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Non-banking Financial Institutions - Summary of the Recent Amendments to the RBI Act

Background

The activities of non-banking financial companies (NBFCs) were being regulated by the provisions of Chapter IIIB of the Reserve Bank of India Act, 1934 (the RBI Act) for over three decades. The emphasis of these regulations was, however, on the acceptance of deposit by NBFCs mainly as an adjunct to monetary and credit policy. Over the years, these companies have become an important segment in the financial system of the country. Besides, there has been inter-penetration of the markets, both, by banks and non-banks resulting in erosion of the distinction between these two kinds of institutions within the group of financial institutions. These developments have rendered the existing regulatory framework inadequate to regulate the activities of NBFCs and provide protection to the depositor. With a view, therefore, to effectively regulating the NBFCs and thereby improving their financial health and viability, an Ordinance effecting comprehensive changes in the provisions of Chapters IIIB and V of the RBI Act was promulgated by the Government of India on January 9, 1997.

The Ordinance has since been replaced by the Reserve Bank of India (Amendment) Act, 1997. The amended Act has also modified the provisions of Chapter IIIC of the RBI Act relating to acceptance of deposits by unincorporated bodies. While the provisions of Chapter IIIB and V have come into effect from the date of the Ordinance, that is January 9, 1997 those relating to Chapter IIIC are effective from April 1, 1997. The salient features of the amended Act are summarised below:

Chapter IIIB

Definition

- i. The "business of a non-banking financial institution" is defined to mean carrying on the business of a financial institution referred to in clause (c) of section 45I of the Act and includes business of a non-banking financial company referred to in clause (f) *ibid*.
- ii. A company engaged in industrial activities or agricultural operations as its principal business is excluded from the definition of 'financial institution'.
- iii. A non-banking financial company has been defined to mean:
 - a. a financial institution which is a company;

- b. a non-banking institution which is a company and which has as its principal business the receiving of deposit under any scheme or arrangement or in any other manner, or lending in any manner; or
- c. any other non-banking institution notified by the Reserve Bank.

Entry Point Norm

- i. An NBFC is required to have a certificate of registration and also have a net owned fund (NOF) of not less than Rs. 25 lakh to commence or carry on the business of a non-banking financial institution. The Reserve Bank, however, can raise the minimum NOF requirement up to Rs. 2 crore. Every NBFC existing as on January 9, 1997 is required to apply to the Reserve Bank for registration before July 8, 1997. NBFCs which are already registered with the Reserve Bank under the earlier guidelines are also required to apply to the Reserve Bank again for registration. NBFCs which were in existence before January 9, 1997 would be allowed to carry on their business until a certificate of registration is issued to them or rejection of their application for registration is communicated to them.

NBFCs having NOF of less than Rs.25 lakh as on January 9, 1997 may carry on their activities but will be required to attain the prescribed NOF of Rs.25 lakh within a period of three years from the date of the Ordinance. The Reserve Bank may, for sufficient reasons, extend this time limit by another three years, subject to the condition that such NBFCs should intimate about their attaining the required NOF to the Reserve Bank within three months from the date of such attainment.

The Reserve Bank is empowered to cancel the certificate of registration issued to any NBFC for failure on the part of the NBFC to fulfil the conditions as laid down under section 45IA of the RBI Act, 1934. A company, aggrieved by the Reserve Bank's order of rejection of application or cancellation of certificate of registration may prefer an appeal to the Central Government within a period of 30 days.

Application Forms for Registration

Necessary application forms for registration will be available at the Regional Offices of Department of Supervision (Financial Companies Wing) of the Reserve Bank. NBFCs are advised to obtain application forms from the concerned Regional Office having jurisdiction over the area where the registered office of the company is located.

Maintenance of Liquid Assets

The NBFCs are required to invest, on a daily basis five per cent of their deposits outstanding at the end of the last working day of the second preceding quarter. The investments will have to be in unencumbered approved securities valued at their market price. The Reserve Bank may also prescribe a higher percentage of liquid assets not exceeding 25 per cent. The Reserve Bank may fix different percentages of investment for different types of companies. For failure to maintain the required percentage of liquid assets in the prescribed manner, the Reserve Bank has been empowered to impose a penalty at the rate of three per cent per annum above the bank rate on the amount of shortfall. If the shortfall continues in the subsequent quarter/s, the penalty would be at the rate of five per cent per annum above the bank rate on the amount of shortfall for subsequent quarters during which the default continues.

Reserve Fund

Every NBFC is required to create a reserve fund and transfer to it every year an amount not less than 20 per cent of its net profit before declaring any dividend. Appropriation from the Reserve Fund is permitted only for the purposes specified by the Reserve Bank.

Prudential Norms and Deployment of Funds

The Reserve Bank has been authorised to determine the policy and issue directions from time to time to the NBFCs regarding income recognition, accounting standards, classification of assets, provisioning for non-performing assets and capital adequacy. The Reserve Bank has also been vested with powers to issue directions to the NBFCs regarding the purpose, quantum of loans and advances and other deployment of funds.

Issue of Directions to NBFCs and Auditors regarding Financial Statements

The Reserve Bank has been empowered to issue directions to the NBFCs and to their auditors regarding matters relating to the profit and loss account, balance sheet and books of account, disclosure of liabilities or any other matter. The Reserve Bank has also been empowered to get a special audit of any NBFC done, appoint an auditor/auditors for the purpose and to issue directions to the auditor/auditors. The remuneration of the auditors for conducting such audit will have to be borne by the NBFC concerned.

Prohibition on Acceptance of Deposits and Transfer of Assets

The Reserve Bank has been empowered to prohibit any NBFC from accepting any deposit for violation of any provisions of the RBI Act. Direction may also be issued to an NBFC not to sell or transfer any of its assets for a period not exceeding six months from the date of the prohibitory order without prior permission from the Reserve Bank.

Winding up of NBFCs

The Reserve Bank has been empowered to file petition for winding up of an NBFC in certain circumstances as enunciated under the newly introduced provisions of section 45MC.

Enforcement of Repayment of Deposit by the Company Law Board

Every deposit accepted by an NBFC is required to be repaid, unless renewed, as per the terms and conditions of the deposit. Where an NBFC fails to repay any deposit, the Company Law Board, either on its own or on being approached by a depositor/depositors, may direct the NBFC to repay the deposit forth with, or within such time and subject to such conditions as may be specified.

Nomination Facility

Nomination facility for deposits held by a non-banking institution has been introduced on the lines of bank deposits. Nomination rules are being framed.

Chapter V

Penalty

The Reserve Bank has been empowered to impose penalty on NBFCs for violation of the provisions of the RBI Act. For carrying on business without a certificate of registration, the Reserve Bank can impose a fine up to the extent of Rs. 5 lakh or twice the amount involved in such contravention, where the amount is quantifiable, whichever is more. A continuing default involves a further penalty of up to Rs.25,000 for every day after the first day of such default. For any other contravention, a fine not exceeding Rs. 5,000 can be imposed by the Reserve Bank. Apart from this, carrying on business without a certificate of registration is an offence punishable with imprisonment of not less than one year which may extend to five years and with a fine of not less than one lakh rupees which may extend up to Rs. 5 lakh. Non-compliance with the orders of the Company Law Board is punishable with imprisonment up to three years and a fine of not less than Rs. 50 every day during which such non-compliance continues. If any auditor fails to comply with any direction given by the Reserve Bank, he will be punishable with a fine up to Rs. 5,000.

Chapter III C

Acceptance of Deposits by Unincorporated Bodies

The amended RBI Act has modified the erstwhile provisions of section 45S of the Reserve Bank of India Act, 1934 relating to acceptance of deposits by unincorporated bodies. The amended provisions have come into effect from April 1, 1997. As per the amended provisions of section 45S of the RBI Act, unincorporated bodies such as, individuals, firms or unincorporated associations of individuals have been prohibited from accepting any deposit, if :

- i. the business of such unincorporated bodies either wholly or partly includes any of the activities of financing, or acquisition of securities, letting or delivering of goods under hire purchase agreement, managing, conducting or supervising, as foreman of chits or kuries.
- ii. the principal business of unincorporated bodies is that of receiving deposits or lending in any manner. An individual or a partner of a firm carrying on such activities has, however, been permitted to accept deposits from relatives and borrow money from certain institutions as specified in the RBI Act.

Any person other than a body corporate, who holds any deposit as on April 1, 1997, which is not in accordance with the provisions of the RBI Act, will be required to repay such deposits either on the maturity of the deposits or within a period of three years from April 1, 1997, whichever is earlier. If any person is unable to repay a part of the deposits for reasons beyond his control or such repayment will cause extreme hardship to him he

should make an application to the Reserve Bank for extension of time for such repayment. The Reserve Bank may, if it is satisfied, by an order in writing, extend such period by a period not exceeding one year subject to such conditions as may be specified by it.

For the purpose of the above provisions, the term 'deposit' has been defined in the RBI Act to include any receipt of money by way of deposit or loan or in any other form, but will not include receipt of money by any person by way of share capital, contribution by partners to the capital of a firm, amounts received from banks and specified financial institutions, amounts received in the ordinary course of business by way of security deposit, dealership deposit, earnest money, advance against orders for goods, properties or services, subscription in respect of chit or any amount received from any unincorporated body registered under any Act relating to money lending.

Prohibition on Issue of Advertisements

Unincorporated bodies are prohibited from issuing any advertisement in any form for soliciting deposit with effect from April 1, 1997.

Penalty

Receipt of deposit in contravention of the above provisions would amount to an offence punishable with imprisonment for a term which may extend to two years or with fine which may extend to twice the amount of the deposit so received or Rs. 2,000, whichever is more, or with both.

It may be mentioned here that in terms of the provisions of the Reserve Bank of India (Amendment) Ordinance, 1997, acceptance of deposit from public by any person, other than a body corporate was prohibited except for personal use. The intention of the amendment was, however, not to prohibit individuals, partnership firms and unincorporated associations of individuals from accepting deposits or borrowings for their own non-financial business. The intention was only to prevent unincorporated bodies from accepting deposits for the purpose of lending. The provisions have been suitably modified in the amendment Act.

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