommended that the Reserve Bank should explore the possibility of redesigning the format of the balance sheet required to be prepared by the NBFCs. The formats of the financial statements prepared by NBFCs as per Schedule VI to the Companies Act, 1956 were designed primarily to capture the business operations of non-financial companies and therefore, did not reflect their particular business characteristics. A committee of officials of the Reserve Bank and the Institute of Chartered Accountants of India (ICAI), set up to examine the issues, recommended in September 1999 that, while the basic structure of the existing formats of balance sheet of NBFCs as prescribed in the Companies Act should be retained, additional disclosure by way of schedules to the balance sheet and profit and loss account may be prescribed to reflect the particular risk profile of non-bank financial intermediaries. These recommendations were discussed with industry associations and others concerned. After taking into account the various suggestions of the industry and other developments, such as, the issuance of new Accounting Standards by the ICAI, and guidelines for corporate governance for listed companies by the SEBI and amendment of the provisions of the Companies Act regarding measures for protection of the depositors, the Reserve Bank has directed NBFCs to append an additional schedule effective March 31, 2003. The additional disclosures cover the following items:

- Secured and unsecured borrowings from various sources and through different instruments and the amount overdue.
- Break up of public deposits in the form of unsecured debentures, partly secured debentures and other public deposits and the amount overdue under each head.
- Break up of secured and unsecured loans and advances as also bills discounted.
- Break up of leased assets into financial leases and operational leases.
- Break up of stock on hire and repossessed assets.
- Break up of hypothecation loans (counted towards lease or hire purchase finance) where

assets have been repossessed or other outstanding loans.

- Break up of current quoted and unquoted investments.
- Break up of long-term quoted and unquoted investments.
- Borrower group-wise credit exposure to related parties and other than related parties.
- Group-wise investment exposure to related parties and other than related parties.
- Position of gross non-performing assets recoverable from related parties and other than related parties.
- Net non-performing assets recoverable from related parties and other than related parties.
- Assets acquired in satisfaction of debt.

6. Business Profile of the NBFC Sector

6.30 The business profile of the NBFC sector as at end-March 2002 broadly reflected long-term trends (Chart VI.1 and Table VI.8). Public deposits worked out to about one-third of total assets of the NBFCs; in case of RNBCs, the share was substantially higher at almost two-third, especially as two of the leading RNBCs account for the bulk of the total NBFC public deposits. The share of public deposits in the case of NBFCs (other than RNBCs) declined sharply during 2001-02; there was a marginal decline in the case of RNBCs as well. Net owned funds of NBFCs also continued to decline in line with long-term trends. The net owned funds of RNBCs, however, turned positive for the first time reflecting a turnaround by one of the leading companies in the sector.

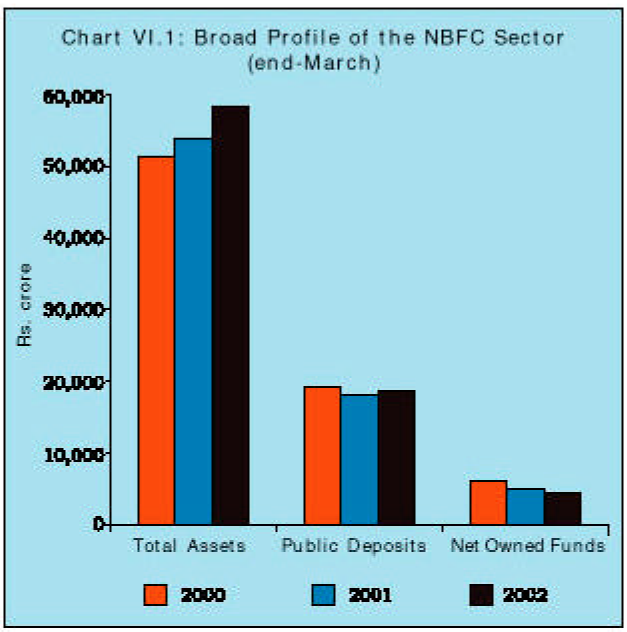


Table VI.8: Business Profile of the NBFC Sector

(As on March 31)

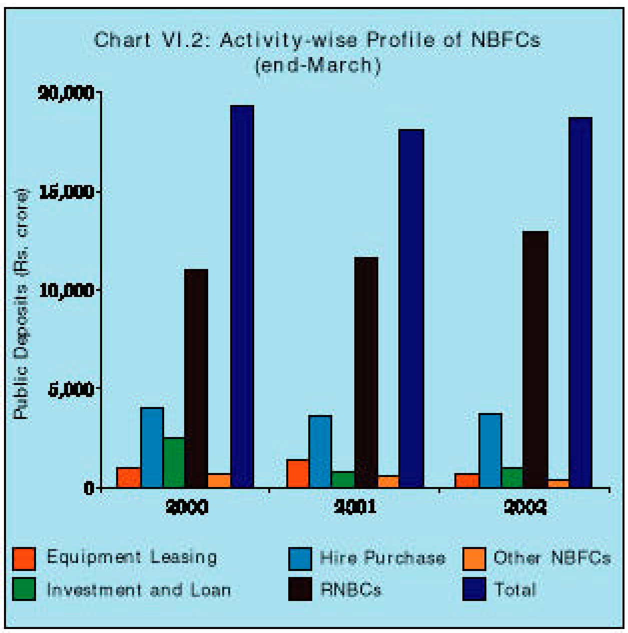
(Amount in Rs. crore)

Item	2001		2002	
	NBFCs	*of which* RNBCs	NBFCs	*of which* RNBCs

1	2	3	4	5
Number of reporting Companies	981	7	910	5
Total Assets	53,878	16,244	58,290	18,458
		(30.1)		(31.7)
Public Deposits	18,084	11,625	18,822	12,889
		(64.3)		(68.5)
Net Owned Fund	4,943	- 179	4,383	111

Figures in brackets are percentage shares to total.

6.31 RNBCs continued to hold a substantial part of the NBFC public deposits, with their share continuing to increase in line with long-term trends (Chart VI.2 and Table VI.9). There was a shift in the composition of deposit mobilisation by the other categories of NBFCs during 2001-02. In contrast to the previous year, public deposits with equipment leasing companies declined sharply while those of investment and loan companies increased.



6.32 The Reserve Bank publishes quarterly data on broad liquidity (L_3) encompassing the monetary and liquid liabilities of the banking sector, post office bank, FIs and NBFCs based on the recommendations of the Working Group on Money Supply: Analytics and Methodology of Compilation (Chairman: Dr. Y.V. Reddy). In view of the data lags, the Working Group recommended that estimates of NBFC public deposits could be generated on the basis of returns received from all NBFCs with public deposits of Rs.20 crore and above. The share of public deposits of all NBFCs continued to stagnate at around 1.0 per cent of L_3. Based on such lead data, NBFC public deposits recorded a marginal growth of 0.8 per cent during 2002-03 (Chart VI.3).

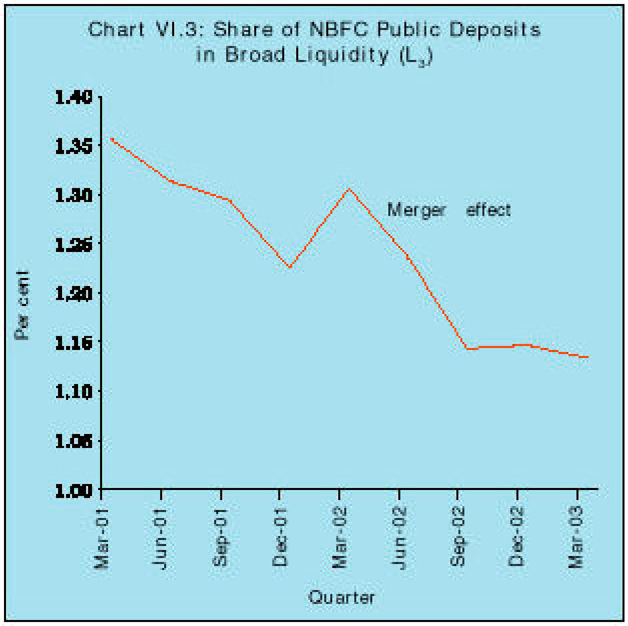


Table VI.9: Profile of Public Deposits of Different Categories of NBFCs
(As on March 31)

(Amount in Rs. crore)

Nature of Business	No. of NBFCs		Public Deposits		Shares in Public Deposits (per cent)	
	2001	2002	2001	2002	2001	2002
1	2	3	4	5	6	7
1. Equipment Leasing (EL)	58	56	1,450	668	8.0	3.5
2. Hire Purchase (HP)	470	463	3,659	3,709	20.2	19.7
3. Investment and Loan (IL)	170	231	785	1,029	4.4	5.5
4. RNBCs	7	5	11,625	12,889	64.3	68.5
5. Other NBFCs*	276	155	564	528	3.1	2.8
Total	**981**	**910**	**18,084**	**18,822**	**100.0**	**100.0**

* Includes Miscellaneous Non-Banking Companies, unregistered NBFCs and unnotified *nidhis*, *etc.*

7. Region-wise Composition of Deposits held by NBFCs

6.33 One of the distinguishing features of the NBFCs is their localised operations. The NBFCs in the Eastern Region continued to dominate the public deposits of registered and unregistered NBFCs as at end-March 2002, essentially because a leading RNBC is based in Kolkata (Table VI.10). The share of the Eastern Region, however, has been declining in recent years while that of the Central Region has been rising, reflecting, *inter alia*, the rapid expansion of a Lucknow-based RNBC. The NBFCs in four metropolitan centres of Mumbai, New Delhi, Kolkata and Chennai continued to account for the bulk of public deposits as at end-March 2002.

8. Interest and Maturity Pattern of Public Deposits with NBFCs

6.34 The interest rate structure of NBFCs (excluding RNBCs) continued to soften during 2001-02, reflecting the recent 350 basis point cut in the ceiling for deposit rates (Chart VI.4 and Table

VI.11). This was in consonance with easy liquidity conditions emanating from strong capital flows on the supply side and poor credit off-take on the demand side. The share of deposits in the interest rate range of 10-12 per cent, close to the regulatory cap of 12.5 per cent, jumped sharply during 2001-02. While there has been a gradual repayment of the high-cost deposits accepted by NBFCs, the overhang of deposits, contracted at 14.0 per cent and above[5] - remained substantial at about a fifth of total deposits. This high interest rate, by and large, also reflects the risk premium NBFCs typically pay *vis-à-vis* bank deposits. At the same time, higher deposit rates further affect their commercial viability in a scenario of falling interest rates.

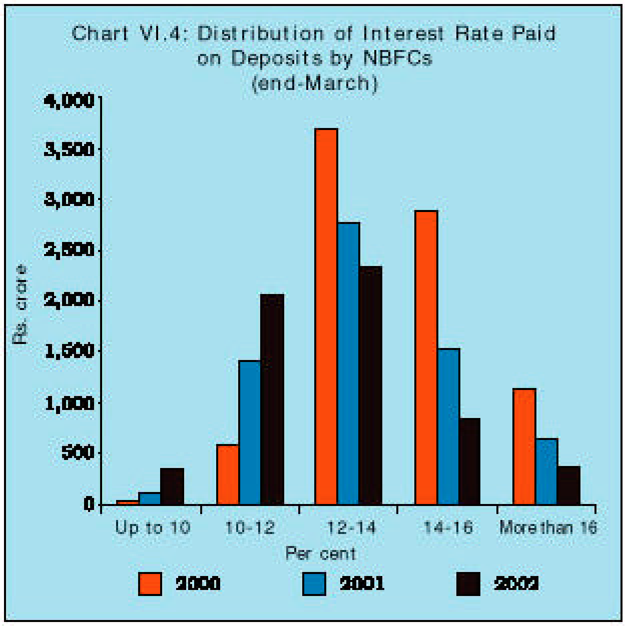


Chart VI.4: Distribution of Interest Rate Paid on Deposits by NBFCs (end-March)

Table VI.10: Region-wise Break-Up of Public Deposits held by Registered and Unregistered NBFCs (As on March 31)

(Amount in Rs. crore)

Region	2001						2002					
	NBFCs			*of which* RNBCs			NBFCs			*of which* RNBCs		
	No.	Amount	Per cent	No.	Amount	Per cent	No.	Amount	Per cent	No.	Amount	Per cent
1	2	3	4	5	6	7	8	9	10	11	12	13
Northern	253	575	3	—	—	—	271	554	3	—	—	—
North-Eastern	—	—	—	—	—	—	3	4	0	—	—	—
Eastern	24	7,932	44	3	7,642	66	21	8,051	43	3	7,812	61
Central	126	4,105	23	3	3,980	34	94	5,207	28	2	5,077	39
Western	81	2,041	11	—	—	—	70	1,467	7	—	—	—
Southern	497	3,432	19	1	4	0.0	451	3,538	19	—	—	—
Total	**981**	**18,084**	**100**	**7**	**11,625**	**100**	**910**	**18,822**	**100**	**5**	**12,889**	**100**
Metropolitan cities												
Mumbai	62	2,011	11	—	—	—	52	1,445	8	—	—	—
Chennai	349	2,918	16	—	—	—	317	3,183	16	—	—	—
Kolkata	23	7,929	44	3	7,642	66	21	8,051	43	3	7,812	61
New Delhi	114	492	3	—	—	—	111	460	2	—	—	—
Total	**548**	**13,350**	**74**	**3**	**7,642**	**66**	**501**	**13,139**	**69**	**3**	**7,812**	**61**

6.35 As a financial sub-sector, NBFCs are a combination of heterogeneous entities. The maturity profile of public deposits held by NBFCs continued to shorten, especially with the repayment of high-cost deposits raised earlier (Table VI.12). The share of public deposits with a maturity of over three years, in particular, declined fairly monotonically, partly reflecting the reluctance of depositors to enter into long-term commitments when interest rates are at historic lows. The increase in public deposits with maturity between 2 to 3 years during 2001-02 was counterbalanced by a decline in most other maturity buckets.

Table VI.11: Distribution of Public Deposits of NBFCs (excluding RNBCs) according to Rate of Interest

(As on March 31)

(Amount in Rs. crore)

Interest Range (per cent)	Amount of deposits		Percentage to total deposits	
	2001	2002	2001	2002
1	2	3	4	5
Up to10	118	358	1.8	6.0
10-12	1,404	2,055	21.8	34.6
12-14	2,759	2,326	42.7	39.2
14-16	1,533	833	23.7	14.0
More than16	646	361	10.0	6.1
Total	**6,460**	**5,933**	**100.0**	**100.0**

Table VI.12: Maturity Pattern of Public Deposits held by NBFCs

(excluding RNBCs)

(Amount in Rs.crore)

Maturity Period	Amount of Public Deposits As on March 31		Percentage to total	
	2001	2002	2001	2002
1	2	3	4	5
Less than 1 year	1,721	1,483	26.7	25.0
1- 2 years	1,741	1,419	27.0	23.9
2- 3 years	2,038	2,198	31.5	37.0
3- 5 years	842	779	13.0	13.1
5 years and above	118	54	1.8	0.9
Total	**6,460**	**5,933**	**100.0**	**100.0**

6.36 The ceiling rate offered on public deposits by NBFCs has come down by 500 basis points since March 2000. As a result, the spread between bank and NBFC deposits has narrowed in recent years (Table VI.13). This is in line with the regulatory guidelines and trends in risk premium.

9. Asset Profile of NBFCs

6.37 Notwithstanding their large number, the NBFC sector continues to be dominated by a few large companies. Twenty NBFCs in the asset range of Rs.500 crore and above continued to account for the bulk of the total assets, with their share increasing further during 2001-02 (Table VI.14). Most of the NBFCs possessed an asset size of below Rs.10 crore. While smaller NBFCs often specialise in addressing local credit needs, their large number continues to pose a regulatory challenge for the Reserve Bank.

Table VI.13: Maximum/Ceiling Interest Rates on Bank and NBFC Deposits
(End-March)

(Per cent)

	Interest Rate / March	2000	2001	2002	2003
	1	2	3	4	5
1.	Maximum interest rate on public sector bank deposits of 1-3 year maturity	10.5	9.5	8.5	6.75
2.	Ceiling interest rate for NBFCs	16.0	14.0	12.5	11.0
3.	Spread (2-1)	5.5	4.5	4.0	4.25

Note:Spread is calculated as difference between the upper end of the interest rate range in case of public sector bank deposits of 1-3 year maturity and the ceiling rate on NBFC deposits.

Table VI.14: Asset Profile of NBFCs (excluding RNBCs*)
(As on March 31)

(Amount in Rs. crore)

	Range of Assets	No. of Reporting Companies		Assets		Percentage to Total Assets	
		2001	2002	2001	2002	2001	2002
	1	2	3	4	5	6	7
1.	Less than 0.25	62	51	7	5	0.0	0.0
2.	0.25 - 0.50	91	88	35	33	0.1	0.1
3.	0.50 - 2	389	383	421	416	1.1	1.0
4.	2 - 10	280	247	1,193	1,076	3.2	2.7
5.	10 - 50	89	74	1,981	1,594	5.3	4.0
6.	50 - 100	15	19	1,019	1,341	2.7	3.4
7.	100 - 500	28	23	7,130	5,962	18.9	15.0
8.	Above 500	20	20	25,848	29,406	68.7	73.8
	Total	**974**	**905**	**37,634**	**39,833**	**100.0**	**100.0**

* The reporting NBFCs (excluding RNBCs) have been regulated on the basis of their asset size as on March 31, 2001 and 2002.

10. Distribution of Assets of NBFCs according to Activity

6.38 The major portion of the assets of NBFCs (excluding RNBCs) continued to be in the form of their specialised areas of hire purchase and equipment leasing. During 2001-02, there was a shift in the portfolio allocation in favour of loans and inter-corporate deposits from equipment leasing, partly reflecting, *inter alia*, the slowdown in economic activity and changes in taxation (Table VI.15).

11. Borrowings by NBFCs

6.39 The source-wise profile of borrowings by NBFCs (excluding RNBCs), more or less, remained the same as at end-March 2001 and 2002 (Table VI.16). Banks have emerged as a major source of credit for NBFCs, accounting for almost a third of their borrowings - commercial bank funding jumped by 20.8 per cent during 2001-02 on top of a 16.2 per cent rise during 2000-01 - partly driven by easy liquidity conditions. The decline in inter-corporate borrowing was compensated by an increase in other sources, such as, securitised paper and bank loans.

Table VI.15: Activity-wise Distribution of Assets of NBFCs (excluding RNBCs)
(As on March 31)

Activity	Amount in Rs.crore		Percentage to total	
	2001	2002	2001	2002
1	2	3	4	5
Loans & Inter-corporate deposits	10,271	13,710	27.3	34.4
Investments	4,344	4,334	11.5	10.9
Hire Purchase	12,887	13,202	34.2	33.1
Equipment Leasing	4,681	3,112	12.4	7.8
Bills	788	673	2.1	1.7
Other assets	4,663	4,802	12.4	12.1
Total	**37,634**	**39,833**	**100.0**	**100.0**

Table VI.16 Classification of Borrowings by NBFCs (excluding RNBCs)
(As on March 31)

(Amount in Rs. crore)

Source	Outstanding		Percentage to total	
	2001	2002	2001	2002
1	2	3	4	5
Money borrowed from Central/State Governments @	3,041	3,353	13.5	14.0
Money borrowed from foreign sources*	670	670	3.0	2.8
Inter-corporate borrowings	2,866	1,996	12.6	8.3
Money raised by issue of convertible or secured debentures including those subscribed by banks	3,758	4,180	16.7	17.4
Borrowings from banks	6,545	7,918	29.0	33.0
Borrowings from Financial Institutions	1,694	1,546	7.5	6.4
Commercial Paper	627	781	2.8	3.3
Others #	3,358	3,555	14.9	14.8
Total	**22,559**	**24,000**	**100.0**	**100.0**

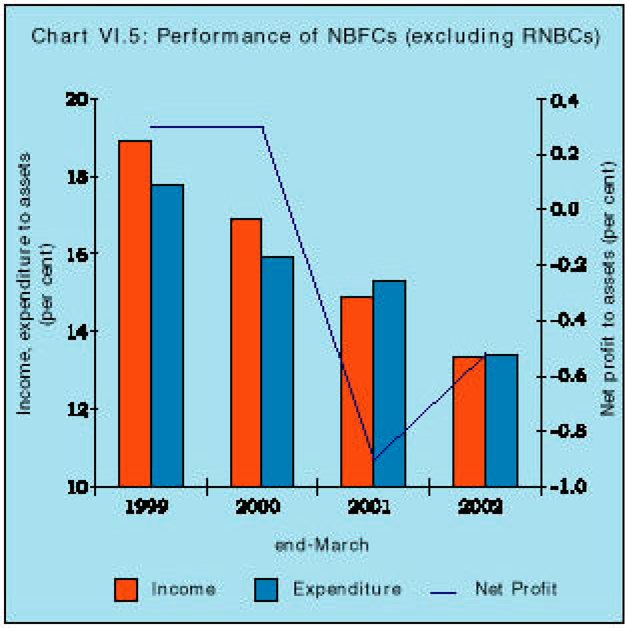
@ Mainly by State Government-owned companies.
* The amount received from foreign collaborators, as well as, from institutional investors (Asian Development Bank, International Finance Corporation, *etc.*). The major amount is in infrastructure and leasing companies.
# Includes security deposits from employees and caution money, allotment money, borrowings from mutual funds, directors, *etc.*

12. Liabilities and Assets of Major NBFCs

6.40 Lead data on the performance of major NBFCs (other than RNBCs) holding public deposits of Rs. 20 crore and above (accounting for three-fourth of sectoral assets) are now available for 2002-03, based on returns instituted on the basis of the Working Group on Money Supply (Chairman: Dr. Y. V. Reddy). The structure of assets and liabilities of major NBFCs during 2001-02 and 2002-03 reveals a decline in public deposits (Table VI.17). This was compensated by a larger recourse to bank loans, partly driven by the softening of bank lending rates. In terms of deployment of funds, investments in corporate paper and other assets recorded an increase in contrast to a decline in the equipment leasing business, in line with sectoral trends. Partly in response to the pickup in industrial activity, loans and advances rebounded in 2002-03.

13. Income - Expenditure Statement of NBFCs

6.41 The NBFCs, as a sector, recorded losses for the second year in succession during 2001-02, as the decline in expenditure could not keep pace with the drop in both fund-based and fee-based income (Chart VI.5 and Table VI.18). The decline in fund income was particularly steep in recent years. Total expenditure fell less sharply as operating expenditure and tax provisions have tended to be sticky. Operating costs of NBFCs, however, continue to be higher than those of banks and financial institutions.



14. Net Owned Funds (NOF) of NBFCs

6.42 With a view to reinforcing financial stability, the Reserve Bank's supervisory framework lays special emphasis on the sufficiency of NOF of NBFCs to restrict excessive leveraging. The ratio of public deposits to the NOF, a measure of the ability to meet its commitments out of its own resources, did not experience any significant change during 2001-02 (Table VI.19). A major concern continues to be that the NOF for a large number of the reporting NBFCs (excluding RNBCs) - holding almost a fifth of public deposits as at end-March 2002 - was negative.

15. Capital Adequacy Ratio

6.43 Beside the adequacy of net owned funds, capital adequacy norms[6], made mandatory for NBFCs in 1998, are a second line of defence to strengthen financial stability. Of the reporting companies, about three-fourths possess a CRAR of above 30.0 per cent, far in excess of minimum statutory stipulations as at end-March 2002 and 2001 (Table VI.20).

Table No. VI.17: Asset and Liabilities of Companies holding Public Deposits of Rs.20 crore and above

(Amount in Rs.Crore)

Item	March 31, 2002		March 31, 2003	
	Amount	Share to total	Amount	Share to total

		(per cent)		(per cent)
1	2	3	4	5
Liabilities				
Paid-Up Capital	1,632	5.5	1,693	6.4
Free Reserve (adj. for loss)	3,133	10.5	1,325	5.0
Public Deposits	4,503	15.1	3,686	14.0
(i) Public Deposits less than 1 year maturity	1,860	6.2	1,542	5.9
(ii) Public Deposits more than 1 year maturity	2,643	8.8	2,144	8.1
Convertible debentures	3,948	13.2	3,755	14.2
Other Borrowings	9,575	32.0	8,675	32.9
(i) From Banks	7,108	23.8	6,785	25.7
(ii) Inter-Corporate Deposits	1,985	6.6	1,428	5.4
(iii) Foreign Government	483	1.6	462	1.8
Other Liabilities	7,103	23.8	7,222	27.4
Total Liabilities	29,895	100.0	26,355	100.0
Assets				
Investment	3,302	11.0	2,696	10.2
(i) Government Securities	610	2.0	492	1.9
(ii) Corporate sector-shares, bonds, debentures	2,584	8.6	2,025	7.7
(iii) Others	108	0.4	179	0.7
Loans and Advances	8,592	28.7	8,576	32.5
Other Financial Assets	12,081	40.4	10,255	38.9
(i) Hire Purchase	9,556	32.0	8,571	32.5
(ii) Equipment Leasing	2,077	6.9	1,546	5.9
(iii) Bills Discounting	448	1.5	139	0.5
Other Assets	5,920	19.8	4,828	18.3
Total Assets / Liabilities	**29,895**	**100.0**	**26,355**	**100.0**

16. Non-Performing Assets

6.44 The gross and net non-performing assets of reporting NBFCs has experienced a steady decline in recent years (TableVI.21).

17. Primary Dealers

6.45 The primary dealer (PD) system has now been in operation for the last eight years. During 2002-03, PDs continued to strengthen their performance in the government securities market (Table VI.22). All PDs recorded a profit during 2002-03 (Appendix Table VI.1). The share of government securities in total assets experienced a sharp rise during the last two years, reflecting an increased interest in building up the government securities portfolio in the wake of the sustained rally in gilt prices for the preceding two years.

Table VI.18: Financial Performance of NBFCs (excluding RNBCs)

(Amount in Rs. Crore)

	Indicator	2000-01	2001-02	Variation during 2001-02	
				Absolute	per cent
	1	2	3	4	5
A.	**Income (i+ii)**	**5,619**	**5,357**	**-262**	**-4.7**
	i)Fund based	5,247	5,005	-242	-4.6
	ii)Fee based	372	352	-20	-5.4
B.	**Expenditure (i+ii+iii)**	**5,741**	**5,321**	**-420**	**-7.3**
	i)Financial	3,400	3,297	-103	-3.0

	ii)Operating	1,164	1,225	61	5.2
	iii)Other	1,177	799	-378	-32.1
C.	**Tax Provisions**	**203**	**248**	**45**	**22.2**
D.	**Net Profit**	**-325**	**-212**	**113**	
E.	**Total Assets**	**37,634**	**39,833**	**2,199**	**5.8**
F.	**Financial Ratios (as per cent of total assets)**				
	Income	14.9	13.4	-1.6	
	Fund Income	13.9	12.6	-1.3	
	Fee Income	1.0	0.9	-0.1	
	Expenditure	15.3	13.4	-1.9	
	Financial Expenditure	9.0	8.3	-0.7	
	Operating Expenditure	3.1	3.1	- 0.0	
	Other Expenditure	3.1	2.0	-1.1	
	Tax Provisions	0.5	0.6	0.1	
	Net Profit	-0.9	-0.5	0.4	

The absorption of primary issues of government paper was, however, marginally lower, reflecting a more aggressive bidding by other investors. While call money borrowings remained a steady source of finance, the average daily utilisation of liquidity support by the PDs was well below the utilisation limit during 2001-02, especially as call rates typically ruled below the Bank Rate.

Table VI.19: Net Owned Fund *vis-à-vis* Public Deposits of NBFCs (excluding RNBCs)

(As at end-March)

(Amount in Rs. crore)

Range of NOF	2001				2002			
	No. of Reporting Companies	Net Owned Fund	Public Deposits	Public Deposits as multiple of NOF	No. of Reporting Companies	Net Owned Fund	Public Deposits	Public Deposits as Multiple of NOF
1	2	3	4	5	6	7	8	9
Up to 0.25	225	-859	807	—	214	-1,351	1,120	—
0.25 – 0.50	346	116	188	1.6	300	103	128	1.2
0.50 – 5.0	305	498	692	1.4	298	477	361	0.8
5 – 10	34	224	94	0.4	30	204	80	0.4
10 – 50	37	775	777	1.0	38	798	718	0.9
50 – 100	12	804	924	1.1	11	798	846	1.1
100 – 500	14	3,063	2,299	0.8	14	3,243	2,680	0.8
Above 500	1	501	679	1.4	—	—	—	—
Total	**974**	**5,122**	**6,460**	**1.3**	**905**	**4,272**	**5,933**	**1.4**

Table VI.20: CRAR of Reporting NBFCs

(As on March 31)

(Amount in Rs. crore)

NBFC Category/ CRAR Range (in per cent)	Less than 10	10-12	12-15	15-20	20-30	Above 30
1	2	3	4	5	6	7
March 2001						
Equipment & Leasing	9	1	1	4	8	30
Hire Purchase	22	1	5	29	58	313
Loan/Investment	23	2	2	5	15	180
RNBCs	2	1	0	0	1	2
Total	**56**	**5**	**8**	**38**	**82**	**525**
March 2002						

Equipment & Leasing	10	0	1	4	9	32
Hire Purchase	17	0	8	32	54	334
Loan/Investment	15	0	1	9	11	121
RNBCs	1	0	0	1	1	2
Total	**43**	**0**	**10**	**46**	**75**	**489**

6.46 PDs' performance, in terms of both return on average net worth and return on average assets, has been lower during 2002-03 as compared with the performance of 2001-02. This was driven by two factors:

- Although the yields continued to soften, during the year, there was a slowdown in the trend giving lower mark-to-market values and trading margins. The 10-year and 20-year yields fell by about 115 and 123 basis points, respectively, during 2002-03 as compared to 287 and 311 basis points, respectively, in the previous year.
- While exiting the position on triggering of stop-loss limits when the yields saw reversals on military action in the Middle East and border tensions, PDs lost a part of their accruals during the year.

6.47 PDs continued to maintain capital to risk weighted assets ratios far in excess of the minimum capital of 15 per cent of aggregate risk-weighted assets, including credit risk and market risk (Appendix Table VI.2). The market risk capital is maintained at the higher end of that estimated under standardised model and the value-at-risk (VaR) method.

Table VI.21: Non-performing Assets of NBFCs

(per cent of credit exposure)

As at end of period	Gross NPAs	Net NPAs
1	2	3
March 1998	11.4	6.7
September 1998	6.4	4.1
March 1999	10.2	7.0
September 1999	7.7	4.4
March 2000	9.9	9.5
September 2000	10.0	6.3
March 2001	11.5	5.6
September 2001	12.0	5.8
March 2002	10.6	3.9
September 2002	9.7	4.3

6.48 Aggregate CRAR for the PDs fell from 38.4 per cent as at end-March, 2002 to 29.7 per cent as at end-March 2003. This was largely due to higher market risk factoring in the volatilies in VaR measure, in the wake of the Iraq war threat (early 2003) and tension at the Indian borders (May 2002). However, the consistent rise in the share of Government securities in the total assets indicate the reduction in the risk profile of the balance sheet.

Table VI.22: Select Indicators of the Primary Dealers (end-March)

(Amount in Rs. crore)

Variable	2001	2002	2003
1	2	3	4
Number of PDs	15	18	18

Total Capital Funds	3,184	4,371	5,055
CRAR (per cent)	40.9	38.4	29.7
Total assets (net of current liabilities and provisions)	14,772	15,305	17,378
Of which: Government Securities	10,401	12,217	14,573
Government securities as percentage of total assets	70	80	84
Return on Average Assets	—	8.4	6.6
Return on Average Net Worth	—	38.7	24.2
Liquidity Support limits	6,000	4,000 (Normal) 2,000 (Backstop)	3000 [Normal] 1500 (Backstop)

18. Other Developments

Information on directors, change of address, etc., in respect of NBFCs

6.49 Every NBFCs (including government companies, irrespective of whether they hold / accept deposits or not) have to inform any change in the address of its registered office, names of its directors, principal officers, authorised signatories and auditors within 30 days of the occurrence of the event.

Developments pertaining to Informal Advisory Group on NBFCs

6.50 An institutionalised decision-making mechanism in the form of an Informal Advisory Group, set up by the Reserve Bank in 1998, has been found to be extremely useful in the formulation of several policy decisions, regulatory measures and amendments to the directions, accounting procedures and policy. The Group deliberates on various issues emanating from the difficulties in compliance with the regulatory framework and serves as a forum for consulting professional bodies, experts and NBFCs themselves. The terms of the Group and its constitution is reviewed every year. The Group comprised a representative each of the ICAI, one regional-level and two apex-level associations of NBFCs, chief executives of one small- and three large-sized NBFCs, besides the functionaries of the Reserve Bank. The Group held two meetings during 2002-03.

Depositor Protection

6.51 The Reserve Bank has initiated several measures for the benefit of depositors, especially given the large number and varying size of various NBFCs. These measures include:

- upgrading legal recourse, by pursuing the enactment of legislation for protection of interest of depositors in financial establishments;
- greater transparency, through an extensive publicity campaign using the print and electronic media to educate the depositors;
- enhancing the effectiveness of supervision, by conducting i) training programmes for personnel / executives of NBFCs in order to familiarise them with the objectives, genesis and focus of the Reserve Bank regulations, ii) seminars for the civil and police personnel

of the State Governments, and iii) training programmes/seminars for auditors in association with the ICAI, to familiarise them with the directions and regulations of the Reserve Bank as applicable to the NBFCs as also the directions applicable to statutory auditors of the NBFCs; and

- reinforcing inter-regulator co-ordination by holding meetings with other regulators like the Registrars of Companies, Department of Company Affairs of the Central Government as well as the civil and police officials of the State Governments.

Web Project

6.52 The Reserve Bank initiated a web project for creating an environment wherein all deposit-taking NBFCs would be able to submit their regulatory returns in electronic form. The rationale behind the project is to eliminate the time-consuming process of data entry at the Reserve Bank's Regional Offices. The scheme envisages that the NBFCs would log on to the Reserve Bank's web site through the internet, access the formats prescribed for reporting, fill in the formats off-line or on-line as per their convenience and submit the returns to the web server. In order to execute the project, a web-enabled COSMOS package was developed and loaded on the web server located at the Institute for Development and Research in Banking Technology (IDRBT), Hyderabad and the server has been mapped to the internet with a link as http:\\dnbsco.infinet.org.in. After the successful testing of the package in an internet environment locally and in collaboration with the Regional Offices of the Reserve Bank, the package is now free from bugs and security threats. The Reserve Bank has been encouraging NBFCs to join the project.

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* As in earlier years, while policy developments in this chapter cover fiscal 2002-03, the analysis of performance of NBFCs is primarily restricted to 2001-02 because of lags in the availability of data.

** The Department of Company Affairs (DCA), Government of India has taken over the entire regulation of mutual benefit financial companies and mutual benefit companies from September 29, 2003.

[1] Net owned fund (NOF) of NBFCs is the aggregate of paid-up capital and free reserves, netted by: (i) the amount of accumulated balance of loss, (ii) deferred revenue expenditure and other intangible assets, if any, (iii) investments in shares of (a) subsidiaries, (b) companies in the same group and (c) other NBFCs, and (iv) loans and advances to (a) subsidiaries and (b) companies in the same group in excess of 10 per cent of owned fund.

[2] Public deposits include any receipt of money by way of deposit or loan or in any other form excluding amounts received as share capital, borrowings from the Central and State Governments, foreign governments, banks, institutions, registered money lenders, *chit* subscription, money received as advance against sale of assets, dealership deposits, security deposits, the money received from other companies and mutual funds, money raised by issue of optionally convertible debentures, secured debentures, hybrid debts/subordinated debts and commercial papers, deposits received from the directors and their relatives and deposits accepted by a private company from its shareholders.

[3] Notes on Account in the balance sheet by public sector banks include: percentage shareholding of the Government of India; percentage of net NPA to net advances; amount of provisions made towards NPAs; depreciation in the value of investment and income tax, separately; capital adequacy ratio (Tier-I and Tier-II capital), separately; sub-ordinated debt raised as Tier-II capital; gross value of investments in and outside India; aggregate of provisions for depreciation and net value of investments; interest income as percentage to average working funds; non-interest income as percentage to average working fund; operating profit as percentage to average working fund; return on assets; business per employee; profit per employee; maturity pattern of loans and

advances; maturity pattern of investments in securities; foreign currency assets and liabilities; movements in NPAs; maturity pattern of deposits and borrowings; lending to sensitive sectors; treatment of restructured accounts; investments in shares; investments in convertible debentures; units of equity-oriented mutual funds held; movement of provisions held towards NPAs and movement of provisions held towards depreciation on investments.

[4] Chapter II provides details in this regard.

[5] The ceiling on the interest rate offered on public deposits by NBFCs was 16 per cent till March 31, 2001.

[6] NBFCs are required to maintain Tier-I and Tier-II capital which should not be less than (a) 10 per cent on or before March 31, 1998; and (b) 12 per cent on or before March 31, 1999, of its aggregate risk-weighted assets and of risk-adjusted value of off-balance sheet items. The total of Tier-II capital, at any point of time, shall not exceed 100 per cent of Tier-I capital.