REPORT OF THE WORKING GROUP ON FINANCIAL COMPANIES

RESERVE BANK OF INDIA

BOMBAY

SEPTEMBER 1992

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बम्बई

RESERVE BANK OF INDIA
BOMBAY.

September 5, 1992

The Governor,
Reserve Bank of India,
Bombay.

Dear Sir,

We submit herewith the Report of the Working Group on Financial Companies.

Yours faithfully,

A.C. Shah
(Chairman)

G.Venkataramanan

Y.H.Malegam

Anita Kapur

P.K.Parthasarathy

O.P.Chawla

Pulapre Balakrishnan

Deepak S.Parekh

Ved Prakash

T.Ramabhadran

D.N.Samarth

K.S.Shere

S.S.Karnik
(Member Secretary)

C O N T E N T S

ABBREVIATIONS USED IN THE REPORT

ABBREVIATION	TERM
1983 Act	Banking Laws Amendment Act, 1983
Advertisement Rules	Non-Banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977
Banning Act	Prize Chits and Money Circulation Schemes (Banning) Act, 1978
Board	High Powered Supervisory Board
CD	Certificate of Deposits
Companies Act	The Companies Act, 1956
DCA	Department of Company Affairs, Government of India
DNBC	Department of Non-Banking Companies
ELC	Equipment Leasing Company
FI	Financial Institution
HFC	Housing Finance Company
HFC Directions	Housing Finance Companies (NHB) Directions 1989
HPFC	Hire Purchase Finance Company
HPFI	Hire Purchase Financial Institution
IC	Investment Company
LC	Loan Company
MBFC	Mutual Benefit Financial Company
MFC	Miscellaneous Finance Company
MNBC	Miscellaneous Non-Banking Company
MNBC Directions	Miscellaneous Non-Banking Companies (Reserve Bank) Directions 1977

ABBREVIATION	TERM
NBC	Non-Banking Company
NBFC	Non-Banking Financial Company
NBFC Directions	Non-Banking Financial Companies (Reserve Bank) Directions 1977
NBFI	Non-Banking Financial Institution
NBI	Non-Banking Institution
NBNFC	Non-Banking Non-Financial Company
NHB	National Housing Bank
NHB Act	National Housing Bank Act, 1989
NOF	Net Owned Fund
RBI	Reserve Bank of India
RBI Act	Reserve Bank of India Act, 1934
RNBC	Residuary Non-Banking Company
RNBC Directions	Residuary Non-Banking Companies (Reserve Bank) Directions 1987
ROC	Registrar of Companies
SEBI	Securities and Exchange Board of India
SRO	Self Regulating Organisation
SCB	Scheduled Commercial Bank

CHAPTER-I
INTRODUCTORY

GENESIS OF THE WORKING GROUP

1.1 The liberalisation and diversification of the financial system - institutions and instruments - in recent years have significantly enlarged the scope and activities of the Non-Banking Financial Companies [NBFCs]. Now over a year, major changes have taken place in different sectors of the economy with a view to correcting the macro- economic imbalances and promoting productivity and efficiency. The financial sector is no exception. The Committee on Financial System, under the chairmanship of Shri M. Narasimham, examined all aspects relating to the structure, organisation, functions and procedures of the financial system and was in favour of bringing NBFCs within the ambit of regulation. The growth of the non-banking financial services sector in India has been accompanied by a corresponding growth in the number of NBFCs offering a diversified range of financial services and products. These companies form an integral part of Indian financial system and a need has been increasingly felt for rationalisation of the regulatory framework for these companies, keeping in view the trend towards liberalisation of the economy in general and the financial sector in particular.

1.2 In order to make an in-depth study of the role of NBFCs and suggest regulatory and control measures to ensure healthy growth and operations of these companies, Reserve Bank of India [RBI] constituted the present Working Group [the Group] by an order dated May 5, 1992. The composition of the Group was as follows :-

1.	Dr. A.C. Shah, Chairman & Managing Director, Bank of Baroda, Bombay.	Chairman
2.	Shri G. Venkataramanan, Additional Secretary, Department of Company Affairs, Government of India, Ministry of Law, Justice & Company Affairs, New Delhi.	Member

3.	Smt. Anita Kapur, Deputy Secretary, Department of Economic Affairs, Ministry of Finance, Government of India, New Delhi.	Member
4.	Shri Y.H. Malegam, Partner, S.B. Billimoria & Co., Chartered Accountants, Bombay.	Member
5.	Shri P.K. Parthasarathy, Executive Director, National Housing Bank, New Delhi.	Member
6.	Shri Deepak S. Parekh, Managing Director, Housing Development Finance Corporation Ltd., Bombay.	Member
7.	Dr. O.P.Chawla, Director, National Institute of Bank Management, Pune.	Member
8.	Dr. Pulapre Balakrishnan, Associate Professor, Indian Statistical Institute, Bangalore and Associate Fellow, Centre for Development Studies, Thiruvananthapuram.	Member

Shri Ved Prakash, Chairman, Motor & General Finance Ltd. New Delhi.	Member
Shri T. Ramabhadran, Managing Director, Sundaram Finance Ltd., Madras.	Member
Shri D.N. Samarth, Chief Officer, Financial Institutions Cell, Reserve Bank of India, Bombay.	Member
Smt. K.S. Shere, Legal Adviser, Reserve Bank of India, Bombay.	Member
Shri S.S. Karnik, Chief Officer, Department of Financial Companies, Reserve Bank of India, Calcutta.	Member- Secretary

TERMS OF REFERENCE

The terms of reference of the Group were as under:

i) To review the role of various categories of non-banking financial intermediaries at present existing in the country such as loan/investment/ equipment leasing/hire purchase/mutual benefit financial companies [MBFCs]/ miscellaneous non-banking companies [MNBCs]/ residuary non-banking companies [RNBCs] and housing finance companies [HFCs] and similar such institutions.

ii) To review the relative provisions of the Reserve Bank of India Act, 1934 [RBI Act], Non-Banking Financial Companies (Reserve Bank) Directions, 1977 [NBFC Directions] Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977 [MNBC Directions], Residuary Non-Banking Companies (Reserve Bank) Directions 1987 [RNBC Directions], the National Housing Bank Act, 1987 [NHB Act] and the Housing Finance Companies (NHB) Directions, 1989 [HFC Directions] and assessing their adequacy in regulating the conduct of business of non-banking companies covered by these Directions in the context of the monetary and credit policies laid down by the Reserve Bank from time to time; to suggest measures for further strengthening legislative provisions governing such institutions so that these institutions subserve the national interest and serve more effectively as an adjunct to the regulation of the monetary and credit policy of the country.

iii) To enquire into methods of operation of these non-banking financial intermediaries [NBFIs] and to recommend measures for ensuring an orderly growth and, in particular, the eligibility criteria for their entry, growth and exit, their viability, capital adequacy, liquidity ratio, debt-equity ratio, credit concentration ratio, disclosure requirements and other prudential norms such as deployment of their resources, creation of reserves and norms for their expenditure, accounting practices and procedures, etc.

iv) To consider the adequacy or otherwise of the supervision and control presently exercised by the Reserve Bank and National Housing Bank [NHB] over such institutions and suggest measures for further strengthening them and also the suitable agency necessary for exercising such control.

v) To examine the adequacy of degree of protection to the depositors' money and to recommend appropriate measures therefor.

vi) To make recommendations on any other related matter which the Working Group may consider germane to the subject of enquiry or any related matter which may specifically be referred to the Working Group by Reserve Bank of India.

SCOPE OF THE STUDY

1.4 As per the order of RBI dated May 5, 1992, referred to hereinabove, the working of non- banking non-financial companies [NBNFCs] did not fall within the scope of the study of the Group. The Group has confined its deliberations to the functioning of and the regulations required for NBFCs only.

METHODOLOGY

1.5 In its study of the NBFCs, the group faced two constraints. First, the data available for a thorough analysis, more particularly the asset composition of NBFCs, was inadequate. Second, within the limited period available, the Group endeavoured to cover various intricate issues.

1.6 The Group has relied on readily available data. Further, the Group issued a circular letter dated June 18, 1992, to certain bankers, economic fora, chambers of commerce and industries, associations of NBFCs, other institutes like Institute of Chartered Accountants, Indian Banks' Association, etc., as also to certain eminent persons having intimate knowledge of the functioning of NBFCs and invited them to submit detailed memoranda on specific points referred to in Terms of Reference and various matters pertaining to the functioning of NBFCs listed in Appendix I of this Report.

1.7 The Group held discussions with some of the leading personalities from the Industry as also from banks/financial institutions. The Chairman and the Member-Secretary visited Madras, New Delhi and Hyderabad to have discussions with certain knowledgeable persons. Four members of the Group also attended at Hyderabad, the meeting of the members of the Management Committee of Equipment Leasing Association and the Federation of Indian Hire Purchase Associations and had detailed discussions with the members of these industries.

1.8 A set of questionnaires was circulated to over 200 NBFCs in different categories. A list of institutions which submitted memoranda, together with a list of those NBFCs which responded to the questionnaire and the persons with whom the Group members had meetings is given in Appendices II and III. For formulating its views, the Group has made use of the information gathered through these sources also.

1.9 Various issues that emerged from these discussions were deliberated upon and the recommendations of the Group are the end result of this process. The Group held six meetings in all.

SCHEME OF THE REPORT

1.10 After reviewing, in brief, in Chapter II the approach and recommendations of the Banking Commission, the Bhabatosh Datta Study Group, the James Raj Study Group, the Chakravarty Committee, the Vaghul Committee and the Narasimham Committee, Chapter III outlines the emergence and growth of NBFCs, the role of various categories of NBFCs and their methods of operation. Chapter IV outlines the implications of operations of NBFCs on monetary policy. Also summerised here are some of the important features of non-bank financial sector regulation in some other countries. Chapter V describes the existing legal framework viz. Chapter IIIB of RBI Act, NHB Act and the Directions issued thereunder. Chapter VI details recommendations of the Working Group for the new regulatory framework, which in the Group's view, is necessary for (i) encouraging orderly growth of NBFCs in our country, (ii) protecting depositors' money and (iii) ensuring the efficacy of monetary and credit policy. These recommendations cover various facets of regulation, including the suitable agency for regulation, the need for licensing/registration and the eligibility criteria therefor, prudential norms, reporting requirements, accounting systems, inspection, norms for acceptance of deposits and lending, deposit insurance, credit rating, need for public awareness campaigns and so forth. The regulatory systems in certain other countries have also been studied and a brief review of regulations prevailing in these countries, viz., the U.K., the U.S.A., Australia, Malaysia, West Germany, Hongkong and Singapore is given in Appendix IV.

APPROACH OF THE WORKING GROUP

1.11 The volume of deposits collected by the NBFCs is small compared to that of the commercial banks. However, the fact cannot be gainsaid that they have a positive role to play in accessing certain depositor segments and catering to specialised credit requirements of certain classes of borrowers. Growth and diversification of NBFCs is an integral part of the development process of the financial market of any economy. The Working Group is of the view that from the angle of depositors' protection and efficacy of monetary and credit policy, what is really required is a well- integrated regulatory framework which, while monitoring and supervising the operations of NBFCs, recognises and also encourages the emergence of new types of financial services and products.

1.12 The approach of the Working Group revolves round the conviction that a thriving, healthy and growing non-banking financial sector is necessary for promoting the growth of an efficient and competitive economy. The aim of regulation is to achieve the above objective. The recommendations of the Working Group are based on the need for putting in place a cohesive regulatory system which will be uniform in its application to all categories of NBFCs.

1.13 Two guiding principles of the proposed system are

(i) the need to discourage unsound NBFCs and (ii) the need for the application to NBFCs of some of the prudential norms that are being applied to banks in view of considerable similarity in their functions. The immensity of the task, due to a large number of entities operating in the financial markets, both in the organised and unorganised sectors, has to be taken into account. It must also be recognised that prohibiting the operations of NBFCs in the unorganised market may be near-impossible in view of the limited administrative infrastructure available with the regulatory authority.

ACKNOWLEDGEMENT

1.14 The Group has immensely benefitted from the discussions the members had with Shri S.Venkitaramanan, Governor, RBI. The first meeting of the Group was addressed by Shri S.S.Tarapore, Deputy Governor and Shri W.S.Saraf, Executive Director, RBI . Shri Tarapore explained the concerns of RBI regarding the working of NBFCs. He said that the number of these companies had increased considerably in the last two decades, but the number of reporting companies was rather small. He added that a disturbing feature observed was that some of the NBFCs had challenged the very basic legislative framework. The financial sector was undergoing rapid changes. In this context, he raised some of the questions for the Group to deliberate upon, such as the ways and means of making these companies fit into the new financial structure, nature of prudential norms for these companies which would be effective but at the same time practical and feasible, type of supervisory authority re-

quired, etc. Shri Saraf raised several issues such as categorisation of companies, norms for raising deposits, classification of deposits, periodic census of non-banking companies, etc.

1.15 The Group has richly benefitted from the discussions it had with Shri M.Narasimham, Chairman, Administrative Staff College of India, Dr. C. Rangarajan, Member, Planning Commission, Shri T.S. Santhanam and Shri R.K. Seshadri of Sundaram Finance Ltd., Shri A. Hasib, Director General, Shaikh Mohd. Ali Allah Bux Urban Banking Development Institute, New Bombay. Shri Farouk Irani was a special invitee for some of the meetings and the Group gratefully acknowledges his valuable contribution. The Group would also like to record its appreciation for the important suggestions received from Shri Devendra Ahuja and Shri V.S. Srinivasan of 20th Century Finance Corporation Ltd. The Group received memoranda from various institutions, associations and individuals, and an encouraging response to its questionnaire from a large number of companies. The Group also had discussions with representatives of several institutions, associations and companies. The Group is grateful to all of them.

1.16 Shri R.Aghoramurthy, Regional Director, Department of Company Affairs, Bombay, represented Shri G.Venkataramanan, Additional Secretary, Dept. of Company Affairs, Government. of India, Ministry of Law, Justice and Company Affairs, New Delhi in several Group meetings and actively participated in the deliberations . The Group places on record his contribution.

1.17 The Group owes a special debt to its Member Secretary, Shri S.S. Karnik who, from his rich experience, made valuable contribution to the deliberations of the Group. The Group was ably assisted by Shri V.K. Bhagnani, Shri Mohindar Kumar and Shri R.K. Das of the RBI and Smt. Minal A. Bhagat and Dr. Parameshwara N. of Bank of Baroda. The Group would like to record its deep appreciation of the yeoman services rendered by them. These officers participated in all the deliberations of the Group and provided exemplary support all along in the preparation of the Report. Dr. A. Vasudevan, Shri S. Bandyopadhyay and Dr. Narendra Jadhav, RBI, Bombay and Dr.K.C. Chakraborty, Bank of Baroda also rendered considerable help to the Group.

1.18 The Group is indebted to Shri Vijay Gawandalkar and Kum. Savitri Jhurani for providing commendable secretarial support.

CHAPTER-II

BRIEF REVIEW OF THE RECOMMENDATIONS OF EARLIER COMMITTEES : RELEVANCE TO NON-BANKING FINANCIAL COMPANIES

2.1 NBFCs have been operating for quite a long time. However, an attempt to regulate them started only in the sixties. Regulation of these institutions was found necessary for the following three reasons, viz. (i) ensuring efficacy of credit and monetary policy, (ii) safeguarding depositors' interest and (iii) ensuring healthy growth of NBFIs. Thus, the Banking Laws (Miscellaneous Provisions) Act, 1963 was introduced to regulate the NBFIs. Subsequently, to enable the regulatory authorities to frame suitable policy measures, several committees were appointed from time to time to conduct indepth study of these institutions and make suitable recommendations for their healthy growth within a given regulatory framework. Each committee has made recommendations considering the contemporary financial scenario. Their suggestions have become the basis for formulation of policy measures by the regulatory authorities.

2.2 In this chapter, the major recommendations pertaining to the working of Non-Banking Financial Intermediaries [NBFIs] contained in the reports of the Study Groups under the Chairmanship of Dr. Bhabatosh Datta (1971) and Shri James Raj (1975) have been summarised. Recommendations of three other Committees/Groups that made certain observations on the working of this sector have also been referred to. These are, (i) the Committee to Review the Working of the Monetary System (Chakravarty Committee - 1985), (ii) the Working Group on the Money Market (Vaghul Committee - 1987) and (iii) the Committee on the Financial System (Narasimham Committee - 1991).

2.3 In recognition of the fact that NBFIs are an integral part of the money market and that for efficient working of the financial system, all parts of the system need to be well integrated and regulated, RBI has striven to promote their orderly growth. It is against this background that from time to time various study groups as referred to hereinabove have been appointed by the Government of India and RBI for examining the role and regulatory framework of NBFCs. The major recommendations of these Committees/Groups are set out hereunder.

BHABATOSH DATTA STUDY GROUP

2.4 The examination of the role and operations of NBFIs constituted a part of the Terms of Reference of the Banking Commission (1970), which in turn appointed a sub-group under the chairmanship of Dr. Bhabatosh Datta for the study of this particular segment of the financial system. The Group observed that NBFIs usefully supplemented the activities of banks in the fields of both deposit mobilisation and lending and that they were capable of playing a dynamic role in the economy. The Group also observed that despite the miniscule size of their operations as compared to that of the banking sector, there was a need to regulate the activities of NBFIs for ensuring the safety of depositors' funds and efficacy of the credit policy on the one hand and encouraging their orderly growth on the other.

2.5 The Group recommended that, keeping in view the difficulties in regulating a very large number of institutions, regulation should aim at reducing the number of entities to be regulated, if possible, by inducing them to form themselves into corporate bodies. For the purpose of regulation, NBFIs may be classified into two categories - **'approved'** and **'non-approved'**. While a specified minimum degree of control may be exercised on all NBFIs, the 'approved' NBFIs, i.e., those which satisfy certain additional requirements (such as adequate amount of capital, reserves, liquid assets, etc.) as laid down by the regulatory authority, may be accorded a special and favourable treatment. Whether an institution was to be categorised as 'approved' or not, was to be left to the judgement of the regulatory authority, keeping in view the quality and scope of the operations of each institution. The Group also suggested that the designation of 'approved' institutions should be bestowed only on corporate bodies and these should be eligible for refinance from the banking system. Their lending operations should also be covered under the Credit Guarantee Scheme and, at an appropriate time, deposit insurance should also be extended to the deposits of those institutions whose manner of conducting business was in conformity with the requirements of the Deposit Insurance Corporation.

2.6 The Group examined the role of the following categories of financial intermediaries:

1. Hire-Purchase Finance Institutions (HPFIs).

2. Investment Companies.

3. Chit Funds/Kuries.

4. Nidhis or Mutual Benefit Funds.

5. Finance Corporations.

The Group opined that the regulatory approach needed to be tailored to the special characteristics of the different types of NBFIs and hence made recommendations for each category separately as discussed below.

2.7 As regards **HPFIs**, the Group observed that their organisational structure in the private sector was not strong enough to take care of the likely demand for hire-purchase credit in future and suggested that there was a need to institutionalise hire-purchase credit and encourage the formation and growth of stronger and larger-sized units. Apart from extending the categorisation of 'approved' and 'non-approved' institutions to this field, the Group recommended that all HPFIs should be compulsorily licensed and the Licensing Authority should be given powers to revoke the licence in case it was satisfied that the operations of a particular unit were unsatisfactory. The Group also recommended that the HPFIs should be required to indicate the true rate of interest charged alongwith the flat rate (i.e., the rate calculated on the basis of the entire amount of advance and not on a diminishing balance basis) which, in practice, was the rate at which HPFIs charged interest. With a view to encouraging healthier and larger-sized units, the Group recommended that permissible debt-equity ratio should increase directly with the size of capital of the unit and the liquidity ratio should be higher for smaller units and lower for bigger units and, in any case, not less than 10 per cent for any unit. Further, the Group recommended that commercial banks may consider entering this field and for enabling them to promote hire-purchase subsidiaries, suitable amendments may be considered in the Banking Regulation Act. It also recommended that interest rate ceiling on hire-purchase charges be prescribed at a flat rate of 10 per cent p.a. for new vehicles and 12 per cent p.a. for old vehicles.

2.8 An examination of the operations of **investment trust companies and unit trusts**, brought the Group to the conclusion that although the genuine investment companies were playing a very limited role in Indian economy, given proper encouragement, they could play a more useful role. Investment preferences in India were so varied that these institutions could create new financial assets to suit the requirements of various classes of savers in the economy. They also recommended that the Government could consider offering to genuine investment companies relief from inter- corporate tax, provided that the companies were prepared to have the same obligations as Unit Trust of India (UTI) i.e., diversification of investments, distribution of a specified minimum portion of income, regulation by authorities, etc. The Group also laid down the criteria for identifying a genuine investment company and submitted that while the number of genuine investment companies was small and, as such, separate regulatory machinery was not required, it would be useful to enact a separate legislation on the lines of the Investment Companies Act of the U.S.A., with the object of protecting the interests of the members of these companies. They also suggested that no industrial or trading company should be permitted to hold any shares in investment companies and that the Government may consider appointing its nominees on the board of directors of genuine investment companies, with a view to ensuring independence of management.

2.9 As regards the working of **Chit Funds** in India, the Group observed that although many among these institutions frequently resorted to unfair methods, it may not be advisable to prohibit them because they were meeting the need of a particular sector of the economy and prohibiting their operations would leave a credit gap; the Group recommended that, instead, these entities should be suitably regulated. They suggested that the ultimate solution to the problem was for the commercial banks to introduce schemes similar to Chit Funds, but without the disadvantages associated with them and, in the meantime, the State Governments could consider starting Chit Funds. Depending on the constitutional position, whether Chit Funds came under the Union list, Concurrent list or State list, either an All India Chit Fund Law may be enacted by the Central Government or a Model Law may be framed, which may then be adopted by State Governments. Further, the Group recommended that to suitably regulate the companies which had registered offices in States having Chit Fund laws and which were operating through branches in those States which did not have such laws (with a view to circumventing regulation), the provisions of Chit Fund laws of the home State of the companies should be made applicable even for their operations in other States. The Group also recommended that offence under Section 294 A of the Indian Penal Code relating to lotteries may be made a cognizable offence so that prize chits could be prohibited.

2.10 While reviewing the operations of **Nidhis or Mutual Benefit Funds**, the Group observed that this category of institutions was performing a useful role and their growth should be encouraged. As their working was akin to commercial banking, they should also be subjected to regulation. For Nidhis which accept demand deposits, the regulations could be similar to those applicable to commercial banks. As regards other Nidhis, they may be licensed by the RBI. Such norms as the minimum amount of paid-up capital and reserves, minimum level of liquidity ratio, etc., may be prescribed. Periodical inspections of these companies should also be conducted so as to make the regulation effective. The Group also recommended classification of these institutions into 'approved' and 'non-approved' categories with concomitant extension of beneficial treatment to the 'approved' category.

2.11 The Group observed that **Finance Corporations**, which were para-banking institutions, depended mainly on public deposits as their source of funds. While the promoters' stake in the business was meagre, they attracted deposits by offering high rates of interest or by distributing prizes in cash or kind. Their lending consisted mainly of making loans to wholesale and retail traders, small scale industries, etc. The Group recommended that regulating this category of institutions was necessary for protecting depositors' interest, as also for ensuring that advances were not made for undesirable purposes. Further only licensed corporations should be allowed to conduct this business and that liquidity ratio - at a rate lower than that for commercial banks - should be prescribed for these institutions. A ratio of owned funds to deposit liabilities should also be prescribed. A ceiling on interest rates on deposits - at a rate higher than that for commercial banks - may also be prescribed. These corporations should be subjected to periodical inspections on sample basis. The Group also recommended that these units be classified into 'approved' and 'non-approved' categories.

2.12 The Group also recommended that the RBI or any other regulatory authority which might be set up, should build up and strengthen its inspection machinery so that NBFIs could be inspected at least on a sample basis.

JAMES RAJ STUDY GROUP

2.13 In the year 1974, another Study Group was constituted under the Chairmanship of Shri James S. Raj for the purpose of reviewing the provisions of the RBI Act relating to NBFCs, the directions issued thereunder and for examining the adequacy thereof, in the light of the recommendations of the Banking Commission. After assessing the performance of NBFCs, the Study Group recommended that the situation as prevailing at that time called for regulation and not prohibition of deposit acceptance by NBFCs. The Group examined the working of NBNFCs, as also NBFCs, as per its terms of reference. (However, their recommendations as regards only the latter category are summarised hereunder, as the former are not pertinent to the study of the present Working Group.) The regulatory framework suggested by this Study Group aimed at keeping the magnitude of deposits accepted by NBFCs within reasonable limits and ensuring that they subserved the objectives of monetary and credit policy and safeguarded, to the extent possible, the interest of depositors.

2.14 While acknowledging the fact that the magnitude of deposits with NBFCs was much smaller than that with the banks, the Group considered that effective regulation was necessary for NBFCs because the number of depositors placing their savings with such companies was very large and because the incidence of malpractices in these companies was rather high. It recommended that NBFCs should be subjected to the same type of controls as banks are under the Banking Regulation Act, 1949. The Group suggested that for the purpose of ensuring effective regulation, it was desirable to enact a separate comprehensive legislation in place of Chapter IIIB of the RBI Act. The Group considered RBI to be the appropriate authority for regulating the activities of NBFCs.

2.15 As regards prudential norms for the functioning of NBFCs, the Group recommended that a ceiling on deposit acceptance should be prescribed for hire- purchase finance and loan companies at ten times their Net Owned Funds (NOF). Investment companies were working within the ceiling already prescribed (25% of NOF) and the Group suggested that these ceilings could continue. Besides, they were permitted to borrow upto 15% of NOF by way of unsecured loans guaranteed by directors, deposits from shareholders, etc. and the Group recommended that this provision could be withdrawn in a phased manner over a period of three years after which the companies could be allowed to accept deposits, etc., within the overall ceiling of 25% of NOF. The Group also recommended that the HFCs could continue to be exempted from such a ceiling. As regards Nidhis, monies received from their members were excluded from the term '**deposits**' and, therefore, the ceiling on deposits was not applicable to them. The Group recommended that the status quo may be maintained in that regard.

2.16 The Group prescribed that every NBFC, other than a Nidhi, commencing business after the proposed regulatory measures were brought into force, should have a **paid-up capital** of not less than Rs.5 lacs (Rs.2 lacs for companies conducting business only at one place with a population of less than five lacs). For existing companies, suitable regulations were prescribed in relation to their **net worth**. The Group recommended that all NBFCs should be required to transfer to the reserve fund, a sum equivalent to not less than twenty per cent of their annual profits before declaring any dividend, as long as the amount in the reserve funds was less than the paid-up capital of the company. They also prescribed that all NBFCs should maintain liquid assets equivalent to not less than ten per cent of their deposits.

2.17 The Group further recommended that loans and advances by NBFCs to their directors and to firms in which they were interested as partners, managers, etc., should be prohibited. No NBFCs, except hire-purchase finance companies [HPFCs], should be allowed to form any subsidiary, except for the purpose of carrying on the same line of business as that of the holding company.

2.18 As regards the period of deposits, the Group suggested that the minimum period should be retained at six months and the maximum period should be fixed at three years in the case of hire-purchase, equipment leasing, investment, loan and miscellaneous financial companies and five years in the case of HFCs. In the case of Nidhis, no such stipulation needed to be laid down.

2.19 The Group recommended that prize chit/benefit/savings schemes, which benefit primarily the promoters and do not serve any social purpose but were, in fact, detrimental to the public interest, should be totally banned. As regards conventional Chit Funds, the Group observed that they constituted convenient instruments combining savings and borrowings and in view of the fact that they were popular institutions, ways and means had to be found to regulate their working so as to ensure that they functioned on sound lines and the malpractices usually observed in the conduct of chits were curbed, to the extent possible. The Group strongly recommended uniform legislation throughout the country and suggested a Model Bill (as recommended by Bhabatosh Datta Group) to be enacted as a Central Act by the Parliament, as that would ensure uniformity in the provisions applicable to Chit Funds throughout the country and would also prevent Chit Fund institutions from taking undue advantage either of the absence of law governing Chit Funds in any State or exploit the benefit of any lacuna or relaxation in any State law by extending their activities to such a State. Further, it was recommended that the administration of the legislation should be left to State Governments, which may seek the advice of RBI on policy matters. Moreover, the Group suggested that private limited companies and unincorporated bodies, may continue to be allowed to run Chit Funds. It also recommended that Chit Fund institutions may be prohibited from accepting deposits, except as advance payment of subscriptions or deposits from the prized subscribers by way of security towards payment of their future instalments.

2.20 As regards the administrative arrangements, the Study Group recommended that the Department of Non Banking Companies [DNBC] of RBI should work in close liaison with the Department of Company Affairs and that the DNBC should be strengthened and reorganised so as to ensure effective implementation of the proposed regulatory measures. Decentralisation of the functions of DNBC was also suggested.

CHAKRAVARTY COMMITTEE

2.21 The Committee attributed the emergence and growth of NBFCs to the need for provision of finance to activities which were not served by the organised banking system. The Committee was of the view that NBFCs had a role to play in the economic development of the country. Therefore, regulation aiming at NBFCs should curb that part of their activities which was not in conformity with credit policy but not that which genuinely helped trade and industry. The Committee recommended that hire-purchase finance institutions in the non-corporate sector needed to be encouraged by policy measures to become companies. Further, a system of licensing appeared to be essential to protect the interest of depositors of the NBFCs and in view of their large number and administrative considerations, a suitable cut off point could be laid down in regard to the level of their business so that those which exceeded that level would be under a legal obligation to obtain a licence. However, the Group did not suggest the level of business which would serve as a cut off point.

VAGHUL COMMITTEE

2.22 The Working Group appointed to examine the possibilities of enlarging the scope of the money market and to recommend specific measures for evolving money market instruments made specific recommendations for liberalising the money market and for ensuring its healthy growth. The Group recommended, inter alia, that the banks and private NBFIs should be encouraged to provide factoring services. Institutions and other units such as companies, trusts, etc. which could satisfactorily demonstrate to RBI that they had a resource surplus of a monthly average of at least Rs.5 crore per annum, should be allowed to participate in the bill discounting market. These recommendations of the Working Group extended the scope of the activities of the NBFCs.

NARASIMHAM COMMITTEE

2.23 The Committee has observed that NBFIs have helped to broaden the market and provided the saver and investor with a variety of options. The Committee has made certain valuable recommendations for the healthy growth of some of the NBFCs. The Committee was of the view that having regard to the important and growing role of leasing and hire- purchase institutions in the financial intermediation process and their recourse to borrowing, minimum capital requirements should be stipulated in addition to the existing requirements relating to gearing and liquidity ratios. Prudential norms and guidelines in respect of conduct of business should be laid down and a system of off-site supervision based on periodic returns should be instituted. The Committee stated that there was considerable potential for the operation of merchant banks and suggested that in the long-run they could be permitted access to the market for deposits and borrowed resources, subject to the maintenance of minimum capital and liquidity and the observance of prudential norms specially tailored to the conduct of their business.

2.24 The Committee believed that to create conditions for sound and orderly growth of the venture capital business, the present guidelines needed to be reviewed and amended to widen the scope of eligibility criteria and impart a measure of flexibility to the operations of venture capital companies. Further, the Committee suggested that well managed NBFIs like hire-purchase and leasing companies, as well as merchant banks, be permitted to operate in the money market. Regulatory framework to govern these institutions should be specified. Such framework should include norms relating to capital adequacy, debt equity ratio, credit concentration ratio, income recognition, provision against doubtful debts, adherence to sound accounting practices, uniform disclosure requirements and assets valuation. Further, eligibility criteria for their entry, growth and exit should be laid down. The Committee recommended that the supervision of these institutions, which form an integral part of the financial system, should come within the purview of the proposed agency to be set up for this purpose under the aegis of the RBI.

2.25 The process of evolution of the regulatory framework for NBFCs has, to a great extent, been the result of the recommendations of these Committees/Groups. The foregoing analysis of the recommendations of various committees reveals that all of them recognised the importance of the role of NBFCs and emphasised the need for a well- established and healthy non-banking financial sector. Some of the recommendations of these committees hold good even in the present context. At the same time, appropriate regulations are required to be incorporated in the existing regulatory framework in view of the changed financial sector scenario. The recommendations of the present Working Group aim at aligning the regulatory system with the requirements of the present time.

CHAPTER III

OVERVIEW OF NON-BANKING FINANCIAL SECTOR

3.1 NBFCs and Unincorporated Bodies have been competing and complementing the services of commercial banks since yester-years all over the world. While, the financial system in a country generally develops through a process of gradual evolution, it has been observed that there is a stage in the evolutionary process wherein the growth of NBFIs is more pronounced than other components of the financial system. Further, they take different forms and sizes depending upon the needs of their clientele. Thus, in the United States of America, the growth of NBFIs was more pronounced during the first three decades of this century and two of the top five commercial lenders are NBFCs and three of the four top providers of consortium finance are non-bank firms at present. In India such marked growth in the non-bank financial sector was noticed in the last two decades. The NBFIs, as a group, have succeeded in broadening the range of financial services rendered to the public during this period.

3.2 The evolution, growth and proliferation of financial intermediaries are essentially the reflection of the different forms of savings (resource) flows and different types of investment (uses) of such funds - whether for current working capital needs or for capital investments and as between different sectors of the economy. They serve different clientele in their role both as repositories of the community's savings and as purveyors of funds for investment needs.

3.3 Initially intended to cater to the needs of the savers and investors, NBFIs later on developed into institutions that can provide services similar to those of banks. In India, several factors have contributed to the growth of NBFIs. They provided tailor-made services to their clients. Comprehensive regulation of the banking system and absence or relatively lower degree of regulation over NBFCs has been one of the main reasons for the growth momentum of the latter. Further, their higher level of customer orientation inasmuch as lesser pre/post sanction requirements, simplicity and speed of their services have attracted customers to these companies. The monetary and credit policy followed by the country has left a section of the borrowers outside the purview of the commercial banks and NBFIs catered to the needs of this section. Further, the marginally higher rates of interest on deposits offered by the NBFIs have also attracted towards them a large number of small savers.

3.4 It is difficult to state with certainty that growth of NBFCs will lead to additionality in resources. Nevertheless, it would be reasonable to assume that, to an extent, there would be some substitution of deposits from low yielding to high yielding categories even at the cost of incurring greater risks associated with the NBFCs. The importance of interest differential as a motivating factor for transfers of deposits from commercial banks to NBFCs is well recognised. Such shifts are not unimportant and are indicative of the elements that determine the totality of resource flows. Deposits with NBFCs might emanate partly through transfer of funds which were already in the banking system and partly through transfers from currency holdings. To the extent the deposits represent the latter category, NBFCs do play a role in enlarging the degree of financialisation of savings through widening of resource base.

3.5 In many countries, NBFIs have been able to serve the household, farm and small enterprise sectors on a sustained basis. However, regulation of their activities was found unwarranted since their operations were limited and they were not in a position to create money like the commercial banks. It was the Gurley and Shaw thesis (Money in a Theory of Finance, 1960) which, for the first time, established that the NBFIs compete with the monetary system and there is need to regulate them. Of late, the vast size of these institutions, both in terms of number of units and depositors, has made it impossible to ignore them.

3.6 There is, thus, a growing realisation among the monetary authorities that there is a need to link financial institutions to the formal financial system with a view to ensuring a competitive environment. It has also been revealed by some research studies that economic development and growth of NBFCs are positively correlated. In this regard, the World Development Report 1989 has succinctly observed that banks in developing countries hold a bigger share of all financial assets (48 percent) than they do in industrialised countries (37 percent). In contrast, non-bank intermediaries and contractual savings institutions (i.e., life insurance and pension funds) hold a much larger share of financial assets in high income countries than they do in developing ones.

3.7 As the demand for financial services grows, countries will need to encourage the development of NBFIs and securities markets in order to broaden the range of services and to stimulate competition and efficiency. Some countries have already made considerable progress towards more diversified financial system. Among developing countries, Brazil, India, Jordan, Korea and Malaysia are having a large non-bank financial sector.

3.8 In India the last decade has witnessed a phenomenal increase in the number of NBFCs. The number of such companies which stood at 7063 in 1981 increased to 24009 by 1990. The compounded growth in the number of companies works out to approximately 14 per cent per annum. Of the above, 20226 companies were organised on private limited basis; thus, the share of private limited companies in the total was as much as 84 per cent, whereas only 16 per cent of the companies were organised on public limited basis.

3.9 There are different categories of NBFCs operating in the country as under:

a) Loan Companies [LCs]

b) Investment Companies [ICs]

c) Hire Purchase Finance Companies [HPFCs]

d) Equipment Leasing Companies [ELCs]

e) Mutual Benefit Finance Companies [MBFCs]

f) Miscellaneous Finance Companies [MFCs]

g) Miscellaneous Non-Banking Companies [MNBCs]

h) Residuary Non-Banking Companies [RNBCs]

i) Housing Finance Companies [HFCs].

3.10 The working and operations of these companies, except HFCs, is regulated and supervised by the RBI, whereas that of HFCs is regulated and supervised by the NHB.

Deposit Growth

3.11 NBFCs have recorded impressive growth in their deposits during the last decade. The growth in their deposits according to each category of NBFC is given in Table 3.1 (see page 25).

3.12 As is evident from Table 3.1, LCs accounted for bulk of the deposits in this sector; their percentage share in the total has steadily declined since the mid-1980s. Contemporaneously, ICs, ELCs and HFCs have expanded their shares in the total. ELCs, which commenced their operations in 1984, have strengthened their position in a short period as far as deposit mobilisation is concerned, accounting for 16 per cent of total in 1990.

3.13 A disturbing feature about the NBFCs noted by the Group is that although there were 24009 companies at the end of 1990, those which submitted periodical returns to RBI/NHB formed only 32.4 per cent of such companies. Thus a large number of companies had not submitted any returns to the Regulatory Authority concerned although it is likely that many among them might not have any deposits from the public. Although, periodic reminders are being issued by the regulatory authorities to the defaulting companies, there has not been much improvement in the situation. Punitive action against these companies has not been possible on account of number of defaulters on one hand and limited administrative infrastructure available with the regulatory authorities on the other.

3.14 Data regarding the share of deposits of reporting companies to total deposits of NBFCs is furnished in Table 3.2 (see page 26). As shown in this table, a small number of companies control sizeable portion of total deposits. Thus, in 1989, 21.2 per cent of the reporting companies accounted for as much as 97 per cent of deposits. It may be observed that the percentage of companies having aggregate deposits of Rs.25 lacs and over to total number of reporting companies has gone up from 8.6 in 1981 to 21.2 in 1989. However, their share in total deposits has gone up marginally from 94.6 per cent to 97 per cent during the same period. This indicates that a larger number of companies have shared the increased deposit volume. It may also be noted that exempted deposits constituted 85.8 per cent of total NBFC deposits in the year 1989.

3.15 Table 3.3 (see page 27) shows the growth of deposits with NBFCs in relation to growth of deposits with the scheduled commercial banks since 1981.

It will be evident therefrom that :

(i) In the last ten years, deposits with NBFCs have grown a ten fold.

(ii) Except for the years 1986 and 1987, the percentage of growth in deposits with NBFCs was higher as compared to that with the Scheduled Commercial Banks.

(iii) The deposits with NBFCs which formed 3.88 per cent to those with the scheduled commercial banks in 1981, had increased to 8.43 per cent in 1990.

3.16 Deposits with NBFCs have increased despite the fact that there are quite a few advantages attached to interest-earning bank deposits, such as, the deposit insurance cover, cheque facilities for saving bank deposits and tax concessions in respect of interest earned. The main reasons for growth of deposits with NBFCs are the greater customer orientation and higher rate of interest offered by them as compared to banks. A depositor is primarily concerned with liquidity, safety and yield on deposits. As far as liquidity is concerned, term deposits with banks and deposits with the NBFCs are more or less at par. As regards safety, there does not seem to be sufficient awareness of the risks a depositor runs in placing his funds with NBFCs whose activities are not sufficiently regulated or supervised. Investment decision by a depositor is largely guided by the yield on his investment. This is more so under conditions of high inflationary pressures. In order to maintain real value of his savings, a depositor might be willing to place his funds with some risk. Further, the NBFCs are in a position to pay higher interest to their depositors, since many of them can deploy their resources in segments where there are credit gaps at rates higher than those charged by banks. NBFCs have some advantage in terms of cost as the reserve requirements and overhead costs are lower compared to those of banks.

3.17 Evolution and role of RNBCs require a specific mention. These companies generally tap the public savings by operating deposit schemes akin to recurring deposit schemes of the banking system. Mobilisation of deposits is from a large number of small and uninformed depositors expressly holding out to them that their money will be kept invested with banks or in Government securities. The depositor finds it advantageous to save in these schemes as collection is done at his door step. In the process, he probably does not consider low rate of return on his savings as an impeding factor. The collection of deposits is done through different tiers of field staff and the commission payable to them for mobilisation of such deposits is sizeable. The company gets the funds at low cost for longer terms. Yields on deployment of such funds are relatively high.

3.18 These companies have been operating under certain regulations which were revoked on the commencement of The Prize Chits and Money Circulation Schemes (Banning) Act, 1978 [Banning Act] on being advised that the Act covers schemes run by these companies. The Supreme Court (reported in AIR, 1987 - Supreme Court 1023) held that the definition of Prize Chits in the Banning Act does not cover the schemes run by such companies. The Court noticed certain adverse features in these schemes such as their long duration, low return on deposits, virtual sharing of first year's collection between the field staff and the company, treating first year's collection as part of income, etc. It was also observed that bulk of the deposits was raised in first year of the scheme and thereafter such deposits withered away in subsequent years; advertisements attracting deposits in beguiling terms were issued. The schemes contained provisions for forfeiting the amounts subscribed by the depositors if they committed certain defaults. In 1987, the RBI issued a separate set of directions for these companies and its salient features are furnished in Appendix V. Important provisions are payment of minimum rate of interest, disclosure of total liabilities, furnishing of returns, etc. These directions were also challenged in Court of Law. The Supreme Court in its judgement dated January 30, 1992 upheld the validity of these directions.

3.19 Many of these companies operate with meagre capital. There are no restrictions on the quantum of deposits such companies can raise. Some of them have a negative net worth. They do not submit periodic returns to the regulatory authority. There is plethora of this type of companies and most of them have not designated their banks as required by the directions issued by RBI. In many cases, amounts deposited in banks and approved securities are significantly lower than deposit liabilities. The aggregate deposits held by such companies as on March 31, 1990 was around Rs.900 crores.

3.20 From the analysis in this Chapter, it is evident that although the magnitude of deposits with NBFCs in relation to total bank deposits still forms a small percentage, there is enough evidence of acceleration in the growth of these deposits. In other words, the NBFCs have been in a position to thrive and consolidate their position despite the impressive geographical and functional diversification achieved by commercial banks.

TABLE 3.1 : DEPOSIT GROWTH OF NBFCs

(Amts in Crore of Rs.)

Fiscal Year	LCs	ICs	HPFCs	ELCs	MBFCs	MNBCs	HFCs	TOTAL
1981	1,027.1	104.9	129.6	–	31.5	168.0	14.6	1475.7
	(69.6)	(7.1)	(8.8)	–	(2.1)	(11.4)	(1.0)	
1982	1,199.5	122.3	147.6	–	31.1	210.7	34.4	1745.6
	(68.7)	(7.0)	(8.5)	–	(1.8)	(12.0)	(2.0)	
1983	1,713.7	206.5	172.0	–	35.6	228.7	73.7	2430.2
	(70.5)	(8.5)	(7.1)	–	(1.5)	(9.4)	(3.0)	
1984	2,153.2	263.1	173.1	16.7	39.6	382.2	133.4	3161.3
	(68.1)	(8.3)	(5.5)	(0.5)	(1.3)	(12.1)	(4.2)	
1985	3,044.2	380.8	316.9	11.0	60.4	441.7	101.0	4356.0
	(69.9)	(8.7)	(7.3)	(0.3)	(1.4)	(10.1)	(2.3)	
1986	3,202.4	423.5	327.7	61.4	73.5	689.3	181.8	4959.6
	(64.6)	(8.5)	(6.6)	(1.2)	(1.5)	(13.9)	(3.7)	
1987	3,602.9	581.7	605.6	64.7	92.1	735.3	259.3	5941.6
	(60.6)	(9.8)	(10.2)	(1.1)	(1.5)	(12.4)	(4.4)	
1988	4,223.5	734.0	785.3	491.7	93.3	772.9	399.0	7499.7
	(56.3)	(9.8)	(10.5)	(6.6)	(1.2)	(10.3)	(5.3)	
1989	5,557.3	1,142.1	973.6	1,257.4	154.1	858.2	467.5	10410.2
	(53.4)	(11.0)	(9.3)	(12.1)	(1.5)	(8.2)	(4.5)	
1990	6,832.9	2,229.5	1,008.2	2,377.1	193.1	956.4	1,178.6	14775.8
	(46.1)	(15.1)	(6.8)	(16.1)	(1.3)	(6.5)	(8.0)	

Note : Deposits include exempted and regulated deposits in all cases unless specified. Deposits of RNBCs are not included. Figures in bracket indicate per cent to total.

TABLE 3.2 : SHARE OF DEPOSITS OF REPORTING COMPANIES.

(Amounts in crore of Rs.)

Fiscal Year	No. of reporting companies	Total deposits	Companies reporting aggregate deposits of Rs. 25 lacs and above.					
			No. of companies	% of col.4 to col.2	Deposits	% of col.6 to col.3	Exempted deposits	% of col.8 to col.6
1	2	3	4	5	6	7	8	9
1981	3443	1475.7	295	8.6	1389.5	94.6	1200.9	86.4
1982	2670	1745.6	369	13.8	1638.3	93.9	1443.6	88.1
1983	2799	2430.2	356	12.7	2327.2	95.8	2108.9	90.6
1984	4240	3161.3	619	14.6	3004.0	95.0	2754.7	91.7
1985	4998	4356.0	883	17.7	4155.4	95.4	3776.9	90.9
1986	6061	4959.6	1107	18.3	4779.4	96.4	4333.1	90.7
1987	7113	5941.6	1336	18.8	5605.6	94.3	4818.4	86.0
1988	7598	7499.7	1481	19.5	7165.4	95.5	6082.9	84.9
1989	7615	10410.2	1617	21.2	10102.8	97.0	8665.0	85.8
1990	7772	14775.8	NA	NA	NA	NA	NA	NA

Table 3.3

Growth in deposits of Financial Companies vis-a-vis Scheduled Commercial Banks.

Fiscal Year	Amount of aggregate deposits with Fin. Companies	Growth rate in %	Amount of deposits with SCBs	Growth rate in %	% of col.2 to col.4
1	2	3	4	5	6
1981	1475.7	-	37988.0	-	3.88
1982	1745.6	18.3	43733.0	15.1	3.99
1983	2430.2	39.2	51358.1	17.4	4.73
1984	3161.3	30.1	60732.0	18.3	5.21
1985	4356.0	37.8	72571.0	19.5	6.00
1986	4959.6	13.9	85704.0	18.1	5.79
1987	5941.6	19.8	102938.4	20.1	5.77
1988	7499.7	26.2	118678.0	15.3	6.32
1989	10410.2	38.8	140150.0	18.1	7.43
1990	14775.8	41.9	175128.0	25.0	8.43

CHAPTER IV

NON-BANKING FINANCIAL COMPANIES AND MONETARY POLICY

4.1 The proliferation of NBFCs in India has coincided with a major structural transformation in the Indian financial system, which has an important bearing on the conduct of monetary policy.

4.2 The Indian financial system, of late, has witnessed a significant financial widening and deepening. This has resulted, inter alia, in a marked shift from monetary assets (such as currency and bank deposits) to non-monetary assets (such as contractual savings and other assets including shares, debentures, units, etc.). As is evident from Table 4.1, the share of currency and bank deposits in the gross financial savings of the household sector has declined from 59 per cent in 1980-81 to around 49 per cent in 1990-91. Correspondingly, the share of non-monetary assets has increased, a bulk of which is reflected in the enlargement of non-contractual savings. In other words, funds which had previously flowed from ultimate providers to ultimate users through financial intermediaries are now, to an extent, diverted away from them and are being provided directly, i.e., some degree of financial disintermediation has taken place in the Indian economy.

Table 4.1: Distribution of Gross Financial Savings(%)

	Assets		1980-81	1990-91
A.	Monetary assets		59.2	48.9
B.	Non-Monetary assets Of which		40.8	51.1
	i)	Contractual savings	25.1	26.8
	ii)	Other assets	15.7	24.3

Source : Report on Currency and Finance, 1990-91, Vol.II.

4.3 Diversion of funds away from the banks, as depicted in Table 4.1, has resulted among other things, in enlargement of the resource base of the NBFCs.

Indeed, the non-bank deposits as a ratio of the gross financial savings of the household sector, have gone up from 2 per cent in 1981-82 to around 7.9 per cent in 1989-90.

4.4 The evolution of NBFCs in India has passed through many developmental stages. Initially intended to serve varied financial needs of savers and investors, the NBFCs gradually underwent a stage of fortification through functional specialisation where these companies started reaping increasing returns through economies of scale. In the process, there has occurred a gradual inter-penetration of markets, both by banks and non-banks resulting in erosion of the distinction within the group of financial institutions between banks and non-banks. The basis for such distinction between banks as credit-creating institutions and non-banks as non- credit creating institutions has lost much of its applicability. As Chandler (The Economics of Money and Banking, 1959) puts it: "Over the years, the process of functional inter-penetration opens new vistas of conducting business that tend to erode the monopoly advantage of existing institutions due to entry of other similar companies and hence resulting in de-specialisation through functional diversifications." Most importantly, therefore, the NBFCs may be seen as the outer fringe of the organised financial sector the core of which is constituted by commercial banks. It may however, be noted that banks and non-banks do not constitute watertight compartments. Indeed, there are tangential contacts between the two segments in various forms such as bill discounting, lines of credit from banks to certain categories of NBFCs etc.

4.5 The stimuli propelling the growth and proliferation of NBFCs in India appears to have emanated from the conflux of a several disparate trends during the last four decades, notably in the eighties. One major influence in this regard, may be the excess demand for credit by private sector units arising from the widening budget deficit. In the face of credit 'rationing' in a milieu of tight monetary policy and the inability of the banking sector to meet the burgeoning credit demand, NBFCs started functioning in the sphere of mobilisation of dormant assets and tapping of new users of credit. In the process, they channelised savings in the economy by collecting funds from savings-surplus units and allocating them to savings-deficit units for investment in real assets, for consumption, for portfolio adjustment of existing wealth, or for all such purposes for which access to bank credit was either denied or restricted. This mechanism is called "transmutation effect" (Smith, Economics of Financial Institutions and Markets, 1971) which refers to the catalytic role of financial intermediaries in converting financial liability with a set of characteristics into financial assets with a different set of characteristics, so as to tailor the asset preference of the economic agents. While it is true that the transmutation effects applies to both banks as well as NBFCs acting as financial intermediaries, the latter category undoubtedly has greater degree of freedom.

4.6 The world-wide experience shows that other important factors contributing towards the growth of NBFCs are changes in the international financial environment and the increasing integration of domestic and international markets and the rapid development of technology in the financial sector like introduction of new communication and transmission systems which reduce transaction costs and speed up information flows. To an extent, all these factors have also contributed to the rapid growth of NBFCs in India, especially during the later part of eighties. Very likely, an additional factor, is the restriction placed on the loanable funds of commercial funds by the higher reserve requirements for banks as compared to the NBFCs.

4.7 While it is generally argued and also sometimes buttressed by practical experience in developed economies that NBFCs increase the efficiency of the financial system by reducing the cost of financing to the customers and accelerating the speed of response to new information, it has also been argued that NBFCs jeopardise the interest of depositors and also undermine the efficacy of monetary and credit policy.

4.8 The deposit-taking NBFCs offer high interest rates and thereby attract large uninsured deposits. Some have a weak capital base and a risky asset portfolio. Failures of such financial companies are not uncommon. In such an eventuality, the ultimate losers are the depositors. Failure of units in non-banking sector could have adverse impact on the banking sector as well, thereby threatening the very core of the financial system of the economy.

4.9 As regards the difficulties associated with the conduct and strategy of monetary policy, Minsky's perceptive observations still remain valid. To quote Minsky, (Central Banking and Money Market Changes, 1957) "Essentially, the relations upon which the monetary authorities base their operations are predicated upon the assumption that a given set of institutions and usages exist. If the operations of the authorities have side effects in that they induce changes in financial institutions and usages, then the relations 'shift'. As a result, the effects of money operations can be quite different from those desired. This would be particularly significant when the central bank is enforcing monetary constraint in an effort to halt inflationary pressures". This line of argument, in the present time, is important in a number of ways as described in the following paragraphs.

4.10 The meaning and usefulness of monetary and credit aggregates as intermediate targets for monetary policy are changing and, at times, eroding. The financial innovations involving new instruments add problems to a meaningful definition of broad money. The current practice of compiling monetary aggregates, i.e., M1, M2, M3, M4 does not cover the deposits with the NBFCs. The pertinent question is whether the new monetary instruments alternatively called quasi-money need to be included to evolve a broader concept of money like the "Divisia Aggregate" as is currently practised in some advanced countries.

4.11 The traditional mechanism of the operation of monetary policy via changes in the availability of credit is often hampered due to operations of NBFCs. Over the period, erosion of the dominant position of banking system along with the increasing substitutability of various channels of finance have made it not only difficult to control the total credit to private sector through credit regulation by banking sector but also made the administrative controls less efficient and more costly. This implies that due to developments of markets for short-term and medium-term debt, it becomes difficult to control total liquidity of the economy by controlling bank credit. Non-banks provide credit to those sectors which are denied credit by banking sector, thereby defeating to some extent the very purpose of quantitative credit controls. Further, it is often argued that financial innovations place an upward pressure on the money (credit) multiplier. Technological advances in cash management tend to reduce the ratio of currency holdings of public to demand deposits. There may also occur a shift in public savings to financial instruments with little or low reserve requirements, thus reducing the "effective reserve ratio". Again, due to relatively growing importance of non-banking sector, the proportion of net flow of loanable funds to this sector and the speed of further disbursements might increase, resulting in higher multiple creation of credit for the whole financial system. Though the empirical evidence is yet to be established from the monetary policy point of view, the significance of monetary and credit aggregates as intermediate target has declined.

4.12 The effect of a change in monetary policy on the economy in terms of its timing, and ultimate effect has become more difficult to predict. The predictability of monetary policy initiatives which operate via demand for money equation, wherein, monetary aggregate is treated as an intermediate target, has become more difficult because demand for money may have undergone 'structural' shifts and become somewhat unstable. Discussing the implications of financial disintermediation, Jadhav (Financial Deepening and Disintermediation, 1988) shows that the process of financial deepening and disintermediation taking place in India has caused structural shifts in the asset portfolio, particularly in the ratios of currency to time deposits, demand deposits to time deposits and narrow money to broad money. In a recent study by Jadhav and Das (Demand Function for Money : A Quarterly Model for India, 1991), it has been shown that the demand function for money in India has, indeed, witnessed 'structural' shifts in 1974 as well as in 1983. The causes for such 'shifts' in money demand functions are generally attributed to structural changes and financial innovations.

4.13 In a regime of monetary policy operating through monetary and credit aggregates as the intermediate target, the growth of NBFCs tend to dilute the efficacy of monetary policy. On the other hand, it is also true that in a regime of monetary policy transmitting through open market operations with interest rate as an intermediate target, the existence of financially strong NBFCs can increase the potency of monetary policy. This is because of the fact that financial innovations tend to speed up the transmission effects of open-market operations. In the present liberalisation process of Indian financial system, the gradual shift of emphasis towards open market operations with increasing importance to interest rate mechanism enhances the scope of monetary policy to have a wider influence on the whole of financial structure, both bank and non-bank sectors. Under these circumstances, the general approach towards the NBFCs should not be that of discouragement but one promoting their healthy growth under carefully designed prudential norms. The successful operations of monetary policy being a matter of overriding concern, it becomes imperative to have a financially strong non-bank sector which can provide competition and impetus for a viable and strong financial structure.

4.14 It may be pertinent to note that the approach is being increasingly followed in several other countries. An analysis of the system of regulation of NBFIs in different countries reveals a few important aspects. NBFIs are near substitutes for banks. Their role is both competitive and complementary to that of banks. In many countries, they are regulated in a way similar to commercial banks but sometimes not to the same extent and degree. There is either a separate set of regulations for NBFCs or the regulations that apply to the commercial banks are also made applicable to them. NBFCs are required to be authorised/registered/licensed in order to carry out the business of deposit taking and lending. They are also required to maintain minimum level of capital. A few countries have already introduced the Basle Committee norms in respect of capital adequacy. Depositors' interest is safeguarded through insurance cover and/or stipulation of prudential norms. The latter seems more popular. Prudential norms include capital adequacy, credit concentration ratio, liquidity ratio and creation of reserve. In some countries, Self Regulating Organisations (SRO) have been constituted. Misleading advertisements by NBFIs are punishable under the law. NBFIs, in all cases, are required to submit periodical returns, failure of which may invite penalties. These practices across the world indeed strengthened the case for prudential regulation of the NBFCs in India. (Summary of the regulatory framework in a few selected countries is given in Appendix IV.)

4.15 The on-going process of financial innovations characterised by emergence of new institutions and instruments is likely to accelerate in the future. Certain long-lasting forces like global integration of national financial-markets, technological advances and changing monetary policy stance may see functional diversifications of the existing and new NBFCs to cater to different asset-preferences of the public. In this dynamic process, just as financial institutions change in response to regulations, the regulatory authorities must change in response to financial innovations. The process referred to as the "regulatory dialectic" (Kane, Accelerating Inflation, Technological Innovation and The Decreasing Effectiveness of Banking Regulation, 1981) which compares the financial institutions and regulatory authorities as two riders on a seesaw that adapt constantly to each other is well recognised the world-over and forms the basic philosophy of regulatory framework.

4.16 All indications are that NBFCs are set to grow in the future. Almost every major industrial house has its own financial company or is contemplating to promote one. Certain undesirable features have been observed in the working of such companies viz. industrial or tradii ¸ concerns secure additional source of finance through these companies either by discounting of bills or similar such facilities thereby circumventing the credit discipline. A large portion of such bills is reported to be pure accomodation bills rather than those based on genuine trade transactions. Further, these companies have taken advantage of low cost of funds and diverted these funds for maximisation of their profits through investment either in money market or capital market. Companies which had confined their business to their principal activity, till recently, have, of late, shown growing tendency for conducting various types of business. Many of the companies provide not only financial assistance to its clientele but also undertake financial services. Thus, the NBFCs should be brought under the regulatory framework not only to ensure their healthy growth but also to improve the efficacy of the credit and monetary policy as well as healthy financial discipline among both providers and users of credit.

CHAPTER-V

Evolution of Regulations and Existing Statutory Framework

Historical Background

5.1 In the sixties, a sharp increase in the volume of deposits held by Non-Banking Companies [NBCs] was noticed. The NBCs were not regulated then and several unhealthy features came to surface. The RBI Act was, therefore, amended by the Banking Laws (Miscellaneous Provisions) Act, 1963 and a new Chapter IIIB containing 'Provisions relating to Non- Banking Institutions receiving deposits and financial institutions', was inserted. It was then felt necessary to have statutory control over acceptance of deposits by NBFIs and to vest RBI, as the custodian of the monetary and credit system of the country, with certain powers for enabling it to effectively supervise, control and regulate the deposit acceptance activities of such institutions. (The evolution of Regulations governing acceptance of deposits by NBCs is given in detail in Chapter 3 of Shri James Raj Study Group Report.)

5.2 In pursuance of the powers conferred under Chapter IIIB of RBI Act, separate Directions were issued to NBFCs and NBNFCs in 1966 relating to acceptance of deposits governing their period, quantum, rate of interest, etc. Later, these Directions were amended from time to time and, in 1973, Directions were also issued to MNBCs conducting prize-chits and related business, after the definition of the term 'deposit' was widened and that of 'Financial Institution' [FI] was made more comprehensive. However, in 1975, due to the insertion of Section 58A in the Companies Act and the Companies (Acceptance of Deposits) Rules, 1975 issued thereunder, RBI withdrew its Directions to NBNFCs and since then these companies were to be regulated exclusively by the Department of Company Affairs, Government of India. Although the provisions of Section 58A applied to all companies, NBFCs were exempted from its application [by a notification issued under Section 58A(7)].

5.3 From 1977 onwards, RBI has been regulating NBFCs under NBFC Directions and MNBC Directions. The NBFC Directions regulated loan, investment, hire-purchase finance, mutual benefit finance, miscellaneous financial and housing finance companies. The MNBC Directions applied to every company, other than a banking or insurance company, which carried on any of the specified activities mentioned therein.

5.4 In 1978, Banning Act was enacted by Parliament, in pursuance of the recommendations of the Raj Committee (para 6.11 page 84 of the Report). This Act banned the conduct of prize chits, savings schemes and money circulation schemes, excluding the conventional chits. In 1982, a legislation to regulate conventional chits viz. the Chit Funds Act, 1982, was passed by the Parliament and various States are adopting it, on more or less similar lines. This enactment was also in pursuance of the Raj Committee recommendations (para 6.18 page 87-88 of the Report).

5.5 By Banking Laws (Amendment) Act, 1983, [1983 Act] certain major amendments were made with effect from February 1, 1984 in Chapter IIIB of RBI Act and a new Chapter IIIC was introduced in that Act for 'Prohibition of acceptance of Deposits by unincorporated bodies'. Chapter IIIC was introduced in the RBI Act for regulating the deposit acceptance by unincorporated bodies, the need for which was felt since long, especially since the Supreme Court, in the case of State of West Bengal Vs. Sapan Kumar, while quashing the investigation under the Banning Act had stated and recommended at para 38, as under :

"The firm appears to be on the brink of an economic crisis, as any scheme of this nature is eventually bound to be. Considering the manner in which the firm has manipulated its accounts and its affairs, I have no doubt that it will secret the large funds and destroy the incriminating documents if they are returned to it. The State Government, the Central Government and the Reserve Bank of India must be given a reasonable opportunity to see if it is possible, under the law, to institute an inquiry into the affairs of the firm and, in the meanwhile, to regulate its affairs. I consider such a step essential in the interests of countless small depositors who, otherwise, will be ruined by being deprived of their life's savings. The big black money bosses will take any loss within their stride but the small man must receive the protection of the State, which must see to it that the small depositors are paid back their deposits with the agreed interest as quickly as possible." (AIR 1982 S.C.949).

The amendments made by 1983 Act, included the following :-

(i) In Chapter IIIB, the definition of 'deposit' was further modified and certain specified categories were excluded from the scope of the term 'deposit'.

(ii) In terms of provisions of Chapter IIIC, restrictions were placed on the number of depositors from whom deposits could be accepted by unincorporated bodies, i.e., individuals, firms and unincorporated associations of individuals. Thus, while individuals were prohibited from accepting deposits from more than twenty-five depositors, (excluding deposits from relations as defined in the Act), the restriction on firms and associations was also twenty-five depositors per partner and individual respectively, subject to the ceiling of 250 depositors per firm/association. It is to be noted that it was considered necessary to put a limit on the number of depositors rather than on the quantum of deposits as the aim was to protect small and unwary depositors.

(iii) The Directions issued to NBFCs were also amended. An important amendment having been made to bring the equipment leasing companies' within the ambit of NBFC Directions.

5.6 In 1987, the Supreme Court held that the business of companies carrying on certain types of 'prize- chit' Schemes, were not hit by the Banning Act. The Court had ruled (AIR 1987 S.C. page 661) that since March 31, 1978, when the Residuary clause was introduced by inserting paragraph 19 in the Directions of 1977, the Reserve Bank has been vested with enough powers to control or regulate any business of the kind run by such companies even if such business is not the business of 'prize-chits' as defined by the Banning Act or as specified in paragraph 2(i) of NBFC Directions. Instead of regulating these types of companies under the NBFC Directions, which were not suitable to regulate this type of business, RBI considered issuing a separate set of Directions in 1987. Accordingly, RBI issued RNBC Directions, as the third set of Directions governing the NBFCs. These Directions were effective from May 15, 1987 and govern all the RNBCs which are not administered by either the NBFC Directions or the MNBC Directions.

5.7 In 1987, the Parliament enacted the NHB Act (provisions whereof came into force on different dates from July 1988 onwards) and established the NHB to operate as a principal agency to promote HFIs both at local and regional levels and to provide financial and other support to such FIs. Thereafter, on June 26, 1989, the NHB issued HFC Directions to regulate the deposit acceptance activities of HFCs as defined in section 2(d) of the NHB Act. Simultaneously, the RBI amended its NBFC Directions and excluded from its purview the HFCs since covered by the HFC Directions.

Existing Regulatory Framework.

5.8 At present, the deposit acceptance activities of various NBFCs (excluding HFCs) are regulated under the provisions of Chapter IIIB of the RBI Act and the three Directions to NBFCs, MNBCs and the RNBCs. The last notification amending the Directions issued to NBFCs and MNBCs, was issued on June 17, 1992. The notification for NBFCs clarified, inter alia, that for deciding the principal business of a financial company engaged in both hire-purchase financing as well as equipment leasing, the volume of both these types of business was to be taken together. The HFCs are regulated by the NHB Act and the HFC Directions issued thereunder.

5.9 The salient features of Chapter IIIB of the RBI Act (as amended upto June 1992) are ;

(i) The term 'Deposit' has been defined in a very broad manner to include any receipt of money by way of deposit or loan or in any other form. However, certain receipts have been specifically excluded from the purview of this definition, e.g., amounts received from banks and financial institutions, those received in ordinary course of business, etc.

(ii) The term 'Financial Institution' [FI] (as per definition amended in 1974) is wide enough to cover financial companies engaged in varied types of activities e.g. financing of any activity (other than its own), investment, hire-purchase, etc. The definition, however, specifically excludes any institution which is an 'industrial concern' as defined in Section 2(c) of the Industrial Development Bank of India Act, 1964, or carries on as its principal business (i) agricultural operations or (ii) purchase or sale of any goods (other than securities) or (iii) the providing of any services or (iv) the purchase, construction or sale of immovable property, so however that no portion of the income of the institution is derived from the financing of purchases, constructions or sales of immovable property by other persons.

(iii) The term 'Non-Banking Institution' [NBI] means a company, corporation or co-operative society [it no longer includes 'firm' (w.e.f. February 15, 1984)]

(iv) Section 45J empowers RBI to give Directions to NBIs regulating or prohibiting the issue of any prospectus or advertisement soliciting deposits of money from the public and specify conditions subject to which they can be issued;

(v) In terms of Section 45 K, RBI is empowered to give Directions to NBIs.

(a) to furnish statements, information or particulars relating to or connected with deposits received by a NBI;

(b) such statements, information or particulars may relate to the amount of deposits, the purposes and the periods for which and the rates of interest and other terms and conditions on which, these are received;

(c) either generally or to any NBI or a group of NBIs in particular, in respect of any matters relating to or connected with the receipt of deposits including the rates of interest payable on such deposits and the periods for which deposits may be received;

(d) if any NBI fails to comply with any direction given by the Bank under sub- section (3), the Bank has power to prohibit acceptance of deposits by that NBI;

(e) any NBI can be required and compelled by RBI to send a copy of its annual balance- sheet and profit and loss account or other annual statements to every person from whom the NBI holds, as on the last date of the year to which the accounts relate, deposits higher than such sum as may be specified by the Bank.

(vi) In respect of FIs, if the Bank is satisfied that for the purpose of enabling it to regulate the credit system of the country to its advantage it is necessary so to do; it may, under Section 45L :

(a)(1) call for such statements, information or particulars relating to the business from FIs generally or any group of FIs or a particular FI as considered necessary, and

(2) give directions to such institutions either generally or to any such institution in particular, relating to the conduct of business by them or by it.

(b) The statements, information, etc. mentioned at (a)(1) above can relate to all or any of these matters - paid-up capital, reserves or other liabilities, investments, persons to whom and the purposes and periods for which finance is provided and the terms and conditions including the rates of interest, on which it is provided.

(c) For issuing Directions to FIs under (a) (2) above, RBI has to have due regard to the conditions in which and the objects for which, the institution has been established, its statutory responsibilities, if any, and the effect the business of such FI is likely to have on trends in the money and capital markets.

(vii) Under Section 45N, RBI has powers to inspect any NBI for certain specified purposes; in terms of Section 58C, it can prosecute institutions and/or persons concerned for failure to comply with the directions issued by it and/or wilful submission of incorrect or incomplete information. In addition, the powers and duties of auditors and provisions relating to prohibition of soliciting deposits by unauthorised persons have been spelt out in Chapter IIIB of the RBI Act.

Salient features of the Directions issued by RBI

5.10 The directions issued to NBFCs, MNBCs and RNBCs contain provisions regulating amounts and period of deposits, rates of interest thereon, ceiling to be maintained, etc. Also, except in case of RNBCs, payment of brokerage is regulated. The Directions exempt from their purview certain types of borrowings/ moneys received by these companies. Important provisions thereof are as follows :

(i) **Period of deposit**

Short term deposits for periods less than 24 months are prohibited. The maximum period of deposits varies from 60 months (NBFCs and MNBCs) to 120 months (RNBCs).

(ii) **Ceiling on deposits/restriction on investments**

(a) Different types of ceilings on acceptance of deposits have been provided even for companies covered by NBFC Directions. Thus for loan and investment companies, as also MNBCs, it is 40% of NOF, whereas for hire- purchase finance and equipment leasing companies, it is not more than 10 times their NOF.

(b) For RNBCs, no such ceiling has been prescribed but investment pattern stipulates that not less than 10 per cent of the aggregate amount of liabilities should be kept in fixed deposits with public sector banks, not less than 70 percent of liabilities in approved securities and not more than 20 percent thereof or 10 times NOF whichever is less, in approved investments.

(iii) Receipts are required to be furnished to depositors and registers are to be maintained by NBFCs.

(iv) Disclosure of specified information is required to be made in any advertisement soliciting deposits and in application forms.

(v) Information to be included in the report to the Board has been specified.

5.11 As regards advertisements by all such companies, the regulations are contained in Non-Banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977, [Advertisement Rules] issued under section 58A (2)(b) and (7)(b), read with section 642 of Companies Act.

Salient features of NHB Act.

5.12 Under section 14 of the NHB Act, NHB is empowered to transact the business enumerated therein. Chapter V of that Act, contains provisions to regulate acceptance of deposits, etc. by HFIs. Thus :

(i) In terms of Section 30, NHB can regulate or prohibit the issue by any HFI of prospectus or advertisement soliciting deposits of money from the public and specify the conditions subject to which any such prospectus or advertisement, if not prohibited, may be issued.

(ii) Section 31 of the Act empowers NHB to give directions to every HFI accepting deposits to furnish to it such statements, information or particulars relating to or connected with deposits received by it. Under the Section, NHB is also empowered, in the public interest, to give directions to HFIs accepting deposits either generally or to any group of HFIs accepting deposits specifically, including directions as to the rates of interest payable on such deposits and the periods for which deposits may be received.

(iii) In exercise of the powers under sub-section (4) of Section 31, NHB can, if any HFI accepting deposits fails to comply with any directions given by it, prohibit the acceptance of deposits by that HFI.

(iv) Under Sub-Section (5) of Section 31, NHB can require any HFI, to furnish a copy of its balance sheet and Profit & Loss Account or other annual statements to every person from whom the HFI holds, as on the last day of the year to which the accounts relate, deposits higher than such sum as may be specified by NHB.

(v) Under Section 32, every HFI has to furnish to NHB statements, information or any particulars required by it.

(vi) In exercise of the powers under Section 34, NHB may at any time, carry out inspections of HFIs accepting deposits for the purpose of verifying the correctness and completeness of any statement, information or particulars furnished to it or for the purpose of obtaining any information or particulars which the HFI has failed to furnish on being called upon to do so.

(vii) Section 35 of NHB Act stipulates the conditions for soliciting or accepting deposits.

Salient features of the Directions issued by NHB

5.13 The Directions issued by NHB are similar to the Directions issued by RBI to NBFCs and contain provisions regulating amounts and period of deposits, rates of interest thereon, ceiling to be maintained, etc. In particular:

(i) The Directions exempt certain types of borrowings/moneys received by HFCs from Governments, Banks, FIs etc.

(ii) HFCs are prohibited from accepting deposits repayable on demand or on notice unless such deposits are repayable after a period of more than 24 months, but not later than 84 months, from the date of acceptance or renewal of such deposit.

(iii) The ceiling pattern for HFCs is different from that of NBFCs and the Directions provide as under:

HFCs with Net-owned Funds -		Can accept deposits
(a)	Upto Rs.10 crores	Upto 10 times of NOF
(b)	Above Rs.10 crores but upto Rs.20 crores	Upto 12.5 times of NOF
(c)	Above Rs.20 crores	Upto 15 times of NOF.

While computing the ceiling for the acceptance of deposits, any loan received from Statutory Corporations and certain other financial institutions and any money raised by the issue of debentures or bonds secured by the mortgage of immovable properties of the Company are required to be added to the amount of deposits accepted by such a company.

(iv) Only on written applications received from the depositor in the specified form, can a HFC accept, renew or convert any deposit. The application form should contain all the particulars specified in the Advertisement Rules framed under section 58A of Companies Act. (These Rules are yet to be amended to include HFCs.)

(v) HFCs are required to furnish receipts to depositors and maintain register of deposits.

(vi) HFCs can pay brokerage or commission upto two percent of deposit amount but these companies cannot pay interest exceeding fifteen percent p.a. on any deposits.

(vii) HFCs are required to maintain minimum percentage of liquid assets which is not less than ten percent of the deposits outstanding in the books of a HFC on any day.

(viii) Provisions requiring furnishing of audited balance sheet and certain returns/particulars, as also a statement to NHB in lieu of advertisement required under the said Advertisement Rules, are included in Directions.

5.14 RBI has, as stated in paras 5.2 and 5.6 above, issued Directions to NBFCs, MNBCs, and RNBCs, while NHB has issued Directions to HFCs. The provisions of the existing four Directions in respect of important regulations, are given in Appendix V.

CHAPTER VI

PROPOSED REGULATORY FRAMEWORK FOR NON-BANKING FINANCIAL COMPANIES.

6.1 In this chapter are detailed the recommendations in regard to the regulatory framework as envisaged by the Group. The chapter is divided in two parts. Part I explains the approach of the Group to regulation/supervision. Part II deals with the system of regulation.

PART I

APPROACH TO REGULATION

6.2 As indicated in the previous chapters, NBFCs in the corporate sector are regulated by the provisions of Chapter IIIB of the RBI Act, Chapter V of NHB Act, and the respective Directions issued thereunder. The regulatory approach at present is based primarily on limiting the quantum of deposits and determining the terms and conditions on which deposits are accepted. For unincorporated bodies, on the other hand, as per the provisions of Chapter IIIC of RBI Act, restrictions have been placed on the number of depositors that an individual/firm or association can accept deposits from, regardless of the amount of such deposits.

6.3 Improvement of the financial system is the primary aim of regulation. For this purpose and for safeguarding depositors' interest, in the opinion of the Group there is a need for - (i) changing the focus of regulation and (ii) adopting steps for making regulation and supervision more effective. It may be mentioned that the recommendations of the Group are based on the working experience of the regulatory authorities (i.e. RBI and NHB) and the views formed by the members of the Group after interaction with eminent persons from the financial field and the representatives of the financial service industry and allied fields.

6.4 The recommendations of the Group are to be viewed against the back-drop of financial sector reforms under way in the country and the need to adapt the regulatory system of NBFCs to this environment. The Group's view is that the regulators have to resist the temptation of over-regulation which will stifle the growth of the non-bank financial sector but have, in fact, to encourage a healthy and orderly growth of these intermediaries so as to ensure the solvency and safety of the financial system of which these companies form an integral part. A well diversified and healthy NBFC sector would impart further depth to the financial system.

6.5 The regulatory authorities the world over have, after putting in place regulatory standards for sound and solvent banking systems, turned their attention to the NBFIs, which, if left unregulated, might have endangered the very working of the financial system and which, on the other hand, when encouraged to grow in an orderly fashion, have lent dynamism and vitality to the entire financial system. Moreover, rapid growth and evolution of the financial market have necessitated that the regulatory system be updated/adapted to the new environment so as to ensure effectiveness of regulation.

6.6 In India also, with the coming of age of the financial services industry and with the emergence of financial companies offering a wide range of new services like venture capital, factoring, portfolio/asset management and so forth, a need has been increasingly felt for changing the very character of NBFC regulation. The diversification of NBFCs along this line was not envisaged, except in a general sense, at the time of framing the relevant provisions of the RBI Act. A need for reviewing these provisions has therefore arisen. Besides, the provisions of regulation and supervision need to be made more purposive with a view to safeguarding depositors' interest and ensuring that the aim and directions of monetary and credit policy are not diluted by a segment of the financial market, perhaps to the detriment of the entire system. A study of the regulatory systems of some other countries indicate that in recognition of the ground realities, they have also embraced comprehensive systems of regulation so as to safeguard depositors' interest.

6.7 The need for changing the approach to regulation has arisen due to various factors. The world over, including India, the boundaries between banks and non-banking companies, financial or otherwise, are becoming blurred, because of the need to provide a variety of financial services under one roof as also the need for effective competition, with the result that each sector has been making inroads into the business of the other. NBFCs have, since long, been undertaking, business in many ways similar to that of banks and banks are entering the fields of hire-purchase, leasing, etc. through subsidiaries. Moreover, with the process of disintermediation gathering momentum, the direct access of companies to the investing public is also increasing and the role of banks in providing the only link between savers and investors is diminishing. NBFCs, as also NBNFCs are competing alongside banks for public savings. Thus, at a time when there is considerable convergence in the functions of banking and non-banking companies, subjecting these two classes of companies to totally different kind and level of regulation is neither healthy nor fair. There is a need, therefore, for prescribing for NBFCs, regulatory and supervisory standards akin to those prescribed for banks in order to create a level playing field.

Need for Decategorisation

6.8 Besides this, within the class of NBFCs itself, there is a blurring of categories due to the emergence of many multi-service companies which prefer, out of commercial considerations, to offer a diversified range of services rather than stick to one or two services. Restricting this process of diversification, by placing category-oriented regulatory straitjackets, does not appear to be warranted.

6.9 Furthermore, it must be reckoned that as the process of liberalisation gathers momentum in India and as the pace of integration with the global economy picks up, more and more innovative kinds of financial services will be available in the country. For bringing these within the present regulatory framework, which is based on the category classification of NBFCs, frequent redefinitions would be required not only of the category classification of NBFCs but perhaps of the very definition of NBFCs.

6.10 It is recognised that there is a wide variation between the needs and the characteristics of various categories of NBFCs as also the risk profile of their assets. Regulatory framework based on category classification of NBFCs has perhaps evolved due to this factor. But now, because of the functional convergence of banks and non-banks as also various categories of NBFCs inter-se, this approach appears to be out of date.

Uniform Regulation

6.11 The Group is, therefore, of the opinion that uniform regulatory norms are required to be prescribed, to the extent possible, for all categories of

NBFCs. This would require dismantling the category-classification of NBFCs and prescribing uniform regulation for all kinds of NBFCs, such that any well-sized company offering any kind of financial service will automatically be subjected to proposed system of regulation. It may perhaps be mentioned here that many of the financial industry representatives with whom the Group had discussions also expressed the need for simplification of category classification and more uniformity in the mode of regulation. As ensuring the safety and soundness of the system is the primary goal of regulation, a common regulatory approach for all NBFCs would be more judicious besides being in tune with the requirement of the day. Moreover, this approach will also facilitate companies operating in one field extending their operations into any of the other fields of non-banking financial business.

6.12 The Group recognises that dismantling of the category-classification of NBFCs will have considerable impact on the asset composition of NBFCs. At present, most of the NBFCs offer specialised services in specific fields of operations, depending upon the category to which they belong. Their operations and expertise are, to a large extent, confined to these specific areas, with limited exposure to other areas, as permissible under the RBI Directions. It is no doubt true that dispensing with category classification will, over a period, intensify competition in the market place and may have deleterious consequences for the survival of some of the established companies. But the removal of inter-category barriers will make the system more forward-looking. Freedom to offer any kind of financial service will make the system more market-driven and efficient. On balance of considerations, the Group believes that the removal of category classification will be for the betterment of all the NBFCs.

Definition of NBFC

6.13 NBFCs are financial institutions. Section 45 I(c) of the RBI Act defines Financial Institutions as under :

"Financial Institution" means any non-banking institution which carries on as its business or part of its business any of the following activities, namely:-

(i) the financing, whether by way of making loans or advances or otherwise, of any activity other than its own;

(ii) the acquisition of shares, stock, bonds, debentures or securities issued by a Government or local authority or other marketable securities of a like nature;

(iii) letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of section 2 of the Hire-Purchase Act, 1972;

(iv) the carrying on of any class of insurance business;

(v) managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any State, or any business, which is similar thereto;

(vi) collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lumpsum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes or gifts, whether in cash or kind, or disbursing monies in any other way, to persons from whom monies are collected or to any other person;

but does not include any institution, which -

(i) is an industrial concern as defined in clause (c) of section 2 of the Industrial Development Bank of India Act, 1964, or

(ii) carries on as its **principal business** -

(a) agricultural operations; or

(b) the purchase or sale of any goods (other than securities) or the providing of any services; or

(c) the purchase, construction or sale of immovable property, so however, that no portion of the income of the institution is derived from the financing of purchases, constructions or sales of immovable property by other persons;

6.14 If the category classification is dismantled, it will be necessary to ensure that only those companies whose principal business falls in categories (i) to (iii), (v) and (vi) above are considered as NBFCs. For this purpose, an activity or combination of activities can be considered as forming **principal business** if not less than 60 per cent of a company's assets are represented by assets relating to that activity or activities and not less than 60 per cent of its revenue receipt is derived from such activity or activities.

6.15 When the definition of NBFCs was framed, the types of NBFCs as existed at that time were taken into account. Since then, a veritable explosion has been witnessed in the type and number of such companies as asset/portfolio management, merchant banking, factoring, venture capital companies, etc. The Group recommends that emergence of such new activities should be taken into account by redefining NBFCs through an amendment of the relevant Act.

Scope of Regulation

6.16 The Group has not made any recommendation regarding regulatory framework for Chit Funds and Nidhis. Chit Funds are administered by the respective State Governments which are expected to take care of the subscribers' interest. As far as Nidhis are concerned, in the opinion of the Group, existing regulations are adequate. Further, these categories of the companies accept deposits from chit contributors or their members. If however, such companies accept deposits from the public, they should also be subjected to regulation along the lines suggested in this Report for other NBFCs.

6.17 A study of deposit acceptance activities in different countries reveals that in many countries, acceptance of deposits from public is restricted to authorised/licensed bodies and unlicensed bodies are not allowed to accept such deposits. Ideally, therefore, it would be desirable to prohibit acceptance of deposits by such bodies. However, in a country like India where the deposit-taking entities abound both in the organised as also the unorganised sectors, a system of regulation covering all these entities would be difficult to operate. On March 31, 1990, number of NBFCs in the corporate sector exceeded 24000. For optimum results, therefore, it will be necessary to confine the regulatory attention to those larger-size companies which account for a lion's share of total NBFC deposits. It may be interesting to note that in 1989, out of over 7000 reporting NBFCs, only about 21 per cent of the companies accounted for almost 97 per cent of NBFC deposits. By adopting this approach, a large number of small-sized companies would be left outside the ambit of the proposed regulation. However, keeping in view the fact that administrative infrastructure available with the regulatory authority is limited, it may be better to restrict the scope of regulation. The Group is of the view that it is better to ensure through an effective system of regulation the safety and solvency of the larger companies. The Group is also of the view that there is a need for prescribing entry barriers in terms of minimum capital requirement so that fly-by-night operators are discouraged. This has been dealt with in greater detail in paragraph 6.24.

Registration

6.18 The Group recommends that a system of registration be introduced for NBFCs and that registered companies (i.e. companies with NOF of over a certain cut-off point as specified in ensuing paragraphs) be subjected to proposed system of regulation. For reasons set out hereunder, registration should be confined only to deposit- taking entities. Non-deposit takers would be outside the system of registration and, therefore, regulation as proposed by the Group. As depositors' protection is the primary object of regulation, only deposit-taking companies need to be subjected to regulation. Those companies which do not accept public deposits but conduct their business by employing their own funds or resorting to borrowings from banks/institutions should be left outside the ambit of regulation. An exception has been made in the case of companies that accept funds under portfolio management or similar schemes. (Paragraph 6.31).

Cut-off Point

6.19 The Group recommends that the scope of regulation be made applicable to those incorporated deposit- taking entities which have NOF of Rs.50 lacs and over. While these companies may be brought under the purview of regulation through the mode of compulsory registration, for other existing companies registration may be kept optional.It may be noted that **throughout this Chapter, the terms 'registration', 'registered NBFC' and 'unregistered NBFC' have been used in relation to the scheme of registration as prescribed by the Group and not in relation to registration under any other statute unless otherwise specified.**

6.20 Common regulatory standard may be prescribed for all registered NBFCs. On the basis of the above- referred cut-off point of NOF of Rs.50 lacs and over, approximately 500 companies which control more than 85 per cent of total NBFC deposits would qualify for compulsory registration. Such companies may be allowed to accept deposits upto a multiple of their NOF as per the norms detailed in Part II of this Chapter. Existing companies which have NOF of Rs. 50 lacs and over and which fail to register should be prohibited from accepting deposits from public.

6.21 All unregistered companies with NOF of less than Rs.50 lacs should be allowed to accept public deposits in accordance with the provisions of section 58 A of the Companies Act, 1956 i.e. only upto 35 per cent of their net worth. This would bring the deposit-acceptance level of all unregistered NBFCs on par with NBNFCs. The task of ensuring their compliance with the provisions of the Companies Act will be performed by the Department of Company Affairs (DCA), Ministry of Law, Justice and Company Affairs, Government of India.

6.22 By proposing that deposit acceptance activity of unregistered NBFCs with NOF of less than Re.50 lacs be restricted to as low a level as 35 per cent of net worth, two objectives are expected to be achieved. As the deposit resources of such NBFCs will only be a fraction of their net worth and their total resources, the risk of loss to the depositors as a class will be limited to a much lower level. Moreover, it is expected that such a low deposit-acceptance ceiling will motivate many an unregistered company to go in for registration. A process of consolidation and rationalisation of the non-banking financial sector is expected to ensue as a result.

6.23 Those existing incorporated entities which have NOF of less than Rs.50 lacs may, if they wish to accept deposits at par with registered NBFCs with NOF of over Rs.50 lacs, obtain registration and comply with regulatory norms. If these companies do not opt to obtain registration, they will have to bring down their deposits to 35 per cent of their NOF over a period as may be specified by the regulatory authority.

Entry Norms

6.24 The Group favours restraining mushroom growth of NBFCs. For this purpose, the Group recommends that all new NBFCs should have minimum NOF of Rs.50 lacs at the time of commencement and should obtain registration. Such companies may in the first two full financial years of their operations be allowed to accept deposits upto 35 per cent of their net worth (as in the case of unregistered companies with NOF of less than Rs.50 lacs). After completion of this period, on the basis of their methods of operations, trade record, financial position, quality of management, etc., the regulatory authority may permit these companies to accept deposits on the same level as permitted to other registered NBFCs.

6.25 The Group also recommends that once the system of registration is operative, after gaining adequate experience, the regulatory authority may consider increasing the coverage of registration by lowering the cut-off point and thereby bringing more companies into the regulatory fold.

6.26 Before addressing the question of unincorporated bodies, it would be pertinent to observe that the Group considered the question of registration versus licensing and favoured the former to the latter in view of the fact that licensing would involve much higher degree of control and supervision and would, therefore, stretch the administrative resources of the regulatory authority too far. After the system of registration is tried and tested, the question of licensing may be reconsidered.

Unincorporated Bodies

6.27 For unincorporated bodies i.e. individuals, association of persons, partnership firms, etc. which constitute quite a sizeable part of the NBFI sector, adequate data as to their size and operations are not available. This has acted as an inhibiting factor for policy formulation in regard to this segment. Such unincorporated bodies are spread throughout the length and breadth of the country and their number is reported to be very large. Some of them render useful services in the economy inasmuch as they mobilise deposits from and provide financial assistance to those sectors and in those regions which commercial banks and NBFCs have not been able to cater to. At the same time, the Group is conscious of the fact that some others have mobilised deposits from gullible public by offering a higher rate of interest and have subsequently failed to repay them. In the process, many depositors have lost their savings.

6.28 The Group is of the view that from the angle of depositors' protection, there is a need to intensify the degree of regulation over these entities. The only regulation that is applicable to them at present is in terms of restricting the number of depositors per individual/partner without a ceiling on the amount of deposits they can accept.

6.29 The Group, therefore, recommends that the RBI Act may be suitably amended for the purpose of prescribing a suitable ceiling on deposit acceptance by unincorporated bodies in addition to the existing restriction on the number of depositors. The regulatory authority may also consider making a beginning in collecting relevant data, with a view to gathering information about the number of such entities and the magnitude of deposits placed with them. Regulatory authority may also acquire necessary powers for conducting inspection/investigation of such units. This may need an amendment to the RBI Act, for at present, RBI does not have powers to call for such information from or conduct inspection of unincorporated bodies. Suitable returns may be devised for gathering such information.

6.30 The regulatory authority may consider prescribing compulsory registration for those unincorporated bodies which have deposits in excess of the prescribed ceiling. Suitable regulatory norms may be prescribed for such bodies by regulatory authority. Such a measure would prevent unregistered NBFCs from converting themselves into unincorporated bodies and continuing their operations without coming under the ambit of regulation. The regulatory authority may consider appointing a Standing Advisory Committee for the purpose of reviewing regulation in regard to unincorporated bodies on an ongoing basis.

Portfolio Management Companies

6.31 Financial companies also accept funds under portfolio management or similar schemes which are not considered as liabilities of the company and which are not reflected in the balance sheet of a company. Though on a strict legal interpretation, the company may not be at risk and the risk is borne by the person placing the funds with the company, it is necessary that volume of such activity undertaken by the company should have some relation to the company's NOF. The Group recommends that the aggregate amount of funds accepted under portfolio management or similar schemes at any point of time should not exceed 20 times the NOF of NBFC.

Asset Side Regulation

6.32 Another focus-shift that the Working Group feels imperative is from emphasis on liability-side regulation to asset-side regulation. So far, apart from prescribing the minimum liquidity ratio for NBFCs, the asset side of a company's balance sheet has been left outside the purview of regulation. Merely limiting the amount of deposits that can be accepted by NBFCs does not safeguard depositors' interest because deploying resources in assets of dubious quality is far more dangerous to a company's health and therefore to the depositors' interest. This is also in line with the international approach to risk assessment of financial companies. The Group concurs with the observation of Narasimham Committee that as in the ultimate analysis, it is the quality of asset portfolio of the financial system that determines the safety of the depositors' or investors' funds, regulatory authority should seek to concern itself with ensuring minimum standards for asset portfolio. With this as the basis of regulation, Group recommends prescription of various prudential norms such as capital adequacy requirement, liquidity ratio, debt-equity ratio, reserve requirement, credit concentration ratio, etc., for the registered companies, which are dealt with in greater detail in Part II of this Chapter.

Supervisory Authority

6.33 For determining the appropriate regulatory authority for the registered companies, detailed discussions were held by the members of the Group. The Group considered whether the registered companies be brought under the direct control of RBI/NHB or they be regulated, along with the banking companies, by the proposed High Powered Supervisory Board [Board] or if there was a need to set up a nodal body for regulating both the registered and unregistered NBFCs. On balance of considerations, the Group is of the opinion that the function of registration and regulation be undertaken by the proposed Board which is being set up as per the recommendations of the Narasimham Committee. The Group agrees with the view of the Narasimham Committee that the "Board should have supervisory jurisdiction not merely over the banking system but also over the development finance institutions, non-bank financial intermediaries and other para-banking financial institutions, such as those which accept deposits from the public or float bonds." It is felt that due to inter-relationship between the activities of banks and NBFCs, it would be advantageous to bring both these categories of companies under the same regulatory authority. Moreover, it is felt that the Board will have the requisite expertise in dealing with all kinds of financial bodies.

6.34 It may be necessary to draw a clear-cut distinction between the regulatory role of Securities and Exchange Board of India [SEBI] and the

Board. While the former would only regulate those companies which provide financial services, the latter would regulate those companies which accept deposits. Those companies which operate in both these fields will be subjected to regulations by both these authorities and there would be a need for close co-ordination between these two regulatory bodies.

Self Regulating Organisations

6.35 In addition to supervision and regulation of the NBFCs by the Board, the Group also sees the need for promoting Self Regulating Organisations [SROs], which may play an increasingly greater role in the regulatory process in the times to come. Such organisations may, to start with, play a useful role by having regular dialogue with the supervisory authorities in regard to the changing needs of the industry and the consequential requirement for reforms in regulation. SROs can thus facilitate interaction between the regulators and the regulated bodies. Membership in such organisations must be made compulsory for each registered NBFC.

PART II
SYSTEM OF REGULATION

6.36 Having elaborated upon the basic approach to regulation, we now turn our attention to specific aspects of regulation. In the opinion of the Group, for ensuring orderly growth of the non- banking financial sector, the system of regulation should consist of the following five facets:

(i) Prescribing norms for entry into deposit- taking business (as outlined in paragraph 6.24)

(ii) Prescribing prudential norms for ensuring minimum standard of asset quality portfolio, as also adequate owned funds and liquidity for meeting unforeseen contingencies.

(iii) Ensuring compliance with the norms through the means of detailed reporting system and auditing.

(iv) Conducting inspection of NBFCs where necessary or where adverse features have been reported by auditors or depositors.

(v) Empowering regulatory authorities to deal with errant companies suitably, as also laying down necessary penalties for non- compliance with the regulatory norms.

REGULATORY NORMS

6.37 The Group has, after prolonged deliberations, come to the conclusion that certain norms as indicated in the following paragraphs are required to be prescribed for NBFCs. The Group also advocates that, keeping in view the fast pace of change in the financial market, these norms be reviewed periodically by a Standing Committee that may be appointed with representatives from Reserve Bank of India, NBFCs, SROs and professional bodies like the Institute of Chartered Accountants of India.

Capital Adequacy Framework

6.38 Capital adequacy framework is one of the most important standards that is required to be prescribed for NBFCs. In a rapidly changing financial market, the role of owned funds as the bedrock of safety in times of turmoil cannot be underestimated. More risky the business, higher has to be the promoter's own stake in it. Capital adequacy standard is a versatile, though complex, tool for ensuring prudent business practices. It is an ideal system for as varied and diversified a market as non-banking financial market. The Group recommends that, after due consideration of the riskiness of each kind of asset, different risk weightages may be assigned to them. In this way, despite the fixation of a uniform capital adequacy ratio for the entire gamut of registered companies, each company will have to maintain capital based on its asset composition and the accompanying prescribed risk weightage. Moreover, off-balance sheet items will also be reckoned for capital adequacy calculation on the basis of credit conversion factors to be prescribed for the purpose on the analogy of the Basle Committee Report.

6.39 A section of interviewees observed that the capital adequacy standard is relevant to those institutions which have a presence in the international financial sector. In India, NBFCs are relatively smaller in size and their activities are confined essentially within the country. Further, even for international banking institutions, capital adequacy framework is a relatively new concept. A view was therefore expressed that these norms need not be made applicable to NBFCs at the present juncture. However, the Group disagrees with this view. The Group recognises the need for prescribing capital adequacy norms and endorses the view that adequacy of the capital should be related to nature and composition of asset portfolio of NBFCs.

6.40 Based on the Basle Committee recommendations, the RBI has already issued specific instructions to all commercial banks in regard to capital adequacy norms and they are required to comply with these by 1994 and 1996 i.e. 1994 for banks that are international in character and 1996 for other banks. The Group considers that capital at 8 per cent of the risk weighted assets and off-balance sheet items on lines similar to that prescribed for banks would be adequate for NBFCs.

6.41 In view of the diversity of the NBFCs and the products offered by them, the exercise of computing risk weights for assets and credit conversion factors for off-balance sheet items broadly acceptable to all sides may take time. This exercise may be undertaken by the Regulatory Authority in close co-ordination with the Institute of Chartered Accountants and representatives of the SROs/NBFCs.

6.42 The Group advocates that the exercise of computing risk weights be completed no later than March 31, 1994 and the capital adequacy standard be introduced after a gap of about one year i.e. by March 31, 1995. During this period of one year, the companies can gear up for complying with the capital adequacy standard. By this time, the progress in regard to compliance with the standard by the banking system will also be known and the time will be opportune for the application of the same to the NBFCs. The existing RNBCs may be given one more year for complying with capital adequacy requirements.

Debt-Equity Ratio

6.43 Until the capital adequacy norms are brought into force, the existing limits on deposit acceptance may continue for all NBFCs. At present, for the calculation of these limits, certain categories of deposits are excluded and there is no overall limit on the size of debt in relation to NOF. The level of risk to which a depositor is exposed, depends not merely on the total amount of deposits but also on the total debt of the company. Therefore, it is necessary that in addition to the existing limit on deposit acceptance, there should also be an overall limit on total debt. In the opinion of the Group, notwithstanding the fact that at present there are various limits on deposit acceptance by NBFCs of different categories without any ceiling on their aggregate debts, in the transitional period a ceiling on total debt may be uniformly fixed for all NBFCs at 15 times of their NOF.

Definition of NOF

6.44 NOF has been defined as the aggregate of the paid- up capital and free reserves as appearing in the latest audited balance sheet of the company as reduced by the amount of accumulated balance of loss, deferred revenue expenditure and other intangible assets, if any, as disclosed in the said balance sheet. It has been brought to the notice of the Group that many NBFCs form subsidiaries and through such subsidiaries engage in business of acceptance of deposits. In view thereof, the Group recommends that NOF may be redefined to exclude from such fund investments made in other NBFCs and subsidiaries as also loans and advances to subsidiaries to the extent that such investments, loans and advances exceed in the aggregate 10 per cent of the NOF of the investing company.

Definition of deposit

6.45 The question of adequacy of the present definition of the term 'deposit' was considered and different definitions of deposits as available in the RBI Act and in the statutes of some other countries were examined. The Group recommends that the existing definition as contained in RBI Act is exhaustive and it may be retained for future also. Several directions issued by the RBI create distinction in deposits of two different types viz. "Exempted" and "Regulated" deposits. The Group recommends that there should be only one category of deposits and that a clear distinction should be made between deposits and borrowings from banks/institutions. Secured debentures will be considered as borrowings, Certificates of Deposits [CDs], Cash Certificates and other deposit-substitutes will also be construed as 'deposits'. Inter-corporate deposits will also constitute a part of 'deposits'. However, borrowings will not. The gearing capacity for a company for raising deposits should be related to total deposits as defined hereinabove. If the regulatory authority so desires, it may create another category of deposit i.e. 'exempted' deposits, but this category will enjoy freedom only in respect of the tenor of deposits and the rate of interest payable on such deposits. For all other requirements i.e. maximum borrowing limits, liquidity norms, etc., there will be only one category of deposit.

Liquidity Ratio

6.46 The Group considered prescribing another sophisticated tool for ensuring that NBFCs maintain adequate liquidity - i.e. linking the required level of liquidity to the period-wise maturity mismatches between the assets and liabilities of each company. However, due to the practical difficulty in monitoring this system, this idea was abandoned in favour of a simpler concept of a flat liquidity ratio at a specified level as is being prescribed at present. The Group is of the opinion that the minimum liquidity ratio be fixed at 10 per cent of total deposit liabilities. The ratio may be adjusted at quarterly intervals. For the purpose of effective regulation of monetary and credit expansion in the economy, the RBI may increase this percentage if the situation so warrants. The Group, however, is of the firm view that such a leverage may be used very sparingly. The proper control mechanism for monetary authority should be through the changes in interest rate structure as interest rate mechanism and not liquidity requirement should in future assume greater importance for expansion and contraction of credit in the economy.

6.47 The requirement of maintaining liquid assets in the form of bank deposits, investments in Government and approved securities by HPCs/ELCs was raised from 10 per cent to 15 per cent of the deposit liabilities which was required to be achieved in phases at 1 per cent in each quarter commencing from November 1, 1991 and reaching 15 per cent on and from November 1, 1992. Liquid assets in excess of 10 per cent are required to be kept only in the form of Central/State Government Securities and/or Central/State Government guaranteed bonds. The Group recommends that NBFCs may be allowed freedom to keep their liquid assets in any form within the definition of liquid assets.

Credit Concentration Ratio

6.48 One of the causes of difficulties of financial companies is over-exposure to a single or a group of companies. An important feature of asset-side regulation is, therefore, prescription of norms as regards credit concentration to a single company or a single Group of Companies. It may be noted that similar provisions are common in regulatory frameworks of some of the countries studied by the Group, such as U.K., Malaysia, Hongkong, etc. Single borrower limit and group exposure limit may be prescribed at 15 per cent and 25 per cent respectively of the NOF of each NBFC. For determining such exposure, financial guarantees may be converted at a suitable credit conversion factor. The regulatory authority may define the term 'Group'.

6.49 To ensure that restrictions imposed in regard to single and group borrower limits do not act as a deterrent for financing the requirement of capital intensive assets or genuine needs of large borrowers, the Group recommends that consortium financing by NBFCs be encouraged by removing the present impediment to such financing. For this purpose, tax laws may have to be changed so that depreciation is allowed as tax-deduction even when assets are jointly held by/charged to all the members of the consortium.

Reserves

6.50 The Group is of the opinion that every company should, for the purpose of building up its internal financial strength, plough back a part of its profits earned to reserves every year. The Group recommends that out of its disclosed net profit, every year, at least 20 per cent should be transferred to reserves till it equals its paid up share capital. As a prudent financial policy, companies may continue transferring a portion of their profits to reserves even after the level prescribed hereinabove has been reached.

Prohibited Investments

6.51 The Group feels that it is necessary to restrain the NBFCs from deploying excessive levels of resources in certain undesirable activities and therefore recommends that the regulatory authority may prescribe a list of such activities which may be revised from time to time.

Interest rates on deposits

6.52 At present, the Directions issued by RBI prescribe a ceiling rate of interest payable on deposits accepted by NBFCs except in the case of RNBCs where the minimum rate of interest has instead been prescribed.

6.53 Views were sought from different sources in regard to whether there was a need to regulate the interest rates on deposits. A large majority was in favour of continuation of interest rate regulation at least until bank interest rates continue to be regulated. They also favoured that interest rates on NBFC deposits should be such as to offer a real return to the investor.

6.54 The Group recommends a two stage strategy as far as interest rates are concerned. In the first stage, since the ceiling rate on deposits of commercial banks continues to be regulated by Reserve Bank, the rates of interest payable on all deposits mobilised by NBFCs should be linked with the rates of interest offered by commercial banks; thus there should be a differential of two to three per cent over the bank deposit rates for the concerned period so as to reflect the higher level of risk attached to NBFC deposits. There should be automatic increase or decrease in the NBFC interest rates in line with changes in those offered by commercial banks. The Group advocates that the differential between the interest rates offered by NBFCs and those by the banking system may bc pegged at two per cent per annum for deposits for three years or less. For deposits maturing after three years, the differential may be pegged at three per cent per annum. This differential is considered adequate by the Group in view of the fact that commercial bank deposit rates have been recently increased to reflect the current market conditions. In the second stage, as and when commercial bank interest rates are deregulated, NBFC interest rates may also be similarly deregulated.

Period of deposit

6.55 Presently all NBFCs except HFCs are allowed to accept deposits for a period no shorter than 24 months and no longer than 60 months. In the case of HFCs, the maximum period is 84 months. In the case of RNBCs, the period of deposits is not less than 12 months and not more than 120 months. The Group advocates that the provisions as regards the period of deposits for all categories of NBFCs also be made uniform.

6.56 Representations were made to the Group that the present stipulation of RBI as far as the minimum period of deposit is concerned was too harsh. Quite a few companies preferred that the minimum period be lowered to 3/6 months. Moreover, interest-sensitive depositors have shown a decided preference for placing their money in shorter term deposits and rolling them over so as to make the most of the changing interest rate pattern. Disallowing NBFCs to accept shorter term deposits may mean refusing them access to this segment of the market. Taking into account these factors, the Group recommends that the minimum period of deposits be reduced from 24 months to 12 months and the maximum to 84 months. As regards the maximum period, the Group is guided by the recent experience of Unit Trust of India and Industrial Development

Bank of India in mobilising long term savings in the economy. The Group believes that there is a class of investors which has a decided preference for long term investments. Besides, companies in the business of hire purchase, equipment leasing, housing finance, etc., need to provide finance to their constituents for relatively longer periods. NBFCs can, therefore, play a significant role by tapping such long term resources and deploying them for the longer term fund requirement of their constituents, thus minimising mismatch in their asset/liability portfolio.

6.57 In the recent times apart from traditional methods of tapping savings in the economy in the form of current, savings bank, fixed, etc., deposits, the commercial banks have been permitted to tap savings by issue of CDs which are intended to provide an alternative avenue for institutional investors. In the light of priority being accorded to housing finance and transport and other similar industries, the Group recommends that such NBFCs may be allowed to attract such investors by issuing CDs. The minimum period of such CDs may be kept at not less than one year. The minimum amount of such deposits may be kept considerably lower as compared to the criterion applicable to commercial banks so as to facilitate a larger number of investors to place their funds in CDs issued by NBFCs.

Deposit Insurance

6.58 Deposit insurance is one of the important means of safeguarding depositors' interest. Some advanced countries like U.K. and USA have extended insurance cover to NBFC deposits also.

6.59 The question of extending deposit insurance cover to NBFCs at this stage is not favoured by the Group. As observed by Raj Committee, before extending insurance cover to NBFCs, it should be "ensured that their methods of operations are standardised, weaker units are weeded out by amalgamation or otherwise and their working is, by and large, put on sound footing." Such consolidation and rationalisation of NBFCs is yet to be achieved. The regulatory framework recommended hereinabove is expected to achieve this result whereafter the question of deposit insurance may be reconsidered. Moreover, it is felt that adequate asset side regulation will go a long way in providing depositor protection. Hence, at this stage, it is not considered judicious to prescribe deposit insurance.

Accounting Standards

6.60 Effective regulation would depend to a large extent on adoption of uniform accounting standards by NBFCs. The Group is of the opinion that suitable accounting standards may be finalised by a Standing Committee with representation from the regulatory authority, Institute of Chartered Accountants, SROs and the financial industry. Some of the areas for which accounting standards need to be established are income recognition, provisioning, valuation of securities, financial leases etc. It is also necessary that disclosure norms be prescribed, particularly in respect of maturity of assets and liabilities. NBFCs should be required to classify their assets and liabilities in four categories as under on the basis of maturity:

(i) Upto 6 months.

(ii) After 6 months and before 1 year.

(iii) After 1 year and before 3 years.

(iv) 3 years and above.

The accounting standards and disclosure norms should broadly conform to the standards and disclosure norms prescribed for banks and financial institutions.

6.61 Even where NBFCs do not maintain their books of account in accordance with the standards prescribed, the standards and disclosure norms should nonetheless be used for calculation of the prudential norms and for the periodic returns to be submitted to the supervisory authorities.

6.62 Given the fact that administrative infrastructure is limited, the Group recommends that auditors be allowed to play a greater role in the supervisory process. Regulatory authorities can not carry out detailed inspections on the level required because of the large number of companies that have to be regulated. Hence, it may be more practical for the regulators to rely on the assistance and cooperation of auditors whose duties necessitate first hand knowledge of a company's accounts. Each registered company may be required to submit periodical returns to the regulatory authorities and the latter may prescribe that these be certified by auditors at intervals as specified by the regulatory authorities. Each company may be required to produce a satisfaction certificate from its auditors certifying that all the prudential norms have been complied with.

6.63 As observed in Chapter III, many NBFCs default in submission of prescribed returns. The regulatory authority should examine whether there is a need for simplifying their returns and SROs may undertake the task of educating the member-NBFCs about the mode of compiling these returns. The regulatory authority should take punitive action against defaulting NBFCs.

6.64 The Regulatory Authority must be empowered to take suitable action where it appears that any NBFC is carrying on business in a manner detrimental to the interests of its depositors, is insolvent or likely to become insolvent, or has contravened the provisions of the regulatory framework. Such action may mean suspension/cancellation of registration or asking the company to take such remedial action as the regulator may deem necessary or assuming control over the business of the company till it is nursed back to sound health.

Credit Rating

6.65 Credit rating is an important tool of credit assessment for the investor who may not have the requisite expertise to gauge the solvency and soundness of the company in which he places deposits. The Group considered the issue of making credit rating mandatory for all registered NBFCs. After due deliberations, however, it is felt that at this stage credit rating may not be made compulsory. However, it should be necessary in the deposit seeking advertisement for the company to indicate prominently the credit rating obtained and if no rating is obtained, the fact that no such rating is obtained. It is felt that this mode of advertisement will itself act as inducement for more and more companies to go in for rating, especially as public awareness of the importance of credit rating in decision-making process increases. The regulatory authority may make such credit rating compulsory for all NBFCs, after a period of five years. In other words, from April 1, 1998 no registered company can issue any advertisement soliciting public deposits unless it has been rated.

Refinance to NBFCs

6.66 As may be observed, the Group has advocated that NBFCs be regulated on lines similar to commercial banks. It is only fair, therefore, that some of the facilities enjoyed by commercial banks be extended to NBFCs too. The regulatory authorities may consider such measures as exempting interest on NBFC deposits from requirement of Tax Deducted at Source, providing refinance to registered NBFCs, etc.

6.67 It may be noted that at present, HFCs are getting refinance from NHB. NBFCs do not have any access to refinance from the Central Bank of the country. With the stipulation of several conditions for the orderly growth of NBFCs, it is expected that this sector will play a healthy role in the country's financial system. In order to meet their temporary needs for funds, the Group recommends that RBI may consider providing to registered NBFCs stand-by refinance facilities. RBI may prescribe suitable eligibility conditions for such borrowings. Stand-by refinance may be provided by RBI against Government and other approved securities. Extension of this facility will induce the companies to invest part of their resources in such securities, where the return, at least at present, is comparable to that available on investments in bank deposits. This will also induce more and more companies to move towards registration and, at the same time, RBI can, by imposition of specific conditions, vitalise registered NBFCs.

Advertisements

6.68 Many companies represented to the Group that rules relating to 'statutory advertisements' to be released in the press should be simplified/rationalised and that repeat advertisements may be permitted to be issued in a simpler and less detailed format. In view of the fact that this would considerably reduce the cost of advertisement for these companies, the Group agrees that detailed advertisement in newspapers may be required to be placed once in a year and that repeat advertisements may be brief. However, each advertisement should invariably contain (a) a specific statement that detailed advertisement can be obtained, on request, from the company and (b) the date and newspaper in which the detailed advertisement was published. The deposit application form should contain all the requisite financial details about the company. The regulatory authorities may consider permitting NBFCs to advertise on television. This also, would require considerable relaxation in advertising rules. However, such rules may be put in place as would prevent NBFCs to allure prospective depositors by giving them an unduly rosy picture.

Timeframe

6.69 It is proposed that all the registered NBFCs (barring RNBCs) be permitted time upto March 31, 1994 to adjust to and comply with the norms of the new regulatory framework (subject to paragraph 6.42). RNBCs may be allowed a slightly longer time - i.e. upto March 31, 1995. Longer time-frame is recommended for RNBCs in view of the fact that presently they are operating under a regulatory framework which is totally different as compared to the framework for other NBFCs. In order to bring them also in the mainstream of the NBFC sector, they would require a longer period to gear up for the new framework.

Exit Policy

6.70 The Group also feels that there should be a suitable exit policy for the registered NBFCs which wish to discontinue acceptance of deposits. Those units which opt for voluntary exit should repay their liabilities before they apply for cancellation of their registration. Application for cancellation of registration should be accompanied by auditors' certificate stating that the liabilities of the company have been settled. The regulatory authority should have power to weed out units which do not comply with its guidelines.

6.71 The regulatory authority should have the powers to apply for the winding up of a company under the following circumstances :

(i) Failure to repay any matured deposit within a period of one year from its due date.

(ii) If a company incurs cash losses for three successive years and efforts to restore it back to good health by any sort of remedial measures have failed or are, in the opinion of the regulatory authority, not likely to succeed.

Legislative Framework

6.72 As mentioned hereinabove, NBFCs are being regulated by directions issued under Chapter IIIB of the RBI Act and Chapter V of the NHB Act. The Group is of the view that it is necessary to enact a separate legislation for regulating NBFCs combining the existing provisions of the above referred Acts and the Directions issued thereunder. An identical set of regulations may be issued for all NBFCs including HFCs.

6.73 This Legislation should be put under the IX Schedule to the Constitution of India. The reason for this is, that as per the provisions of Article 31B of the Constitution, when an Act or Regulation is put in the IX Schedule by a constitutional amendment, no such Act or Regulation or any provision thereof, shall be deemed to be void on the ground that such Act, Regulation or provision thereof, is inconsistent with or takes away or abridges any fundamental rights. It may be noted, however, that although putting the proposed legislation in regard to NBFCs under the IX Schedule will make it beyond challenge on the ground of violation of fundamental rights, the Constitutional Amendment Act by which the Act itself is put under the IX Schedule, will be open to challenge on the limited ground that it damages any of the basic or essential features of the Constitution or damages the basic structure of the Constitution and the question whether the fundamental rights as such constitute one of the basic features of the Constitution, is itself a moot point.

6.74 It should also be remembered that any orders passed under the Act by way of subordinate legislation or delegated legislation will be open to challenge for violation of fundamental rights, irrespective of whether such orders were issued prior to or after putting the Act under the IX Schedule. Moreover, amendments to the Act will also not be protected unless the Amendment Acts are also put under the IX Schedule. Hence all the regulations under the existing statutes and directions will have to be included in the proposed statute.

6.75 In as much as financial markets are in a constant state of evolution, the statute may itself require subsequent amendments and this may become cumbersome in view of the legal position explained hereinabove. It may, therefore, be necessary to weigh this alternative of enacting a separate statute and putting it under the IX Schedule, which may, in any case be a lengthy process and may unduly delay the implementation of the recommendations of the Group.

6.76 As an immediate measure, the Group recommends that the three Directions issued for different categories of NBFCs be repealed and combined into one Non-Banking Financial Companies' Directions for regulating all categories of NBFCs, including MNBCs and RNBCs , but excluding HFCs which may be regulated by suitable amendments in the directions issued under the NHB Act. Suitable provisions may be incorporated in the Statute/Directions to the effect that contravention of the provisions of the Statute/Directions will be punishable by fines/imprisonment. The Act and/or directions may provide for granting necessary powers to the regulatory authority to exempt any specific NBFC from the provisions of the regulations for a limited period, if regulatory authority is satisfied about the need for such exemption.

Publication of List of Registered Companies.

6.77 As mentioned earlier, the Group recommends classification of different types of NBFCs into two categories viz. the registered and the unregistered companies. The registered companies will follow the guidelines of the regulatory authority in respect of prudential norms. Therefore, they would be in a better position to meet their obligations towards their depositors. The depositors should be made aware of this fact. Thus, the Group recommends that the list of registered companies be published at regular intervals and at least once in a year. If for some reason registration is suspended by the regulators, this fact should also be published in newspapers. The list and modification therein should be published in national as well as local newspapers. Registered companies should display their registration certificate in their offices. They should also print their registration number in their deposit-seeking advertisements and on the deposit receipts.

Public Awareness Programme

6.78 The Group also feels that there is a need to undertake some kind of public awareness/education programme which will acquaint the public with the difference between registered and unregistered companies. The Group recommends that this work of educating the depositors and the public at large should be done by the SROs. They should publish a list of their members periodically. Only registered companies should be allowed membership of the SROs and as already stated earlier, such membership may be made compulsory for all registered units.

Liaison Between the Regulatory Authorities

6.79 The registered companies will be under the control and regulation of the Board and the unregistered companies will be under the control of the DCA. The Group feels that there is a need for close liaison between the two regulatory authorities. The Board should send the list of registered units to the Registrars of Companies [ROC]. The Regional Directors of DCA or ROC, on a regular basis should, in turn, send a list of financial companies registered under the Companies Act to the Board. The ROCs may also be required to send copies of the balance sheets of financial companies to the Board, in cases where the NOF of these companies exceed Rs.50 lacs so that the Board can identify errant companies, if any.

6.80 The Group has made several suggestions keeping in view healthy growth of NBFIs within a broad regulatory framework. Obviously it will increase the administrative workload at the supervisory level. Thus, the Board should be suitably equipped to handle the workload relating to not only banks, but also NBFCs. To the extent possible, the work should be decentralised by establishing cells of the Board at all important centres in the country. The emphasis of regulation is to be on the quality of supervision rather than on the quantitative coverage and hence the regulatory machinery must be built up with this objective in view.

CHAPTER VII

Summary of Major Observations and Recommendations of the Group

7.1 Summary of major conclusions and recommendations is given in the following paragraphs. Full context thereof is not restated here as it has been extensively dealt with in the preceding chapters. The numbers of the relevant paragraphs of the chapters relating to the conclusions and recommendations have been indicated within brackets to facilitate ready reference.

7.2 Growth and diversification of non-banking financial companies (NBFCs) is an integral part of the development process of the financial market of the economy. The approach of the Group revolves round the conviction that a thriving, healthy and growing non-banking financial sector is necessary for promoting the growth of an efficient and competitive economy. From the angle of depositors' protection and efficacy of monetary and credit policy, what is really required is a well-integrated regulatory framework which, while monitoring and supervising the operations of NBFCs, recognises and even encourages the emergence of new types of financial services and products. (1.11 & 1.12)

7.3 In the last two decades, non-banking financial sector has witnessed a marked growth. Some of the factors which have contributed to this growth have been, lesser regulation over this sector vis-a-vis the banking sector, higher deposit interest rates offered by this sector, higher level of customer orientation, the speed with which it caters to customer needs and so forth.(3.3)

7.4 Number of NBFCs increased from 7063 in 1981 to as much as 24009 in 1990, thus registering compounded annual growth of about 14 per cent. Deposits with these companies grew ten fold during this period.(3.8 & 3.15)

7.5 Non-bank deposits as a ratio of gross financial savings of the house hold sector went up from 2 per cent in 1981-82 to 7.9 per cent in 1989-90. Although, the magnitude of deposits with non- banking financial companies in relation to total bank deposits still forms a small percentage, there is enough evidence of acceleration in the growth of these deposits which underlines the need for effective regulation. (3.20 & 4.3)

7.6 Although, the number of non-bank financial intermediaries, both in the organised and unorganised sectors is very large, only about 1600 companies which constitute 21 per cent of the reporting companies account for as much as 97 per cent of total deposits.(3.14)

7.7 The need for bringing NBFCs under the regulatory framework arises not only for ensuring their healthy growth but also for improving the efficacy of the credit and monetary policy as well as for inculcating healthy financial discipline among both providers and users of credit.(4.16)

7.8 The Group recommends dismantling of the category- classification of NBFCs and application of uniform regulation for all NBFCs.(6.11 & 6.12)

7.9 The Group recognises the need for effective regulation of all deposit-taking entities, howsoever small they may be. However, due to the large number of operators in this field and the limited size of administrative infrastructure, the Group advocates that regulatory attention be confined to those larger-size companies which account for a lion's share of total non-banking financial companies' deposits. (6.17)

7.10 All the existing deposit-taking companies with net owned funds of Rs.50 lacs and over should compulsorily register (as explained in paragraph 6.19) with the regulatory authority. This cut-off point may be reviewed subsequently. Companies with net owned funds below this cut-off point may, if they so prefer, opt for registration. Registered companies will be allowed to accept public deposits upto a multiple of their net owned funds. Unregistered companies with net owned funds of less than Rs.50 lacs will be allowed to accept public deposits at a lower level i.e., in accordance with provisions of Section 58 A of the Companies Act, 1956.(6.20, 6.21 & 6.23)

7.11 The Group favours prescription of entry norms for all new NBFCs such as (a) minimum net owned funds of Rs.50 lacs at the time of commencement; (b) registration with the regulatory authority; (c) restriction on deposit-acceptance activity at the level permitted to unregistered companies in first two full financial years of operation and (d) permission for deposit acceptance at par with the existing registered companies after completion of this period, on the basis of track record, quality of management, methods of operation, etc.(6.24)

7.12 The Group is of the opinion that the function of registration and regulation be undertaken by the proposed High Powered Supervisory Board.(6.33)

7.13 The Group advocates that the focus of NBFC- regulation be shifted from liability-side to asset-side of NBFC balance sheet and is in favour of prescribing capital adequacy standard based on risk-weighted assets as prescribed for commercial banks. The Group recommends that the regulatory authority, in co-ordination with the representatives of NBFCs, Self Regulating Organisations and the Institute of Chartered Accountants, may complete the exercise of computing risk weights and credit conversion factors by March 31, 1994 and that capital adequacy ratio at the rate of 8 per cent of the risk weighted assets and off-balance sheet items be introduced by March 31, 1995.(6.32, 6.38, 6.41 and 6.42)

7.14 Until the time, capital adequacy framework is introduced, the existing limits on deposit acceptance may be continued subject,however, to an overall debt equity ratio of 15:1.(6.43)

7.15 The Group recommends placing restrictions on the portfolio management activities of these companies.(6.31)

7.16 In addition, the Group favours that NBFCs be required to (a) maintain liquidity ratio of 10 per cent of their total deposit liabilities, (b) limit their risk exposure to single and group borrowers to 15 and 25 per cent of their net owned funds respectively, (c) transfer at least 20 per cent of their net profit to reserves every year until reserves equal the company's share capital and (d) refrain from investing in certain undesirable activities as defined by the regulatory authority. (6.46, 6.48, 6.50 and 6.51)

7.17 The Group favours that until the time commercial bank deposit interest rates are regulated, NBFC interest rates also continue to be regulated and that the latter be pegged two to three per cent above the former. The Group also favours that NBFCs be allowed to accept deposits for periods ranging between 12 to 84 months as against the existing range of 24 to 120 months. (6.54 & 6.56)

7.18 The Group favours abolition of the existing distinction between the terms 'exempted' and 'regulated' deposits for the purpose of calculating the gearing ratio and instead suggests that a distinction be made between 'borrowings' and 'deposits'. The regulatory authority may, if it deems fit, create a distinction between 'exempted' and 'regulated' deposits for the purpose of tenor of deposit, rate of interest etc. Deposit insurance is not recommended at this stage.(6.45 & 6.59)

7.19 The Group recommends making credit rating compulsory for all registered companies, not in the immediate future but after a period of five years. The Group also recommends relaxations in the Advertisement Rules.(6.65 & 6.68)

7.20 The Group suggests prescription of norms regarding income recognition, disclosure or transparency of accounts, provision for bad and doubtful debts, etc. A committee may be constituted for formulating these norms. Suitable reporting formats may also be devised so that effective supervision may be undertaken by the regulatory authority.(6.60 & 6.61)

7.21 The Group favours assignment of a greater role to auditors in the supervisory process. Periodical statements to be submitted by NBFCs to regulatory authorities will need certification by the auditors. Based on the rule of exception, NBFCs may be inspected by the regulatory authority. (6.62)

7.22 The regulatory authority should be empowered to suspend/cancel registration of these companies and even move for winding up where it so deems necessary.(6.64 & 6.71)

7.23 As regards unincorporated entities, apart from the existing restriction on the number of depositors, the Group recommends prescription of ceiling on the quantum of deposits they can accept. A Standing Advisory Committee may be constituted for reviewing regulatory requirements for these bodies.(6.27 & 6.30)

7.24 The regulatory authority should publish the list of all NBFCs periodically.(6.74)

7.25 The Group recommends that the regulatory authority and the self regulating organisations may initiate a public awareness programme for educating the depositors about the risks associated in placing deposits with various kinds of non-banking financial companies.(6.78)

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(Chairman)

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Y.H.Malegam

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O.P.Chawla

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Deepak S.Parekh

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K.S.Shere

S.S.Karnik
(Member Secretary)

Bombay:
September 5, 1992.

APPENDIX I

Specific points relating to the Terms of Reference of the Working Group and functioning of NBFCs on which views/suggestions were sought for the work of the Group.

1) Effect of acceptance of deposits by NBFCs on savings, pattern of savings, investment and pattern of investments.

2) Whether the provisions contained in Chapter IIIB of the RBI Act are adequate for the purpose of regulating the deposit acceptance activities of these companies from the point of view of their effectively serving as an adjunct to the monetary and credit policy of the country, besides protecting the funds of depositors. Specific aspects in which the provisions of the Act could be further strengthened for fulfilling the objective in view.

3) Whether Non-Banking Financial Companies (Reserve Bank) Directions, 1977, Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977, Residuary Non-Banking Companies (Reserve Bank) Directions, 1987, Housing Finance Companies (NHB) Directions, 1989 fulfill the objectives. Specific areas where further amendments are needed.

4) Role of various categories of NBFIs in mobilising deposits and making loans, advances, investments, etc.

5) Details of the mode of operations of the NBFCs.

6) Presently, these companies have been categorised into different groups. Whether there is continued need for such categorisation or grouping of these companies needs change.

7) Specific suggestions for regulating the conduct of NBFCs, MNBCs, RNBCs and HFCs under the relative sets of directions.

8) Suggestions regarding restricting the area of operations of these companies.

9) Suggestions regarding the norms which may be prescribed in respect of capital structure, deployment of resources, debt-equity

ratio, liquidity norms, transparency of balance sheet, etc. of the various classes of NBFCs.

10) Suggestions whether such companies should have certain minimum capital before commencing the activity of acceptance of deposits. Should such companies be allowed to operate only after obtaining a licence or licence should be granted after they attain a minimum level of business.

11) Suggestions for regulating the utilisation of funds borrowed by NBFCs by way of deposits.

12) Specific views regarding definition of the term 'Deposits'. Is there a need for having two categories of deposits viz., exempted and regulated deposits. Suggestions for adding or deleting any specific category of item from the exempted deposits.

13) Suggestions regarding the extent to which and period for which NBFCs may raise deposits. Should the interest structure on these deposits be deregulated ?

14) Norms for maintenance of liquid assets for meeting the deposit liabilities. Should it be a percentage to total liabilities or a percentage to liabilities maturing ?

15) Suggestions, if any, for improving the quality of advances made by NBFCs. The need, if any, for imposition of a ceiling on the risk assets to be held or on the loans to be granted by such companies.

16) Is there any need for credit rating of these companies by recognised credit rating agencies viz., CRISIL, ICRA, etc.

17) Suggestions regarding prudent accounting norms and extent of transparency in the balance sheet of such companies.

18) Your views regarding adequacy or otherwise of supervisory role presently performed by RBI.

19) Whether there is any need for empowering the RBI in regard to granting 'quasi-judicial powers' on the lines of powers enjoyed by Company Law Board.

20) Suggestions if any, for ensuring the protection of depositors' money in NBFCs.

21) Suggestions regarding the extent to which the activities carried on by such companies through their subsidiaries can or should be controlled.

22) Specific operations/activities of the NBFCs which are not in the interest of the healthy growth of the financial system, customers' interest and National interest.

23) Suggestions on any other relevant topics which is considered germane to the subject matter of the Study presently being conducted by the Working Group.

APPENDIX II

List of Banks/Chambers of Commerce/Associations of Companies/Institutions/Companies and Individuals who submitted detailed memoranda emcompassing specific points arising out of the Terms of Reference of the Working Group.

I. **Banks**

1. Bank of India, Bombay.
2. State Bank of India, Bombay.
3. Indian Overseas Bank, Madras.
4. Indian Bank, Madras.
5. Standard Chartered Bank, Bombay.
6. ANZ Grindlays Bank, Bombay.
7. Canara Bank, Bangalore.
8. Allahabad Bank, Calcutta.
9. New Bank of India, New Delhi.
10. Andhra Bank, Hyderabad.

II. **Chambers of Commerce**

1. The Associated Chambers of Commerce and Industry of India, New Delhi.
2. The Federation of Andhra Pradesh Chambers of Commerce and Industry, Hyderabad.
3. The Madras Chamber of Commerce and Industry, Madras.
4. Indian Merchants' Chamber, Bombay.

III. **Associations of Companies**

1. Chamber of Nidhis, Madras.
2. The Punjab & Haryana Finance Companies Association, Jalandhar.
3. Residuary Non-Banking Company's Association, Allahabad.
4. Association of Leasing, Finance and Housing Development Companies, Bombay.
5. Equipment Leasing Association (India), Madras.

IV. Institutions

1. Indian Banks' Association, Bombay.
2. Institute of Chartered Accountants of India, New Delhi.
3. Securities & Exchange Board of India, Bombay.
4. Industrial Development Bank of India, Bombay.
5. The Credit Rating Information Services of India Ltd., Bombay.

V. Individuals

1. Shri R.K. Seshadri, Former Deputy Governor, Reserve Bank of India.
2. Shri Sharat K. Gupta,
   Chartered Accountants, Bareilly.
3. M/s. Tholiya & Company, Cost Accountants, Bombay.
4. Shri A.S. Thiyagarajan, Vice President and Area Executive, Citibank N.A., Bombay.

VI. Others

1. Citicorp Securities & Investments Ltd., Bombay.
2. 20th Century Finance Corporation Ltd., Bombay.
3. Sundaram Finance Ltd., Madras.
4. The Peerless General Finance & Investment Co. Ltd., Calcutta.
5. Shriram Investments Ltd., Madras.
6. The Peerless Field Staff Union, Calcutta.
7. Peerless Karamchari Samity, Calcutta.
8. Peerless Field Employees' Union, Calcutta.
9. South Asian Financial Exchange Ltd., Madras.
10. Casion Finance & Investment (India) Ltd., Calcutta.

VII. Companies

A. Hire Purchase & Leasing Companies

1. Apple Credit Corporation Ltd., Madras.
2. India Equipment Leasing Ltd., Madras.
3. RMB Associates Ltd., New Delhi.
4. Pioneer Leasing (India) Limited, Bombay.
5. The Reliable Agro Engineering Services Pvt. Ltd., Jalandhar.
6. Classic Financial Services & Enterprises Ltd., Calcutta.
7. Raksons Leasing & Finance Limited, New Delhi.
8. The Vysya Bank Leasing Limited, Bangalore.
9. United Leasing Ltd., New Delhi.
10. Kirloskar Investments And Finance Ltd., Bangalore.
11. Lynx India Ltd., Calcutta.
12. PSB Finance & Hire Purchase Limited, Chandigarh.
13. PSB Finance & Leasing Limited, Chandigarh.
14. Cholamandalam Investment & Finance Company Ltd., Madras.
15. SRF Finance Ltd., New Delhi.
16. Concord Credit & Leasing Co.(P) Ltd., Kochi.
17. Industrial Credit & Development Syndicate Limited, Manipal.
18. Grover Leasing Ltd., New Delhi.
19. Dugar Investments Limited, Madras.
20. Concert Investments & Leasing Ltd., Cochin.
21. Sundaram Finance Limited, Madras.
22. U.P. Instalment Supply Pvt. Ltd., Bareilly.
23. Anil Auto Finance Private Limited, Calcutta.
24. Hindustan Leasing Ltd., New Delhi.
25. Kerala Ex-Service Hire Purchase Finance Co. Pvt. Ltd., Sasthamcotta, Quilon (Kerala)

26. Lakshmi General Finance Limited, Madras.
27. Bell Leasing and Hire Purchase (Pvt) Ltd., Cochin.
28. Auto Dealers Private Limited, Calcutta.
29. Bikaner Commercial Co. Ltd., Calcutta.
30. Sakthi Finance Ltd., Coimbatore.
31. Shetty Leasing (India) Ltd., Bangalore.
32. The Hooghly Trust Pvt. Ltd., Calcutta.
33. Seyad Shariat Finance (P) Ltd., Tirunelveli.
34. Gujarat Lease Financing Ltd., Ahmedabad.
35. Pennar Finance Ltd., Hyderabad.
36 Model Housing And Finance Ltd., Hyderabad.
37. Mukunda Industrial Finance Ltd., Bangalore.
38. Ashok Leyland Finance Ltd., Madras.
39. Batliboi Financial Services Ltd., Bangalore.
40. Integrated Finance Company Co. Ltd., Madras.
41. Nagarjuna Finance Ltd., Hyderabad.
42. DCL Finance Ltd., Hyderabad.
43. Narbheram Leasing Co. (P) Ltd., Jameshedpur.
44. Indian Seamless Financial Services Ltd., Bombay.
45. Sunder Leasing Private Ltd., Bombay.
46. Midland Financiers (Doaba) Pvt. Ltd., Jalandhar.
47. Oberoi Leasing & Finance Company Private Limited, Calcutta.
48. Overseas Sanmar Financial Limited, Madras.
49. Harita Finance Limited, Madras.

B. Loan and Investment Companies

1. Canbank Financial Services Ltd., Bangalore.
2. Power Finance Corporation Ltd., New Delhi.
3. Avik Investment & Trading (P) Ltd., Calcutta.
4. Canbank Factors Ltd., Bangalore.

5. The Avenir Finance & General Investment Co. Ltd., Chinsurah, Dist. Hooghly (West Bengal)
6. Botanic Savings and Investment Co. Pvt. Ltd., Howrah.
7. The Celebrate Small Savings & Investments (I) Ltd., Calcutta.
8. Debdut Savings & Investment Co. Ltd., Midnapur.
9. Intact Investments Company (India) Ltd., Guruvayur, Kerala.
10. Manipal Investments Ltd., Manipal (Karnataka)
11. U.P. Electronics Corporations Ltd., Lucknow.
12. Birla Brothers Private Limited, Calcutta.
13. PNB Finance & Investment Limited, New Delhi.

C. <u>Mutual Benefit Finance Companies</u>

1. The Mylapore Hindu Permanent Fund Ltd., Madras.
2. Jayalakshmi Mutual Benefit Fund Ltd., Bangalore.
3. Unifold Finance & Investment Co. (P) Ltd., Bagnan Station Road (North) Dist. Howrah.
4. The Mayavaram Financial Chit Corporation Ltd., Mayiladuturai (Tamil Nadu).
5. Latesh Chit Fund Pvt. Ltd., Faridabad.

D. <u>Miscellaneous Non-Banking Companies</u>

1. Little Flower Kuries and Enterprises Ltd., Cochin.
2. Associated Kuries (P) Ltd., Thrissur.
3. St. Mary's Finance Ltd., Kochi.
4. Sree Lakshmi Datta Chits & Finance (P) Ltd., Madras.
5. Shahdara Chits Pvt. Ltd., New Delhi.
6. Shakun Chit Fund & Leasing Ltd., Saproon, (Solan), H.P.
7. The Catholic Union Chitties Ltd., Mala (Kerala).
8. The Kerala State Financial Enterprises Limited, Trichur.

E. Residuary Non-Banking Companies

1. Satadal Savings & Investment (India) Ltd., Midnapore.
2. The Srijani Finance & Investment Co. Ltd., Calcutta.
3. Dunhil Finance & Investments (India) Ltd., Calcutta.
4. Credence Finance & Industrial Investment (India) Ltd., Calcutta.
5. Monali Finance & Investment (P) Ltd., Calcutta.
6. Annuity Savings & Investment (India) Ltd., Calcutta.
7. Saradamayee Savings & Finance Co. Ltd., Midnapore.
8. Matchless Investment (P) Ltd., Jaipur.
9. Safety General Finance and Investment (India) Ltd., Coimbatore.
10. Sahara India Savings and Investment Corporation Ltd., Lucknow.
11. Malwa Savings & Finance Co. Ltd., Patiala.
12. Bright Future Finance & Investment Ltd., Calcutta.
13. The Peerless General Finance & Investment Company Ltd., Calcutta.
14. Ennoble Finance & Industrial Investment Co. Ltd., Bellary (Karnataka).
15. Excelsior General Finance (India) Ltd., Najibabad.
16. The Udayan Credit & General Investment Co. Ltd., Calcutta.
17. Priya Associates Ltd., New Delhi.
18. Pearly Finance & Investment Limited, Calcutta.
19. Sanchayani Savings & Investment (I) Limited, Calcutta.
20. The Memorial Finance & Investment (I) Ltd., Calcutta.
21. Overland Investment Company Ltd., Calcutta.

APPENDIX III

List of individuals/institutions/companies etc. with whom the Working Group had interviews on various aspects relating to the work of the Group.

1. Shri Pradip P. Shah, Managing Director, The Credit Rating Information Services of India Ltd., Bombay.
2. Shri M.R. Pai, President,
   All India Bank Depositors' Association, Bombay.
3. Shri Uday S. Kotak, Director,
   Kotak Mahindra Finance Ltd., Bombay.
4. Shri Rajendra P. Chitale, Partner,
   M.P. Chitale & Co., Chartered Accountants, Bombay.
5. Shri S. Datta, Vice President,
   Citibank N.A., Bombay.
6. Shri Devendra Ahuja, Chairman,
   Shri V.S. Srinivasan, Vice Chairman, and
   Shri Sanjaya Kulkarni, Director
   20th Century Finance Corporation Ltd., Bombay.
7. Shri Farouk Irani, Chairman,
   Association of Leasing, Finance & Housing Development Companies, Bombay.
8. Dr. R.H. Patil, Executive Director,
   Industrial Development Bank of India, Bombay.
9. Shri Niamatullah, Deputy General Manager,
   State Bank of India, Bombay.
10. Shri P.C. Sen, Chairman & Managing Director and
    Shri S.K. Roy, Joint Managing Director
    The Peerless General Finance & Investment Co. Ltd., Calcutta.
11. Shri R. Hariharan, General Manager,
    Wall Street Finance Ltd., Bombay.
12. Shri M.V. Prabhu, Managing Director,
    Canbank Factors Ltd., Bangalore.

13. Shri J. Radhakrishnan, General Manager(Law), State Bank of India and
Shri T.S. Narayanaswamy, Dy. General Manager,
SBI Factors and Commercial Services Pvt. Ltd., Bombay.

14. Shri N.S. Viswanathan, Dy. General Manager,
State Bank of India, the Convenor,
Shri K.L. Khetarpaul, Joint Chief Officer,
Industrial & Export Credit Department,
Reserve Bank of India, and
Shri T.T. Srinivasaraghavan,
General Manager (Leasing),
Sundaram Finance Ltd., and
the members of the Sub-Committee to review the Norms for financing Hire Purchase and Leasing Companies, Bombay.

15. Members of the Management Committee of Equipment Leasing Association (India) and Federation of Indian Hire Purchase Associations at Hyderabad.

16. Representatives of Housing Development Finance Corporation Ltd., L.I.C. Housing Finance Ltd., Can Fin Homes Ltd., G.I.C. Grih Vitta Ltd., Dewan Housing Finance Ltd. in a meeting taken by Shri P.K. Parthasarathy, Executive Director, National Housing Bank, Bombay.

17. Shri T.S. Santhanam, Chairman,
Sundaram Finance Ltd., Madras.

18. Shri R.K. Seshadri, Madras (former Deputy Governor, Reserve Bank of India)

19. Shri A. Hasib, Bombay, (former Executive Director, Reserve Bank of India).

20. Dr. C. Rangarajan, Member,
Planning Commission, New Delhi.

21. Shri M. Narasimham, Chairman,
Administrative Staff College of India, Hyderabad.

APPENDIX IV

REGULATION OF THE ACTIVITIES OF NON BANK FINANCIAL COMPANIES (NBFCs) IN CERTAIN COUNTRIES.

The system of regulation of NBFIs in a few countries has been studied with a view to drawing lessons from their experiences. The countries include, the United Kingdom (U.K) the United States of America (U.S.A), Australia, Malaysia, West Germany, Hongkong and Singapore. The Group selected these countries because of the special features of NBFIs in these countries which were expected to help it to concretise views on regulation of NBFIs In India. U.K. has a well diversified financial system. NBFIs are regulated by a separate legislation and the SRO concept has been well received in U.K. In the U.S.A., NBFIs provide varied range of services and their deposits are also insured as in the U.K. In Australia, the NBFIs are regulated by an Act which operates concurrently with State and Territory laws. Many NBFIs have converted themselves into banks in recent years. In West Germany, a different set of regulation is laid down for each category of NBFIs. In Malaysia, a wide variety of institutions are operating in an environment of macro- economic stability. In Hongkong, a single set of regulations governs both banks as well as deposit-taking institutions. In Singapore, finance companies operate along the same line as commercial banks except that they cannot operate current accounts. Thus, regulatory framework for governing NBFIs in each of the countries has certain special features and have relevance one way or the other to the Indian situation; a study of the same would enable one to understand their characteristics and draw lessons for NBFIs in India.

UNITED KINGDOM

The two major enactments which regulate deposit taking and investment business in the U. K. are the Financial Services Act, 1986 and the Banking Act, 1987. The prime objective of the Banking Act is the protection of depositors' interests. The Financial Services Act, on the other hand, regulates the investment business. Over and above these, there are statutes which regulate the activities of specific categories of companies, such as the Building Societies Act, the Friendly Societies Act, the Insurance Companies Act, the Loan Societies Act and the Credit Unions Act. Of these, the first two,i.e., the Financial Services Act and the Banking Act, have been examined in some detail below.

The Bank of England is the supervisory and regulatory body for deposit taking institutions. The Banking Act imposes an absolute prohibition on deposit taking by institutions which have not been officially authorised by the Bank of England to do so. In addition to exercising specific powers of authorisation, the Bank supervises the institutions authorised by it and keeps under review the operation of the Act and the developments in the field of banking which appear to the Bank to be relevant to the exercise of its powers and discharge of its duties. Deposits have been clearly defined under the Act and certain persons and transactions have been exempted from the Bank's supervisory ambit. Some examples of such exempted classes are, Building Societies, Friendly Societies, etc., which, as already mentioned, are regulated by other statutes. The Act provides for the establishment of an advisory committee to the Bank of England, known as the Board of Banking Supervision, consisting of three ex-officio members,viz., the Governor, the Deputy Governor and the Executive Director of the Bank of England. Over and above these, six independent members are appointed jointly by the Chancellor of the Exchequer and the Governor of the Bank of England. The Board advises the Bank of England on matters relating to supervision and administration of the Act.

Procedures covering the application for authorisation, the screening/refusal thereof and the revocation or restriction of the authorisation, have been laid down under the Act. Minimum criteria for authorisation emphasize such aspects as the quality of directors, controllers and managers of the institution, whether the institution conducts its business in a prudent manner and with integrity and skill, etc. The minimum paid-up capital and reserves at the time of authorisation for any financial institution is required to be Stg.Pd. one million (more than Stg.Pd.five million for Banks). Guidelines regarding capital adequacy, maintenance of adequate liquidity, provision for depreciation of assets and for bad and doubtful debts, maintenance of adequate accounting and other records and control systems are also laid down. The Act does not contain prescribed ratios and the mechanics of supervision are deliberately left for the Bank of England to implement on a case to case basis, without recourse to detailed statutory provisions.

The Act empowers the Bank to call for up-to-date and accurate prudential information and statistics so as to enable it to monitor continuing compliance with the authorisation criteria and to decide whether it should seek remedial action on the part of the authorised institution by persuasion and encouragement or by imposing certain specific conditions upon it or by revocation of the authorisation granted to it.

The Bank may request for information and documents from authorised institutions and connected parties, supported, if necessary, by an accountant's report. The Act also empowers the Bank to appoint investigators to assess the state, conduct, ownership and control of authorised institutions. The Bank has the right to require authorised institutions to provide a report from an accountant containing any information which the Bank needs. Detailed guidelines have been given by the Bank for the authorised institutions and the reporting accountants on the scope of such a report. The Act paves the way for auditors to play a larger part in the supervisory process. Section 47 of the Act also provides for the exchange of information between the Bank of England and the auditors.

The need to protect the public against misleading advertisements which invite potential investors to make deposits is well recognised and the Act empowers the Treasury, after consultation with the Bank and the Building Societies Commission, to make regulations for regulating the system, form and content of deposit advertisements. Such regulations came into force on 29th April, 1988. Transactions by an authorised institution with any person, leading to a risk of losses in excess of ten per cent of the available capital will have to be reported to Bank of England, after they have taken place, but transactions raising this risk to twenty five per cent or more will have to be reported at the proposal stage. Recognition of the fact that an important element of a formalised structure for supervision of the banking sector is an effective scheme of compensation to protect depositors in the event of an authorised institution failing, the deposit protection scheme was introduced in 1979. A Standing Fund under the scheme was started and is administered by Deposit Protection Board. The limit of protection prescribed under the Act is Stg. Pd. 20,000. Only 75 per cent of the deposit is protected. Therefore, effective ceiling is Stg. Pd. 15,000.

The Financial Services Act, 1986 has established a new regulatory framework for undertaking investment business in the U.K. The thrust of the new regulatory framework under this Act is that firms must be 'authorised persons' or 'exempted persons' to carry on investment business in the U.K. Undertaking business without authorisation or exemption is a criminal offence.

Authorisation to carry on investment business may be obtained either from the Securities and Investment Board (SIB - the agency designed by the Government to oversee the regulatory system under the Act) or by joining one or more of the SROs. To obtain authorisation, firms have to demonstrate to SIB or to relevant SRO that they are "fit and proper" to carry on investment business. They will also need to comply and ensure that their employees and representatives comply with detailed rules covering their conduct of business. The rules include a requirement for firms to disclose any material interest they may have in a transaction, a prohibition on providing investment services without a detailed customer agreement, obligations on firms when engaging in off-exchange dealings to report transactions and closing prices to SIB or the relevant SRO and the much publicised provisions on 'polarisation',i.e., the need for intermediaries to choose, when selling the products of life assurance and unit trusts, between being fully independent advisers or selling the products of only one company or group. Additional regulations cover provisions relating to capital adequacy, accounting records and handling of clients' money. Failure to comply with any of these rules could result in disciplinary action.

UNITED STATES OF AMERICA

All financial institutions which do not accept demand deposits and/or do not offer commercial loans are classified as NBFIs. NBFIs include insurance companies, investment banks and brokerage firms, real estate companies, finance companies, mutual funds, pension funds, savings and loan associations, mutual savings banks and credit unions. All these institutions are classified into five categories, viz., Deposit-type NBFIs, Contractual-type NBFIs, Investment- type NBFIs, Financial Companies and others. In recent years the distinction between different classes of financial institutions are becoming increasingly blurred in the U.S.A.

The non-banking financial intermediaries are governed by the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). The DIDMCA contains the following important provisions:

1. Regulations and ceilings to be phased out in six years (since done).

2. State usury ceilings on mortgage lending and agricultural loans will, in most cases, be eliminated.

3. New powers for non-bank depository institutions are to be delineated.

4. Interest-bearing transactions accounts are now legalised. These include Negotiable Orders of Withdrawal (NOW), accounts at commercial banks, savings and loan associations and mutual savings banks, share drafts of credit unions and automatic transfer service accounts at commercial banks.

The Act also states that non-bank depository institutions should maintain reserve requirements in the form of vault cash or non-interest-bearing deposits in the Federal Reserve System. These requirements were the same as in the case of cmomercial banks, only savings and loan association, mutual savings banks and credit unions were convered. Any depository institution maintaining transactions accounts and a non-personal time deposits were entitled to discount and other borrowing facilities from the Federal Reserve System.

Mutual Savings Banks (MSB) are either State-Chartered or Federally Chartered. Deposit insurance for State- Chartered MSBs is provided by the FDIC and for Federally Chartered MSBs by the Federal Savings and Loan Insurance Corporation. Savings and Loan Associations are State Chartered or Federally Chartered. Federal Home Loan Bank Board is the lender of last resort to them. Federal Savings and Loan Insurance Corporation provides deposit insurance. Credit Unions can be either State Chartered or Federally Chartered. They are governed by the Federal Credit Union Act of 1934. The National Credit Union Administration (NCUA) is the regulatory authority for federal credit unions. Their lender of last resort is the Central Credit Facility, a federal government agency.

The Glass-Steagall Act, 1933 prohibits member banks of the Federal Reserve System from engaging directly in securities underwriting (except certain specified securities). In terms of Section 20 of the Act, subsidiaries of the Bank holding companies (Section 20 companies) can function as investment banks. The Federal Reserve Board has also insisted that these companies observe a number of prudential norms, called 'firewalls', designed to insulate insured bank affiliates from the risks associated with such companies.

Under the Securities Exchange Act of 1934, Section 20 Companies must register as broker-dealers. As registered broker-dealers, they are subject to Securities and Exchange Commission (SEC) regulation under the securities laws, must comply with SEC's net capital rules and must join an SEC-approved SRO. The Board, as the primary regulator of bank holding companies, enforces the 'firewall' requirements.

The Investment Company Act of 1990 requires registration with the SEC of all non-exempt investment companies and are subject to statutory provisions that regulate, among other things, the composition of management and management's accountability to shareholders, approval of investment advisory contracts, changes in fundamental investment policies, transactions between the investment company and affiliated persons and the capital structure of the investment company.

The Competitive Equality Banking Act of 1987, (CEBA) enacted on August 10, 1987, required a non-banking company that controlled a non-bank bank on March 5, 1987 and that wished to establish its eligibility for certain "grandfather privileges" under CEBA, to provide to the Board, various details regarding the activities of banks. However, the Act prescribed certain limits on their activities and if the limits are exceeded "grandfather rights" are lost. Any company which acquired or formed a non-bank bank after March 5th, 1987, must comply with the Bank Holding Company Act or divest its bank subsidiary.

Thrifts are regulated by the Savings and Loan Holding Company Amendments of 1967. The Act specifies certain conditions for a 'qualified thrift lender'.

With effect from December 1989, risk-based minimum capital requirement for Federal Savings and Loans Associations was 6.4 per cent and this represents the lowest level to which 'risk-weighted assets' as a proportion of total capital may fall. This minimum requirement was be increased to 7.2 per cent by the end of 1990 and to 8 per cent by the end of 1992 as per the Financial Institutions Recovery, Reform and Reinforcement Act.

In addition to the risk-based requirement, Federal Savings and Loans Associations have to satisfy two further capital requirements - in effect leverage ratios - stipulated by Congress. The first is a 'tangible capital requirement' which requires holdings of 'tangible capital' to be equal to at least 1.5 per cent of 'tangible assets'. The second, the 'core capital requirement', prescribes that core capital does not fall below 3 per cent of tangible assets. Both requirements are effective from December 1989.

The FDIC has affirmed that non-bank banks may obtain FDIC insurance for deposits, but must also comply with FDIC regulations governing insured institutions, including restrictions on securities activities.

Non-bank banks are far from unregulated entities. Except for the BHCA and the small number of Federal and State laws that incorporated its definitions, such banks are subjected to all Federal and State banking laws that applied to similar depository institutions that had not limited their activities in order to avoid the 'bank' definition. Non-compliance of guidelines attracts punishment which will be varied, ranging from loss of charter and right to do business to hefty fines.

AUSTRALIA

NBFIs include corporations which may be generally described as finance companies, permanent building societies, merchant banks and money market groups including authorised dealers in the short term money market, pastoral finance companies and credit unions.

The Financial Corporations Act, 1974 relates to those corporations, other than banks, which engage in borrowing and lending of money in a major way and whose assets exceed A.$ one million. In order to allow flexibility and reduce administrative burdens, any direct controls that are imposed under the Act will apply to those corporations which, together with related corporations, have total assets in excess of A.$ five millions. The cut-off point may be prescribed from time to time.

The Act is primarily concerned with economic management. Most non-bank financial institutions are also subject to supervision under State or Territory laws regarding the rights of borrowers and lenders and the financial stability of companies. The Act operates concurrently with the State or Territory laws.

The Act requires a registered corporation or a related corporation to furnish to the Reserve Bank of Australia, statements relating to its business, particularly with respect to its borrowings, lending, assets, liabilities and rates of interest on money borrowed or lent. The Reserve Bank of Australia will also lay down guidelines regarding the assets ratio, lending policy and interest rates to be followed by the NBFIs. The Bank may also impose controls on the amount, purpose or direction of lending of the corporations. The Reserve Bank with the approval of the Treasurer can fix maximum rate of interest payable to or chargeable by corporations.

The Reserve Bank may instruct the registered corporations, or those in specified categories, to maintain particular kinds of prescribed assets equal to an amount ascertained in accordance with the regulations. There are no reserve deposit requirements or statutory reserve deposits. To preclude a corporation from using words that imply that registration under this legislation confers any special status on it or guarantees its financial soundness or stability, corporations are prohibited, in the course of their business, from advertising or holding out that they are, for example, "registered under the Financial Corporations Act, 1974" or "registered with the Reserve Bank". The Chief Official of the Department of Treasury shall appoint at least one committee from which he shall seek, from time to time, advice on matters to be included in regulations and on the operation of the Act. The Reserve Bank is the regulatory authority for the non-bank financial companies. Failure to comply with any of the rules is subject to a penalty. Where a corporation is convicted of an offence for failing to comply with a requirement of the Act, Section 23 provides that the Australian Industrial Court may, upon the application of the Attorney - General, direct compliance by the corporation.

MALAYSIA

Non-Bank Financial Institutions in Malaysia include Provident, Pension and Insurance Funds, Development Banks, savings institutions like National Savings Banks and Deposit Taking Co-operatives (DTCs), Unit Trusts, Building Societies and National Mortgage Corporation. These institutions put together accounted for 32 per cent of the total assets of the financial system in 1988. All these institutions are governed by the Banking and Financial Institutions Act, 1989. This Act provides for an integrated system of supervision for the Malaysian Financial System. The regulatory authority is the Bank Negara Malaysia (Central Bank).

The Act distinguishes three types of financial institutions - licensed institutions, scheduled institutions and non-scheduled institutions. Licensed institutions are subjected to strict regulations. Regulatory regime for scheduled institutions is to be determined by the Minister of Finance on the recommendations of the Bank Negara, Malaysia. The Act does not apply to Non-Scheduled institutions but empowers Bank Negara to investigate and take action in respect of these institutions when so directed by the Ministry of Finance. One of the aims of the Act is to ensure that the public place their savings only with licensed financial institutions properly supervised by Bank Negara.

Only licensed institutions can carry on deposit taking business. No person other than a licensed institution is permitted to issue or publish or facilitate any person to issue any advertisement to solicit deposits. Penalties have been prescribed for violation of these provisions. The Bank Negara, Malaysia has prescribed minimum capital of $ 20 million for banks, $ 10 million for merchant banks and $ 5 million for finance companies. The Bank has also introduced capital standards in accordance with the Basle Committee recommendations. No licensed institution can carry on its business, if its capital funds are below the minimum stipulated level, without the written consent of the authority.

The amount to be transferred to reserves ranges between 25 per cent and 50 per cent of net profit. The Bank Negara, Malaysia can specify additional amount if deemed necessary. The Bank has authority to regulate the dividend payment by the companies. It is also empowered to prescribe the specific level of liquid assets which may vary from time to time. If an institution fails to maintain the requisite level of liquid assets, it cannot extend credit facilities. A licensed institution is not permitted to grant any credit facility, without security, except to the extent specified by the Bank Negara. Acceptable security is also specified by the Bank. The Bank can place restrictions on individual exposure. The Bank can also call for any information relating to the policy, procedures, terms, sanctioning authority etc. from the licensed institutions. The extent to which a director or an officer can sanction credit limits is also restricted. Any violation of this will attract heavy penalty. The Act prohibits politically active persons from holding directorship in financial institutions.

The Bank has prescribed detailed guidelines regarding, interalia, duties and responsibilities of directors, credit limit to single customer, suspension of at all times. Credits granted to any one borrower in excess of 15 per cent of the credit institutions 'loanable funds' are to be reported to the Central Bank. There are limits to the extent to which credit can be sanctioned to a single party. There are also restrictions on the grant of loans to directors.

Investigation of non-banking companies may be carried out by the concerned authorities. Each category of specialised institutions is having its own association. These associations represent in public, the interests of their members. Inside an association, opinions are exchanged on the matters concerning association's policy and specific problems may be dealt with by consultation or by forming committees.

HONGKONG

The Banking Regulation Ordinance (1986) regulates the commercial banks and the Deposit-taking Companies in Hongkong. Hongkong has got a three-tier financial system consisting of Licensed Banks, Restricted Licensed Banks (RLBs) and Deposit-taking Companies (DTCs). The Banking Regulation Ordinance aims inter alia, at, regulating banking business and the business of taking deposits, and provides for the supervision of authorised institutions in the interests of protecting the depositors. The Governor of Hongkong also appoints the DTC advisory committee consisting of the Finance Secretary, Secretary for Monetary Affairs, the Commissioner and such other persons, numbering four to twelve, as considered appropriate for the purpose of advising him. The Governor also appoints the Commissioner of Banking whose principal function is to promote the general stability and effective working of the financial system.

The aforementioned ordinance defines 'deposit' as under:

Deposit means a loan of money -

(a) at interest, at no interest or at negative interest; or

(b) repayable at a premium or repayable with any consideration in money or money's worth.

interest on non-performing loans, provision for bad and doubtful debts, submission of financial statements and annual accounts, prohibition of loans to directors/staff and related companies, code of conduct for directors/officers, employees, etc. Income on cash basis alone is to be taken as income. Adequate provision has to be made for bad, doubtful and sub- standard loans.

The powers and duties of the auditors have also been spelt out in detail. The auditor is charged with the responsibility of reporting to the Bank any irregularities identified in the operations of the institution. All licensed institutions have to submit to the Bank Negara, Malaysia their audited balance sheet and profit and loss account, sources of their funds as also the purpose and manner in which these funds have been utilised. The Act empowers the Bank to appoint any officer or employee or any other person as an investigating officer. The Bank has the power to prosecute in any court, any offence committed under the Act with the written consent of the public prosecutor.

WEST GERMANY

Non-Bank Financial Institutions are governed by special/supplementary laws in the Germany. The Enactment regulating these institutions are the Mortgage Bank Law and Investment Companies Law, Stock Exchange Law, Securities Deposit Law, the Cheque Law and the Bill of Exchange Law. These regulations apply to all institutions including building societies, postal giro offices and postal savings banks which are not subjected to the KWG (Banking Act applicable to commercial banks).

The mortgage banks offer long-term housing loans secured by mortgages and credit to public authorities, especially local communities. The loans are financed by issuing either mortgage or local government bonds. Building societies offer mortgages and bridging loans. Potential borrowers must first build up savings with them (usually upto two-third of the loan amounts) over a period of time. Instalment credit institutions finance their activities through other banks and financial institutions and are only allowed to accept deposits under special licence from the bank supervisory authority.

The main concern of the Federal Supervisory Officer is to safeguard the interests of the depositors. Therefore, the Authority has prescribed certain requirements of equity capital and maintenance of liquidity by NBFIs. They have to invest their funds in such a way so as to safeguard adequate solvency

However, it does not include a loan of money- -

(i) upon terms involving the issue, by any company, of debentures or other securities in respect of which a prospectus has been registered under the Companies Ordinance;

(ii) upon terms referable to the provision of property or services; or

(iii) by one company to another (neither company being an authorised institution) at a time when one is a subsidiary of the other or both are subsidiaries of another company.

Only authorised institutions are permitted to undertake business of taking deposits. Institutions may be either registered with the office of the Commissioner or licensed with the Office of the Financial Secretary. While registered DTCs are not allowed to accept short term deposits, licensed ones are allowed. However, no DTC is allowed to receive deposits in savings accounts. The minimum paid up capital for Registered Licensed Banks is HK$ 100 million and for Deposit Taking Companies, it is HK$ 25 million. The Basle Committee norms regarding capital adequacy were introduced with effect from the end of 1989. As a result, the minimum capital adequacy requirement for authorised institution was raised from 5% to 8%. The Commissioner is authorised to increase the capital adequacy ratio upto a ceiling of 12% in case of licensed banks and 16% in case of DTCs.

The paid-up capital is determined after deducting from the share capital of a company, any debit balance appearing in the latest audited profit and loss account. The Commissioner or the Financial Secretary are authorised to revoke the deposit taking registration or licence if the company has ceased to carry on the business of deposit taking, the share capital of the DTC is less than the specified amount, the company has not submitted information which can affect its method of business, the business of the company is carried out in a manner which is detrimental to the interests of its depositors, etc. The Commissioner/Financial Secretary is also authorised, under certain circumstances, to suspend registration/licence for a temporary period of upto six months. The Commissioner/Financial Secretary has the power (if it appears to him that the functioning of the institution is not in accordance with the provisions of the Ordinance) to instruct the company to take any action which he may deem necessary, to appoint a person to advise the institution, to assume control of and carry on the business and report to the Governor in Council the circumstances warranting his actions.

The Commissioner has been authorised to examine the books, accounts and transactions of any authorised institution. Every authorised institution and its auditors are required to comply with the Companies Ordinance with respect to the audit of a company's accounts, whether or not the institution is incorporated under that Ordinance. Every authorised institution is required to lodge with the Commissioner, as also publish in a newspaper, a copy of its audited annual balance sheet along with notes thereon, a copy of the profit and loss account, a copy of the auditor's report, full and correct names of all the persons who are directors or managers of the institution and names of all its subsidiaries. The Commissioner is authorised to collect any additional information which he deems fit.

Every authorised institution has to submit to the Commissioner, monthly and quarterly returns of its assets and liabilities and such other information as the Commissioner may call for. The Commissioner may instruct the institution that the return should be accompanied by an auditor's certificate to the effect that the return is in accordance with the provisions of the Ordinance. If the authorised institution holds the shares of another company, the same has to be reported. Under the provisions of the Ordinance, no person is allowed to become a Chief Executive, a Director, a Secretary or a Controller of an authorised institution without the written consent of the Commissioner.

Every DTC is required to transfer at least one-third of its net profit to reserves if the capital and reserves are below the specified level. Authorised institutions are also required to make adequate provision for bad and doubtful debts. They are required to maintain a liquidity ratio of 25 per cent on the basis of the sum of its liquefiable assets and the sum of its qualifying liabilities in each calendar month.

An authorised institution is not permitted to grant any credit facilities against the security of its own shares or shares of its associates. It should not extend credit more than 25% of its paid-up capital and reserves to a single party. It is not permitted to make advances to its directors, relatives of a director, employees etc. exceeding 10 per cent of its paid-up capital and reserves.

An authorised institution is not allowed to purchase or hold any interest in land situated in or outside Hongkong of a value exceeding 25 per cent of its paid- up capital and reserves.

No institution/person other than an authorised one can issue an advertisement. If the Commissioner is of the opinion that an authorised institution has issued false advertisement, it may require the institution to withdraw and to cease issuing such advertisement. Contravention of the provisions of the Ordinance are punishable by fine and/or imprisonment.

SINGAPORE

Finance Companies were not regulated or licensed in Singapore until early 1960s. With the growth in their activities, concern developed over the lack of proper control and protection for depositors. Consequently, the Finance Companies Act, 1967 was passed under which only those finance companies which have been granted licences, were to be permitted to operate. In Singapore, finance companies operate along the same lines as commercial banks. They collect fixed and savings deposits. However, they are not permitted to operate current accounts, deal in gold and foreign exchange or grant unsecured loans in excess of S.$ 5,000. They are free to quote their own interest rates which, in general, are slightly higher than those offered by commercial banks. They provide mortgage loans, hire purchase loans, building and construction loans, loans for shipping companies, leasing companies, general commerce, etc.

Finance Companies are governed by the Finance Companies Act which is administered by the Monetary Authority of Singapore (MAS). The Act stipulates the minimum capital and reserve fund requirements which finance companies must maintain and other conditions for the conduct of business. The finance companies are required to maintain minimum cash balances and stipulated liquid assets ratios. In 1988 the minimum cash balance to be maintained was 6 per cent of their total liabilities, while the liquid assets ratio was 10 per cent. These ratios may vary from time to time.

The Finance Companies Act was revised in 1984 to provide a broader definition for the financing business, to improve the supervisory powers and control of MAS over the audit of finance companies and to ensure their prudent lending. Supervision by MAS takes the form of field inspections, review of regular returns submitted and consultation with the finance companies.

APPENDIX V

Statement showing the salient features of the four sets of Directions issued by the Reserve Bank of India and National Housing Bank to Non-Banking Financial Companies (Position as on July 31, 1992)

Non-Banking Financial Companies (Reserve Bank) Directions, 1977 contained in Notification No. DNBC 38/DG(H)-77 dated June 20, 1977 as amended upto June 1992	Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977 contained in Notification No. DNBC 39/DG(H)-77 dated June 20, 1977 as amended upto June 1992	Residuary Non-Banking Companies (Reserve Bank) Directions, 1987 contained in Notification No. DFC 55/DG(O)-87 dated May 15, 1987	Housing Finance Companies (NHB) Directions, 1989 contained in Notification No.NHB.HFC.DIR 1/CMD-89 dated June 26, 1989 as amended upto September 23, 1991.
1	2	3	4
I. Date of commencement of Directions			
July 1, 1977	July 1, 1977	May 15, 1987	June 26, 1989
II. Types of Non-Banking Financial Companies covered			
(Banking, Insurance and Stock Exchange or Stock broking companies are excluded from the purview of all the four sets of directions).			
(i) Equipment Leasing Companies Companies carrying on as their principal business, the activity of leasing of equipment or financing of such activity. (ii) Hire Purchase Finance Companies Companies carrying on as their principal business of hire purchase transactions or the financing of such transactions. Note The principal business of a company engaged both in Hire purchase financing as well as Equipment leasing will be decided after taking together the volume of both the business activities.	All non-banking financial companies carrying on any of the following types of business. (i) Collecting whether as a promoter, foreman, agent or in any other capacity, monies in one lumpsum or in instalments by way of contributions or subscriptions or by sale of units, certificates or other instruments or in any other manner or as membership fees or admission fees or service charges to or in respect of any savings, mutual benefit.	Residuary Non-Banking Companies Company which is a non-banking institution, being a company, which receives any deposit under any scheme or arrangement, by whatever name called, in one lumpsum or in instalments by way of contributions or subscriptions or by sale of units or certificates or other instruments or in any other manner and which according to the definitions	Housing Finance Companies "Housing Finance Company" means any institution as defined in Section 2(d) of the National Housing Bank Act, 1987(53 of 1987) but does not include a firm or an unincorporated association of individuals. As per Section 2(d) of the National Housing Bank Act, 1987: "housing finance institution" includes every

(1)	(2)	(3)	(4)
(iii) <u>Investment Companies</u> Companies carrying on as their principal business the acquisition of securities viz. shares, stock bonds, debentures, debenture stocks or securities issued by Government or by a local authority or other marketable securities of a like nature. (iv) <u>Loan Companies</u> Companies carrying on as their principal business the providing of finance whether by making loans or advances, or otherwise for any activity other than their own but does not include an equipment leasing, hire purchase or housing finance companies. (v) <u>Mutual Benefit Financial Companies</u> Companies carrying on their principal business of accepting deposits from their members and which are notified by the Central Government under Section 620 A of the Companies Act, 1956.	thrift or any other scheme or arrangement by whatever name called, and utilising the monies so collected or any part thereof or the income accruing from investment or other use of such monies for all or any of the following purposes - (a) giving or awarding periodically or otherwise to a specified number of subscribers as determined by lot, draw or in any other manner, prizes or gifts in cash or in kind whether or not the recipient of the prize or gift is under a liability to make any further payment in respect of such scheme or arrangement. (b) refunding to the subscribers or such of them as have not won any prize or gift, the whole or part of the subscriptions, contributions or other monies collected with or without any bonus, premium, interest or other advantage howsoever called, on the termination of the scheme or arrangement or on or after the expiry of the period stipulated therein.	contained in the non-banking financial companies (Reserve Bank) Directions, 1977 or, as the case may be the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977 is not i) an equipment leasing company. ii) a hire purchase finance company. iii) a housing finance company. iv) an insurance company. v) an investment company. vi) a loan company vii) a mutual benefit financial company and viii) a Miscellaneous non-banking company.	institution, whether incorporated or not, which primarily transacts or has its principal object, the transacting of the business of providing finance for housing whether directly or indirectly.

(1)	(2)	(3)	(4)
	(ii) 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 his turn as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement be entitled to the prize amount. <u>Explanation</u> For the purposes of this sub-paragraph, the expression "prize amount" shall mean the amount by whatever name it be called, arrived at by deduction from out of the total amount subscribed at each instalment by all subscribers, (a) the commission charged by the company or service charges as a promoter or a foreman or an agent and (b) any sum which a subscriber agrees to forgo, from out of the total subscriptions of each instalment, in consideration of the balance being paid to him. (iii) Conducting any other form of chit or Kuri which is different from the type of business referred to in sub-paragraph (ii) above. (iv) Undertaking or carrying on or engaging in or executing any other business similar to the business referred to in sub-paragraphs (i) to (iii).		

(1)	(2)	(3)	(4)
III. <u>Definition of the term 'deposit'</u>			
(i) The term 'Deposit' has been defined in Section 45 I(bb) of the Reserve Bank of India Act, 1934 (2 of 1934) as under :-	Same as in Col.1	Same as in Col.1	Same as in Col.1
"Deposit" includes and shall be deemed always to have included any receipt of money by way of deposit or loan or in any other form, but does not include -			
(a) amounts raised by way of share capital,			
(b) amounts contributed as capital by partners of a firm,			
(c) amounts received from a scheduled bank or a co-operative bank or any other banking company as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949.			
(d) any amount received from - the Development Bank, a State Financial Corporation, any financial institution specified in or under Section 6 A of the Industrial Development Bank of India Act, 1964 or			

(1)	(2)	(3)	(4)
(e) any other institution that may be specified by the Bank in this behalf			
(f) 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,			
(g) any amount received from an individual or a firm or an association of individuals not being a body corporate registered under any enactment relating to money lending which is for the time being in force in any State; and			
(h) any amount received by way of subscriptions in respect of a chit			
Explanation I - "Chit" has the meaning assigned to it in clause(b) of Section 2 of the Chit Funds Act, 1982.			
Explanation II - Any credit given by a seller to a buyer on the sale of any property(whether movable or immovable) shall not be deemed to be deposit for the purpose of this clause.			

(1)	(2)	(3)	(4)
(ii) For the purpose of the directions the term 'deposit' does not include certain types of deposits such as - (a) any money received from the Central Government or a State Government or any money received from any other source and the repayment of which is guaranteed by the Central Government or a State Government or any money received from a local authority or a foreign Govt. or any other authority. (b) borrowings from commercial banks or specified financial and other institutions. (c) inter-company deposits (d) money received from a director (e) money received from shareholders in the case of private limited companies. In the case of (d) and (e) money received should be under declaration that money lent to the company has not been acquired by them by borrowing or accepting deposits from other persons. (f) security deposits from employees provided that the amount of such security deposit is deposited with a scheduled bank or a post office. (g) any money raised by the issue of debentures or bonds secured by the mortgage of immovable properties of	Same as in Col.I. Further, any money received or collected under a transaction or arrangement referred to in sub-paragraph (2) of paragraph 2 of the Notification is not treated as 'Deposit'. Money received in trust or in transit are not exempt.		Same as in Col.I except those mentioned against items (g),(h),(i) and (j)

(1)	(2)	(3)	(4)
the company or money raised by the issue of bonds or debentures with the option to convert such debentures or bonds into equity share capital			
(h) subscriptions to any shares, etc. calls in advance etc.			
(i) advance subscriptions for item (g),			
(j) any money received in trust or any money in transit			
(vide paragraph 3 of the Notification)			
Note: Money received by a Mutual Benefit Financial Company from its shareholders are not treated as deposits.			
IV. <u>Period of deposit</u>			
(a) Acceptance of deposits repayable on demand or on notice is prohibited.	(a) Same as in col.1	(a) Same as in Col.1	(a) Same as in Col.1
Note: Mutual Benefit Financial Companies are allowed to accept deposits from their members, repayable on demand or on notice or repayable after any period. The companies shall not accept or renew deposits except from their shareholders.			
(b) Minimum period of deposits : 24 months Maximum period of deposits : 60 months	(b) Minimum period of deposits : 6 months Maximum period of deposits : 36 months	(b) Minimum period of deposits :12 months Maximum period of deposits :120 months	(b) Minimum period of deposits : 24 months Maximum period of deposits : 84 months

1	2	3	4
V. <u>Ceiling on deposits</u>			
(i) <u>Loan and Investment Companies</u>			
(a) No loan/Investment Co. shall accept deposits against unsecured debenture or any deposit from a shareholder (not being a deposit received by a private company from its shareholders) or any deposit guaranteed by director of a company exceeding 15 per cent of its NOF.	Same as in the case of Loan and Investment Companies.	No ceiling has been prescribed.	No housing finance company shall have deposits in excess of the limits specified below. Housing Finance Co. with NOF — Borrowings multiple of the NOF (a) Upto Rs.10 crores — 10 times (b) Above Rs.10 crores but below Rs.20 crores — 12.5 times (c) Above Rs.20 crores — 15 times
(b) any other deposit should not exceed 25 per cent of its NOF.			
(ii) Hire Purchase Finance and <u>Equipment Leasing Companies</u>			
No Hire Purchase Finance or Equipment leasing Companies can accept deposits in excess of ten times its net owned funds.			
VI. <u>Furnishing of receipts to depositors</u>			
Every non-banking financial company shall furnish to every depositor a receipt containing certain particulars prescribed in the directions.	Same as in column 1	Same as in column 1	Same as in column 1.

(1)	(2)	(3)	(4)
VII. <u>Register of deposits</u>			
Every non-banking financial company is required to maintain one or more registers for recording certain specified particulars in the case of each depositor. The registers are required to be kept at the registered office of the company and preserved in good order for eight calendar years following the financial year in which the latest entry is made of the repayment or renewal of any deposit of which particulars are contained in the register. (The relative direction also requires the company to deliver a copy of the notice filed with the Registrar under the proviso to Section 209(1) of the Companies Act, 1956 to the Reserve Bank within seven days of such filing, in case the company keeps its books at any place other than its registered office).	Same as in col.1	Same as in col.1	Same as in col.1

(1)	(2)	(3)	(4)
VIII. Information to be included in the Board's report Certain particulars of unclaimed/unpaid deposits are required to be included in every report of the Board of Directors laid before a company in its general meeting under Section 217(1) of the Companies Act, 1956 and, in case such deposits exceed Rs.5 lakhs, the company should also indicate the steps taken or proposed to be taken by the Board for payment of the amounts due to the depositors and remaining unclaimed or undisbursed.	Same as in col.1	In every report of the Board of Directors laid before the company in general meeting under Section 217(1) of the Companies Act, 1956 the following information shall be included (i) compliance with the provisions of Directions (ii) Total number of depositors and total amount due to them remaining unclaimed or unpaid after the date on which the deposit became due for repayment or renewal according to the contract with the depositor or the provisions of the directions, whichever may be applicable (iii) If the amount of unclaimed or unpaid deposits exceeds in the aggregate the sum of Rs.5 lakhs, a statement on the steps taken or proposed to be taken by the Board for repayment of such amounts	Same as in col.1

(1)	(2)	(3)	(4)
IX. Ceiling on the rate of interest and <u>brokerage</u> No non-banking financial company shall (i) invite or accept or renew deposit on a rate of interest exceeding 15% per annum. Interest may be paid or compounded at rests which shall not be shorter than monthly rests. (ii) pay to any broker for deposits collected by or through him, brokerage, commission, incentive or any other benefit by whatever name called, in excess of the rates specified below:	Same as in column 1.	i) On and from 15th May 1987, the amount payable by way of interest, premium, bonus or other advantage, by whatever name called, by a residuary non-banking company in respect of deposits received from that date, shall not be less than the amount calculated at the rate of 10 per cent per annum (to be compounded annually) on the amount deposited, provided that where, at the request of the depositer, a residuary non-banking company makes repayment of the deposit after the expiry of a period of one year but before the expiry of the period for which the deposit had been accepted, the amount payable by the company by way of interest, premium, bonus or other advantage on such deposit shall be reduced by two per cent from the rate which the company would have ordinarily paid by way of interest, bonus, premium or other advantage, had the deposit been accepted for the period for which such deposit had run. ii) No such provision.	On and from the July 27, 1991 no housing finance company shall - i) invite or accept or renew any deposit on a rate of interest exceeding 15 per cent per annum which shall be applied at quarterly rests. (Provided that where interest is paid at shorter rests, such interest shall be discounted so as not to exceed the interest stipulated on quarterly rests). ii) pay to any broker for deposits collected by or through him brokerage, commission, incentive or any other benefit by whatever name called, in excess of two per cent (not per annum) on such deposits.
(a) where a deposit is for a period not exceeding one year — One per cent (not per annum) of such deposit	Same as in column 1.		
(b) where a deposit is for a period exceeding one year but not exceeding two years — One and a half per cent (not per annum) of such deposits	One and quarter per cent (not per annum) of such deposits.		
(c) where a deposit is for a period exceeding two years — Two per cent (not per annum) of such deposit	One and half per cent (not per annum) of such deposits.		

(1)	(2)	(3)	(4)
X. Maintenance of a minimum percentage of liquid assets Every hire purchase finance company and equipment leasing company shall maintain in India (i) in an account with a scheduled bank (free from any charge or lien) or (ii) in unencumbered approved securities (such securities being valued at their market value for the time being) or partly in such an account or partly in such securities, a sum which shall not at the close of business on any day be less than ten per cent of the deposits outstanding in the books of the company on that day. Provided that from November 1, 1991, such company shall maintain in India, a sum which shall not at the close of business on any day, be less than the sum as specified below: (a) on and from November 1, 1991, not less than 11 per cent; (b) on and from February 1, 1992, not less than 12 per cent; (c) on and from May 1, 1992, not less than 13 per cent; (d) on and from August 1, 1992, not less than 14 per cent; (e) on and from November 1, 1992, not less than 15 per cent; of the deposits outstanding in the books of the company, so however that at any time at least the sum	No such provision	On and from 15th May 1987 (i) Every residuary non-banking company shall deposit and keep deposited in fixed deposits with public sector banks or invest and keep invested in unencumbered approved securities (such securities being valued at their market value for the time being), or in other investments, which in the opinion of the company are safe, a sum which shall not at the close of business on 31st December 1987 and thereafter at the end of each half year that is, 30th June and 31st December be less than the aggregate amounts of the liabilities to the depositors whether or not such amounts have become payable. Provided that of the sum so deposited or invested - (a) not less than 10 per cent shall be in fixed deposits with any of the public sector banks; (b) not less than 70 per cent shall be in approved securities; (c) not more than 20 per cent or ten times the net owned funds of the company, whichever	Every housing finance company shall maintain in India (i) in an account with a scheduled bank (free from any charge or lien) or (ii) in unencumbered approved securities (such securities being valued at their market value for the time being) or partly in such an account or partly in such securities a sum which shall not at the close of business on any day be less than ten per cent of the deposits outstanding in the books of the housing finance company on that day.

(1)	(2)	(3)	(4)
exceeding 10 per cent of the total deposits outstanding in the books of company, shall be invested in securities of only the Central and/or State Governments or any bonds guaranteed by the Central and/or State Governments. There is no provision for maintenance of a minimum percentage of liquid assets for loan/Investment/Mutual Benefit Financial Companies.		amount is less, shall be in other investments. Provided that such investments shall be with the approval of the Board of Directors of the company. Explanation "Net owned Funds" shall mean the aggregate of the paid-up capital and free reserves as appearing in the latest audited balance sheet of the company as reduced by the amount of accumulated balance of loss, deferred revenue expenditure and other intangible assets, if any, as disclosed in the said balance sheet. (ii) Every residuary non-banking company shall entrust to one of the public sector banks designated in that behalf, deposits and securities referred to in clauses (a) and (b) of the priviso to sub paragraph (i) to be held by such designated bank for the benefit of the depositors. Such securities and deposits shall not be withdrawn by the residuary non-banking company, or otherwise dealt with, except for repayment to the depositors. (iii) Every residuary non-banking company shall furnish to the Reserve Bank within thirty days from the close of business on 31st December 1987 and thereafter at the end of each half year that is as on 30th June and 31st December a certificate	

(1)	(2)	(3)	(4)
		from its auditors, being members of Institute of Chartered Accountants, to the effect that the amounts deposited in fixed deposits and the investments made are not less than the aggregate amounts of liabilities to the depositors as on 30th June and 31st December of that year. <u>Explanation:</u> For the purpose of this paragraph, (a) "Aggregate amounts of liabilities" shall mean total amount of deposits received together with interest, premium, bonus or other advantage by whatever name called, accrued on the amount of deposits according to the terms of contract. (b) "approved securities" means, the securities in which the Trustee is authorised to invest trust money by any law for the time being in force in India and bonds or fixed deposits issued by any Corporation established or constituted under any Central or State enactments. (c) "public sector banks" means, the State Bank of India, the Subsidiary Banks and the corresponding new banks referred to in Section 45(1) of the Reserve Bank of India Act, 1934 (2 of 1934).	

1.	2.	3.	4
		(d) "unencumbered approved securities" shall include the approved securities lodged by the company with another institution for advance or any other credit arrangements to the extent to which such securities have not been drawn against or availed of.	
XI. <u>Submission of balance sheet</u>			
Every non-banking financial company shall furnish to the Reserve Bank all audited balance sheet as on the last date of each financial year and an audited profit and loss account in respect of that year as passed by the company in general meeting together with a copy of the report of the Board of Directors laid before the company in such meeting in terms of section 217(1) of the Companies Act, 1956 within 15 days of such meeting.	Same as in Col. 1	Same as in col.1	Same as in col.1 (Instead of RBI the audited balance sheet and profit and loss account to be submitted to National Housing Bank)
XII. <u>Provision for submitting Auditors' certificate</u>			
Every non-banking financial company shall furnish to the Reserve Bank, alongwith the copy of the audited balance sheet as provided above, a certificate from its Auditors being members of the Institute of Chartered Accountants to the effect that the full liabilities to the depositors of the company including interest payable thereon are properly reflected in the balance sheet and that the company is in a position to meet the amount of such liabilities to the depositors.	No such provision	No such provision	As in col.1 (instead of RBI the certificate to be submitted to National Housing Bank).

1	2	3	4
XIII. <u>Advertisements soliciting deposits</u>			
(i) Every non-banking financial company shall comply with the provisions of the Non-Banking Financial Companies and Miscellaneous Non-Banking Companies(Advertisement) Rules, 1977. Further in every advertisement to be issued thereunder should contain certain prescribed particulars regarding the actual rate of return on deposit, mode of payment to depositors, maturity period of deposit, interest payable on deposit, interest rate on premature withdrawal of deposit, any other special features,etc.	Same as in col.1	Same as in col.1	A statement, containing full details, can be filed with National Housing Bank if a company intends to accept deposits.
(ii) A statement, containing full details, in lieu of advertisement, can be filed with Reserve Bank if a company intends to accept deposits without inviting them from any person,			
(iii) Every non-banking financial company is required to accept, renew or convert any deposit on a written application by the depositor on the form to be supplied by the company. This form should contain all particulars referred to in item(i) above.			

1.	2.	3.	4.
XIV. <u>Submission of returns</u>			
(i) Every non-banking financial company shall submit before 30th June to the Reserve Bank a return furnishing the information specified in the First Schedule to the directions with reference to its position as on March 31, every year.	Same as in col.1	same as in col. 1	Same as in col.1 The return is required to be submitted to National Housing Bank as also Reserve Bank.
(ii) In addition to (i) above, a company shall furnish particulars of its principal officers and directors and specimen signatures of the officers authorised to sign on its behalf returns specified above. Any change in this regard shall be intimated to the Reserve Bank within one month from the occurence of such change.	-do-	-do-	Same as in col.1
XV. <u>Exemptions</u>			
The Reserve Bank of India, may if it considers it necessary for avoiding any hardship or for any other just and sufficient reason, grant extensions of time to comply with, or exempt any non-banking financial company or class of such companies from, all or any of the provisions of the directions either generally or for any specified period subject to such conditions as the Bank may impose.	Same as in Col.1	Same as in col.1	The exemption may be granted by National Housing Bank.

1.	2.	3.	4.
XVI. Non-applicability of certain other directions			
No such provision	The provisions of the Non-Banking Financial Companies (Reserve Bank) Directions, 1977 are not applicable to the miscellaneous non-banking companies	The provisions of the Non-Banking Financial Companies(Reserve Bank) Directions, 1977 and Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977 are not applicable to the Residuary Non-Banking Companies.	It is hereby clarified that the supersessions of the Non-Banking Financial Companies (Reserve Bank) Directions, 1966 and the Non-Banking Financial Companies (Reserve Bank) Directions, 1977, as amended from time to time, shall not in any way affect : (i) any right, obligation or liability acquired, accrued or incurred thereunder; (ii) any penalty, forfeiture, or punishment incurred in respect of any contravention committed thereunder; (iii) any investigation, legal proceedings or remedy in respect of any such right, privilege, obligation, liability, penalty, forfeiture or punishment as aforesaid, and any such investigation, legal proceedings or remedy may be instituted, continued, or enforced and any such penalty, forfeiture or punishment may be imposed as if those Directions have not been superseded.