REPORT OF

THE EXPERT GROUP

FOR DESIGNING A SUPERVISORY FRAMEWORK

FOR NON-BANKING FINANCIAL COMPANIES

RESERVE BANK OF INDIA
MUMBAI
APRIL 1996

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Member, Advisory Council
to the Board for Financial
Supervision

Reserve Bank of India
Mumbai,

April 22, 1996.

Shri S.P.Talwar,
Deputy Governor,
Reserve Bank of India,
Mumbai.

Dear Sir,

Report of the Expert Group for Designing a Supervisory Framework for Non-Banking Financial Companies (NBFCs)

I have pleasure in submitting the report of the Expert Group set up by the Bank for designing a Supervisory Framework for NBFCs.

On behalf of the Group, I would like to express our gratitude to the Bank for reposing confidence in us by entrusting the assignment. I trust that the Bank would find the recommendations made by the Group useful in formulating its policies in regard to exercising supervision over NBFCs.

Yours faithfully,

(P.R. KHANNA)

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REPORT OF THE EXPERT GROUP FOR DESIGNING A SUPERVISORY FRAMEWORK FOR NON-BANKING FINANCIAL COMPANIES (NBFCs)

EXECUTIVE SUMMARY

The summary of major observations and recommendations of the Group is given in the following paragraphs. The numbers of the relevant paragraphs of the chapters relating to the observations and recommendations have been indicated within brackets to facilitate easy reference.

1. The control exercised hitherto over the NBFCs was limited to ensuring compliance of regulatory provisions relating to deposit acceptance activities. The focus of periodical inspection conducted was mainly confined to examination of deposit liabilities of the entities regulated. (1.2)

2. The present scenario revealed that the NBFCs had grown to assume a significant role in the process of financial intermediation. The Reserve Bank of India(Bank) had taken on its mailing list a phenomenally large number of companies i.e. 37,880 as on March, 31, 1994 (since increased to 41,361 as on August 31, 1995) based on the information furnished by the various offices of Registrar of Companies (ROCs) ever since 1966 for exercising regulatory control. Of these, about 10,000 companies only were submitting the statutory returns/balance sheets at annual intervals to the Bank. As such, more than 70 per cent of the NBFCs listed in the record of the Bank had not been in the Bank's regulatory focus as some of these non-reporting NBFCs might not have at all commenced business or might not be in existence any

more. The Group recommends that effective steps should be taken to co-ordinate the exchange of information between the various offices of ROCs and the Bank to ensure prompt updation of the Bank's mailing list. (3.1.2)

3. The aggregate deposits, consisting of both regulated deposits and exempted borrowings, mobilised by the reporting companies were consistently growing at a fast pace over the years and the aggregate deposits of NBFCs stood at Rs.56,559 crore as on March 31, 1994 forming 17.4 per cent of the deposits with the scheduled commercial banks (SCBs). (3.2.2)

4. The regulated deposits of all the reporting companies at Rs. 17,436 crore (provisional) as on March 31, 1994 formed 5.4 per cent of the deposits with SCBs. Nevertheless, it must be noted that although the volume of regulated and aggregate deposits mobilised by NBFCs is still small in comparison with total bank deposits, the annual growth rate had been significant vis-a-vis the corresponding average growth rate of bank deposits. (3.2.4)

5. The regulated deposits of a few selected large size companies at Rs.8,703 crore and their exempted borrowings at Rs.26,624 crore constituted 50% and 68% of the regulated and exempted deposits of all the reporting companies respectively. (3.2.5)

6. Out of the total companies which have reported deposits (8,835), 2,464 companies alone (constituting 28 per cent) accounted for 99.4 per cent of the aggregate

deposits. There was also a definitive concentration amongst a relatively smaller number of NBFCs both in terms of aggregate deposits mobilised and their asset size. (3.2.7)

7. As the scenario of the NBFCs is fast changing with multiplication of financial services and products offered by them, the Group feels that the Bank needs to perceive this segment as an integral part of the financial system and accordingly focus its attention to ensure that

- NBFCs carry on their business in conformity with the overall framework of the monetary and credit policy; and
- these function on sound, solvent and healthy lines so that these are in a position to meet their liabilities to the depositors and other creditors as and when the claims accrue. (4.1)

8. The Group recommends that the existing statutory powers vested in RBI in Chapter III B of the RBI Act, 1934 should be enhanced to effectively equip the Bank for better achieving the macro-level goals of ensuring healthy and orderly functioning and growth of NBFCs with special reference to a) fulfilment of entry point conditionalities for incorporation of new entities such as track record, minimum capital b) compulsory registration c) investment in approved securities to the extent prescribed d) creation of reserve fund etc. (4.3)

9. As regards unincorporated bodies, enforcement of provisions contained in Chapter III C of the RBI Act should be left to the State Governments and the Bank may extend

support to the Governments as and when called for. The Group also recommends that the existing provisions may be refined and strengthened. (4.4.1, 4.4.2 & 4.4.3).

10. The Group recommends introduction of a comprehensive supervisory framework towards achieving the regulatory and supervisory objectives. Accordingly, all the bodies incorporated as NBFCs engaged, inter alia, in accepting deposits/borrowings from the public, corporates, banks etc. must be brought under the supervisory net of RBI regardless of the capital base of the entities. However, the number of reporting companies being large, the supervisory attention and focus should be directed in a comprehensive manner only to NBFCs having NOF of Rs.100 lakh and above. (4.5)

11. For better and effective supervision over NBFCs, the existing jurisdiction of Regional Offices of Department of Supervision (DoS) should undergo change. (4.6)

12. For exercising prudential supervision and for focussing supervisory attention of varying intensity, the Bank should stratify the NBFCs as under :

- A Unregistered NBFCs
- B Registered NBFCs with asset size
  - i) upto Rs. 25 crore
  - ii) above Rs. 25 crore but less than Rs. 500 crore
  - iii) Rs. 500 crore and above (5.3)

13. The Group suggests that in view of the large number of entities falling under the regulatory jurisdiction of the Bank and as a long term strategy, all the NBFCs should be supervised mainly through off-site surveillance system regardless of whether the entities are registered with the Bank or otherwise. (5.4.1)

14. The off-site surveillance system will structurally be an in-house review and analytical system based on various statutory returns and other statements. The system should be operated on an on-going basis and it should be capable of capturing the critical events that go into each major segment of the business cycle of the NBFCs. (6.1.2)

15. The entire process of capturing data from the returns for the purpose of annual survey and the detailed scrutiny thereof should be completed within a maximum period of three and six months respectively from the due date prescribed for submission of the annual return. (6.2.2)

16. As the quantum of aggregate deposits mobilised by the unregistered NBFCs do not constitute any significant share of the aggregate deposits of the NBFCs as a whole, the Group feels that detailed supervision need not be focussed on the unregistered companies. Ensuring receipt of the annual returns, balance sheets from them and scrutiny thereof is considered to be adequate for the purpose. (6.3.3)

17. The Group suggests that it should be made incumbent on the part of the statutory auditors/directors to compulsorily furnish their reports in the Balance sheets. The scope

of the required certification by the auditors under para 13A of the Directions applicable to NBFCs should also be widened. (6.3.4 & 6.3.5)

18. As a part of the off-site surveillance strategy, the Group suggests that the registered companies, apart from submitting prescribed annual return and half-yearly return on prudential norms should submit an annual statement on operational data with various ratios. The data submitted should be subjected to extensive analysis including entity study, peer group comparison of solvency, soundness etc. (6.4.1 & 6.7.1)

19. In order to achieve the objective and enhance the effectiveness of the prescribed statutory returns, the Group suggests some procedural refinements. (6.5)

20. The Group suggests that prudential returns may be required to be submitted in floppy media alongwith hard copies duly authenticated. (6.6.2)

21. In order to broad base and supplement the supervisory exercises undertaken through off-site surveillance/on-site inspection, the Group feels that the fast-changing developments that take place in the financial services sector must also be captured. Accordingly, the Group recommends introduction of a market intelligence system which envisages interaction of the Bank's supervisory officials with the associations/federations of the industry at regular intervals, besides scanning the industry-relevant

'rating watch' charts published by the credit rating agencies and other media. Any company-specific or industry-specific information having systemic relevance must activate the on-site machinery to cause on-the-spot study or result in other appropriate actions. (6.9.1 & 6.9.2)

22. The Group recommends introduction of on-line corporate memory/profile building process based on observations generated from off-site surveillance system, market intelligence, complaints, supervisory rating, record of compliance with the directions and inspection findings. (6.10)

23. The Group recommends introduction of a superviosry rating system for the registered NBFCs. (7.1.1)

24. The supervisory rating system may be designed on the basis of different levels of a) regulatory/supervisory compliance b) capital adequacy and c) ratings assigned by the credit rating agencies. The rating process may assign weightage points for each parameters and arrive at the supervisory rating. Based on the rating, the NBFCs could then be placed in three different supervisory 'watch-lists' of LOW, MEDIUM AND HIGH RISKS. (7.2.2, 7.2.4, 7.2.5 & 7.2.6)

25. The ratings assigned to NBFCs will primarily be the tool for triggering on-site inspections at various intervals. (7.2.8)

26. Supervision over unregistered NBFCs may largely be exercised through off-site surveillance mechanism and their on-site inspection may be conducted selectively as deemed necessary depending on circumstances. (8.1.2 & 8.2.1)

27. The periodicity for conducting on-site inspections of the registered NBFCs should be modulated based on the positioning of the NBFCs in the supervisory 'watch -list'. Those positioned in the watch list of LOW RISK should be subjected to the on-site inspection generally once in three years while those under the watch list of MEDIUM RISK should be subjected to on-site inspections once in every two years and one year. The companies which fall under HIGH RISK category should be subjected to immediate on-site inspection. (8.3.1 & 8.3.2)

28. While objectives of on-site inspection should consist of ensuring regulatory compliance, evaluation of financial soundness/solvency, appraisal of management and identification of areas requiring corrective action, the proces should cover reviewing of compliance of regulations and supervisory guidelines, appraisal of assets quality, analysis of key financial indicators and assessment of policies, systems and procedures. (8.4.1 & 8.4.2)

29. The Group recommends that an elaborate supervisory model akin to that which is applied to the Banking sector should be developed in-house for overseeing the large size NBFCs with asset size exceeding Rs.500 crore each. (8.10.1)

30. On the basis of findings of on-site inspection, a composite supervisory rating may be assigned to the registered NBFCs. (8.10.2)

31. The Group suggests that the returns in First Schedule and Schedule A should be certified by the statutory auditors before their submission to the Bank. Similarly, prescribed certification by the auditors of NBFCs regarding disclosure of liabilities to the depositors in the balance sheet and their ability to repay to the depositors may be made applicable to MNBCs and RNBCs also. (9.1 & 9.3)

32. The Group recommends that effective steps should be taken in co-ordination with the ICAI to create awareness about the requirements of section 45 MA of RBI Act among the audit professionals. (9.2)

33. It should be made obligatory on the part of the auditors to report to the Bank immediately if during the course of audit, the auditor learns of facts which a) might warrant qualification or withholding of certificate of audit b) endanger the existence of the entities audited and c) indicate that the NBFC has severely infringed the regulatory provisions/supervisory guidelines. (9.5)

34. The Group recommends introduction of a system whereby the names of NBFCs which have not complied with the regulatory framework/directions of the Bank or have failed to submit the prescribed returns consecutively for two years should be published in regional newspapers. Further, the names of such companies may also be removed from the mailing

list of the Bank after prohibiting them from carrying on financial business including deposit taking. (10.2)

35. In the case of large size NBFCs where serious violation of regulations/deficiencies have been observed, immediate process of dialogue should be initiated with the Chairmen/CEOs of the concerned NBFCs for remedial action. (10.4)

36. The Group recommends that the Bank should resort to extensive computerisation of its activities with special reference to analysis of statutory returns and statements received as a part of the supervisory exercise. Accordingly, the Bank should train adequate number of its personnel on the usage of computers for the purpose. (11.2)

37. With the increasing liberalisation of the Indian financial system, a number of multinational companies have made in-roads into the Indian financial services sector. However, given the large resources available at the command of these corporates vis-a-vis the Indian entities, the Group feels that there is a need to exercise caution and ensure that the level playing field is maintained. (12.2.2)

38. Some of the NBFCs are undertaking through subsidiary units, allied financial services viz., stock broking, investment banking, asset management, portfolio management, merchant banking etc. The Bank may, therefore, examine as to what extent its surveillance system should scan through the financial parameters of the subsidiaries of the NBFCs. (12.2.3)

39.The Group feels that there is a need to devise a suitable system for co-ordinating on-site inspection of NBFCs by the Bank in tandem with other regulatory authorities so that these are subjected to one-shot examination by different regulatory authorities. (12.2.4)

40. Some of the non-banking non-financial companies (viz. industrial/manufacturing units) are also undertaking more and more financial activities including acceptance of deposits, investment operations, leasing etc. to a sizeable extent. The adequacy or otherwise of the existing regulatory control may be examined with a view to guarding against the possibility of misuse of the financial system by such companies. (12.4)

41. Some of the plantation and animal husbandry companies not falling under the regulatory control of either D.C.A. or the Bank have been soliciting monies from the public repayable in kind after long periods stretching upto 25 years. There is, therefore, a need to identify an appropriate authority to regulate the activities of these companies insofar as their mobilisation of public deposit is concerned. (12.5)

42. Although the Bank has introduced a comprehensive system of ensuring financial discipline through prudential norms, the NBFCs may continue to follow the conventional method of accounting insofar as preparation of Balance Sheet/Profit and Loss accounts is concerned. The Bank may, therefore, explore whether the balance sheet etc. compilations could be done by the NBFCs in tune with prudential norms/

guidelines so as to have better transparency of their financial position in the larger public interest. (12.6)

43. The NBFCs have been registering a fast growth in terms of volume and nature of activities which are akin to banking activities. Keeping in view the long term objective of ensuring sound and healthy growth of NBFCs, there is a need for enactment of a separate comprehensive legislation in place of Chapter III B of RBI Act, 1934, covering the entire gamut of operations of the NBFCs. (12.9)

CHAPTER I

INTRODUCTORY - GENESIS OF THE WORKING GROUP

1.1 Consequent upon the initiatives taken during the recent past towards liberalisation of the economy and deregulation of the financial system, the financial sector including the NBFCs segment registered a manifold growth.In particular,the NBFCs segment recorded a significant and phenomenal growth both in terms of number of entities and quantum of deposits accepted from the public and corporates. In order, therefore, to ensure that there is a healthy and orderly growth of NBFCs and that these bodies subserve the overall monetary and credit policy of the country, prudential norms and guidelines have been prescribed. Furthermore, in order to have an integrated supervision over the financial sector, the Reserve Bank of India(Bank) decided to bring the NBFCs also under the purview and supervisory control of the Board for Financial Supervision (BFS) created under the aegis of the Bank. Accordingly, beginning July, 1995 the responsibility for supervision of the NBFCs had devolved on the Department of Supervision (DoS) of the Bank.

1.2 The NBFCs were hitherto subjected to a set of regulatory stipulations relating largely to quantum of deposits, period of deposits, payment of interest and commission/brokerage, maintenance of liquid assets. Compliance with such regulatory stipulations was being monitored till July 1995 by the Department of Financial Companies of the Bank through receipt of annual returns as well as by conducting on-site inspections. The process of on-site inspection was, therefore, largely confined to examination of liabilities and compliance of Bank's directions by the NBFCs. However, NBFCs over time have grown and have started playing a relatively significant role in the economy especially in mobilisation of deposits from the public and dispensation of credit to Road Transport and SSI sectors and corporate bodies. They are also undertaking multifarious other financial activities. Consequently, the need to perceive the NBFCs as an integral part of the credit delivery system has crystallised warranting institution of a comprehensive prudential supervisory system over and above the existing regulatory framework. In order, therefore, to design an effective supervisory framework, the Bank constituted the Expert Group under the Chairmanship of Shri P.R. Khanna, Member of the Advisory Council of the BFS, by an order dated April 21, 1995. The composition of the Expert Group is as under:

1. Shri P.R.Khanna Chairman	Senior Partner, Khanna & Annadhanam, Chartered Accountants, New Delhi.
2. Shri J.Goswami Member	Chief General Manager, Department of Financial Companies, Reserve Bank of India, Central Office, Calcutta.
3. Shri K.M.Elavia Member	Kalyaniwalla & Mistry, Chartered Accountants, Mumbai
4. Shri G.S.R.K.Rao Member	Executive Director, Credit Rating Information Services of India Ltd., Mumbai.
5. Shri G.K.Raman Member	Managing Director, Sundaram Finance Ltd., Madras.

6. Shri S.D.Nadkar Member	Managing Director, Anagram Finance Ltd., Ahmedabad.
7. Shri V.S.Srinivasan Member	Managing Director, 20th Century Kinetic Finance Ltd., Pune.
8. Shri T.Bandyopadhyay Member Secretary	Addl.Chief General Manager, Department of Financial Companies, Reserve Bank of India, Central Office Cell, Mumbai.
9. Shri A.M.M. Sarma Special Invitee	Chief General Manager, Department of Supervision, Reserve Bank of India, Central Office, Mumbai.
10. Shri P.R.Gopala Rao Special Invitee	Addl. Chief General Manager, Department of Supervision, Reserve Bank of India, Central Office, Mumbai.
11. Shri S.Bandyopadhyay Special Invitee	Addl. Chief General Manager, (Since retired), Department of Financial Companies Reserve Bank of India, Central Office Cell, Mumbai..

TERMS OF REFERENCE:

1.3 The Terms of Reference of the Group are as under :

i) Defining the supervisory jurisdiction of Non-Banking Financial Companies in terms of entities and supervisory responsibilities and powers.

ii) Defining the objectives, scope and strategy of prudential supervision of NBFCs.

iii) Recommending a framework for on-site examination of NBFIs (including periodicity, coverage and methodology).

iv) Designing an off-site monitoring system.

v) Developing a system of supervisory ratings and making it the basis for modulating supervisory attention and resources.

vi) Suggesting how external audits can be made a resource for prudential supervision.

vii) Post-examination and off-site review/follow up for making it result and action oriented.

viii) Any other related areas including recommendations for training and computerisation.

SCOPE OF THE STUDY

1.4 The Group has confined its deliberations, as per its terms, mainly on framing a Supervisory Framework for NBFCs. Although the existing regulatory framework does not fall within its scope, a few recommendations have been made by the Group for consideration. The Group has also referred to some other issues, which have arisen lately, for review by the Bank and appropriate action.

METHODOLOGY

1.5 The Group has primarily relied on readily available data relating to number of NBFCs held on record of the Bank together with the quantum of deposits accepted by them - regulated and exempted, existing regulatory stipulations and the system of reporting by NBFCs to the Bank. Furthermore, the Group invited representatives of four major Associations/ Federation of the industry as also the Chairmen/Managing Directors/Chief Executive Officers of some of the leading NBFCs to submit detailed memoranda on specific points indicated in the Terms of Reference. The list of Associations/Federation, NBFCs and the persons with whom the Group had meetings is given in Annexure I. Various issues that emerged from these discussions were deliberated upon. Sub-groups were also set up to address distinct issues relating to on-site inspection, off-site surveillance and supervisory rating systems. The Group met 12 times in all. The recommendations of the Group are the end result of this process.

ACKNOWLEDGEMENTS

1.6 The Group would like to place on record its appreciation to the large number of representative bodies who have put forth their views on the various issues pertaining to the terms of reference in addition to submission of their views in writing. The Group gratefully acknowledges the contributions made by Sarvashri S.S. Tarapore, S.P. Talwar, Deputy Governors, D.S.R. Raju, Executive Director and O.P. Sodhani, Executive Director (Retd.) who brought to bear on the deliberations of the Group their indepth knowledge of the issues pertaining to the Non-banking financial services segment. Furthermore, the Group would like to place on record its deep appreciation of the contributions made by the Member-Secretary, Shri T. Bandyopadhyay by presenting voluminous background notes, data and special papers on

several aspects/areas required for the Group's deliberations. The Group also places on record the services rendered by Shri M. Palanisamy, Assistant General Manager, Department of Supervision, Mumbai Regional Office for conducting the proceedings of the Group's meetings besides extending assistance in drafting the report. The assistance received from Shri D.T. Jethani, Assistant General Manager, Inspection Department in finalising the report also deserves appreciation. Shri V.T. Sawant bore the brunt of typing and allied processing work of the report of the Group and his services deserve special mention.

CHAPTER II

BRIEF REVIEW OF THE RECOMMENDATIONS OF EARLIER COMMITTEES

2.1.1 Although NBFCs have been operating for quite a long time in India, an attempt to regulate them started only in the sixties. Regulation of these institutions was found to be necessary for three reasons viz., ensuring efficacy of credit and monetary policy, safeguarding depositors' interest and ensuring healthy growth of Non-Banking Financial Intermediaries (NBFIs). Thus, the Banking Laws (Miscellaneous Provisions) Act, 1963 was introduced to incorporate a new chapter (i.e. Chapter III B) in the Reserve Bank of India Act, 1934 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 in-depth study of these institutions and make suitable recommendations for their healthy growth.

2.1.2 The recommendations/observations of the earlier committees relating to NBFCs as highlighted in the report of the Working Group headed by Dr. A.C. Shah and those of the Shah Working Group are summarised hereunder to trace the evolution of regulations of NBFCs:

BHABATOSH DATTA STUDY GROUP(1971)

2.2.1 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.

The Group recommended that

i) keeping in view the difficulties in regulating a very large number of institutions, regulations should aim at reducing the number of entities to be regulated, if possible, by inducing them to form themselves into corporate bodies; and

ii) 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(1975)

2.2.2 The Study Group recommended that the situation as prevailing at that time called for regulation and not prohibition of deposit acceptance by NBFCs. 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 interests of depositors.

CHAKRAVARTY COMMITTEE(1987)

2.2.3 The Committee recommended that

i) regulations 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; and

ii) a system of licensing appeared to be essential to protect the interests 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.

NARASIMHAM COMMITTEE(1991)

2.2.4 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.

2.2.5 The Committee further 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.

SHAH COMMITTEE(1992)

2.2.6 The Working Group on Financial Companies set up by the Bank under the Chairmanship of Dr.A.C. Shah to make an in-depth study of the role of NBFCs and suggest control measures to ensure healthy growth and operations of these companies observed as under:

i) From the angle of depositors' protection and efficacy of monetary and credit policy, what was really required was a well-integrated regulatory framework which, while monitoring and supervising the operations of NBFCs, recognised and even encouraged the emergence of new types of financial services and products.

ii) Although the number of non-bank financial intermediaries, both in the organised and unorganised sectors was very large, only about 1600 companies which constituted 21 per cent of the reporting companies accounted for as much as 97 per cent of total deposits.

iii) Category-wise classification of financial companies might be abolished and uniform regulation might be applied to all financial companies.

iv) The Group recognised 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 advocated that regulatory attention be confined to those larger size companies which accounted for a lion's share of total non-banking financial companies' deposits.

v) All the deposit-taking companies with net owned funds (NOF) of Rs.50 lakh and over should compulsorily register with the regulatory authority. This cut-off point might be reviewed subsequently.

vi) As regards new financial companies, entry norms viz. minimum net owned fund of Rs. 50 lakh and a cooling period before accepting deposits might be enforced.

vii) The regulations might be directed to the asset side such as limit on credit concentration and prohibiting investments in undesirable activities.

viii) Capital adequacy standards might be laid down based on risk assessment of assets and credit conversion factors for off-balance sheet items.

ix) The 'exempted' category of deposits should be removed and all deposits should be treated alike. Inter-corporate deposits should be reckoned as part of deposits. A clear distinction should be made between deposits and borrowings from banks/institutions.

x) Net owned fund of a financial company should be redefined to exclude investments in other non-banking financial companies and subsidiaries as also loans and advances to subsidiaries to the extent the aggregate of such investments, loans and advances exceed 10 per cent of the amount of the paid up capital and free reserves of the company as reduced by the amount of accumulated balance of losses, deferred revenue expenditure and other intangible assets.

xi) Aggregate amount of funds which an NBFC could accept under portfolio management schemes might be related to the net owned fund of the company.

xii) NBFCs might be allowed to accept deposits for a period ranging between 12 months and 84 months. Furthermore, so long as interest rates on bank deposits were regulated, interest rates on deposits accepted by non-banking financial companies should be 2 or 3 percentage points more than those offered by commercial banks.

xiii) Prudential norms for income recognition, transparency of accounts and provisions for bad and doubtful debts should be prescribed.

xiv) Auditors might be assigned more responsibilities with regard to compliance of regulations.

xv) The Group recommended that NBFCs must get themselves credit rated every year.

2.3 The foregoing analysis of the recommendations of various Study Groups/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. The recommendations of the present Expert Group aim at designing a supervisory framework in alignment with the regulatory system and the requirements of the present time. The Group also feels that the regulatory system needs to be under constant review in view of the dynamic changes that are taking place in the financial services sector so as to ensure, as aforesaid, a healthy growth of the non-banking financial sector.

CHAPTER III

PRESENT SCENARIO OF NBFCs

Nature and size of the segment

3.1.1 The Indian situation of the NBFCs segment of the Financial System has long remained unique. The Bank held on its record as many as 37,880 diverse NBFCs for the purpose of regulation as on 31st March 1994 and this number has been increasing from year to year as shown below :

Statement showing the number of companies held on the mailing list and reporting companies

Year	Number of NBFCs	Number of MNBCs	Number of RNBCs	Total	Of the companies at Col.5, no. of companies which submitted Annual Returns	Of the reporting companies at Col.6,no.of companies which reported NIL deposits
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1992	24501	6226	531	31258	11375	2412
1993	28084	6606	534	35224	11124	2355
1994 (provisional)	30245	7102	533	37880	10845	1650

NBFCs = Non-Banking Financial Companies i.e. loan, investment, hire purchase/leasing and mutual benefit (Nidhi) companies.
MNBCs = Miscellaneous Non-Banking Companies i.e. Chit Fund Companies.
RNBCs = Residuary Non-Banking Companies i.e. deposit taking companies but not belonging to the other categories.

STATEMENT SHOWING THE CATEGORY-WISE NUMBER OF COMPANIES AS ON SEPTEMBER 30, 1995 WITH NET OWNED FUND OF

Category	Rs.50 lakh to Rs.2 crore	Above Rs.2 crore
Hire purchase	81	88
Loan	190	110
Investment	356	239
Equipment Leasing	25	46
MBFCs(Nidhis)	3	-
MNBCs(Chit cos.)	5	-
RNBCs	1	3
Total :	661	486

3.1.2. The Bank has taken on its record as many as 37,880 NBFCs upto March 31, 1994 (since increased to 41,361 as on August 31, 1995) based on the information furnished by the various offices of Registrar of Companies (ROCs) ever since 1966. Of these, the Bank is, however, extending its regulatory attention only to 10,845 companies (as on March 31, 1994) by virtue of their submitting the annual statutory returns pertaining to the year 1993-94. As such, more than 70 per cent of the NBFCs listed in the record of the Bank have not been in the regulatory focus as some of them may not have at all commenced business, some may not be continuing their activities as finance companies or some may have gone into liquidation or may not be in existence any more.The gap between the number of NBFCs held on record(i.e. mailing list) and the number of NBFCs which are submitting the annual returns has been consistently widening as the Bank is not in a position to track the status of those companies which have defaulted in submission of the annual returns nor the information pertaining to companies which are wound up/have changed their business activites are readily forthcoming from the ROCs. The Group, therefore, recommends that proper and effective steps be taken to co-ordinate the exchange of information between the ROCs and the Bank to faciliate expeditious updation of the Bank's mailing list. If necessary, the issue may be taken up with the Department of Company Affairs (DCA) for streamlining the process of receipt of data relating to companies incorporated/wound up etc.

3.1.3 Of the reporting companies at 10,845 as on March 31, 1994, the number of relatively large size companies with net owned fund of Rs.50 lakh and above was only 1147 with investment, loan and hire purchase companies dominating in number. Furthermore, out of these relatively large size companies, 745 companies have already registered themselves with RBI (as on December 31, 1995) and they are subjected to the guidelines on prudential norms and capital adequacy as prescribed by the Bank.

PROFILE OF GROWTH IN AGGREGATE DEPOSITS OF NBFCs

3.2.1 Statements showing regulated deposits and exempted borrowings of NBFCs (Table I), growth in aggregate deposits of NBFCs (Table II), share of the companies which have reported deposits of Rs.25 lakh and above in the aggregate deposits of all the companies (Table III) and growth in aggregate deposits of financial companies *vis-a-vis* scheduled commercial banks (Table IV) are furnished below :

TABLE - I

STATEMENT SHOWING REGULATED DEPOSITS AND EXEMPTED BORROWINGS OF FINANCIAL AND MISCELLANEOUS NON-BANKING COMPANIES

(Amount in Crore of Rs.)

Fiscal Year	Regulated deposits: Public deposits	Other deposits	Total	% of Col.4 to Col. 7	Exempted deposits/ borrowings	Aggregate deposits	% of Col.6 to Col.7
1	2	3	4	5	6	7	8
1984	219.9	55.7	275.6	8.7	2885.7	3161.3	91.3
1985	363.8	45.7	409.5	9.4	3946.5	4356.0	90.6
1986	422.1	63.4	485.5	9.8	4474.1	4959.6	90.2
1987	708.6	123.7	832.3	14.0	5109.3	5941.6	86.0
1988	1022.8	114.1	1136.9	15.2	6362.8	7499.7	84.8
1989	1312.7	183.2	1495.9	14.4	8914.3	10410.2	85.6
1990	1609.4	164.0	1773.4	12.1	12869.6	14643.0	87.9
1991	1894.9	145.8	2040.7	11.8	15195.5	17236.2	88.2
1992	2648.1	176.0	2824.1	13.8	17614.4	20438.5	86.2
1993	3388.0	899.8	4287.8	9.5	40668.6*	44956.4	90.5
1994 (provisional)	5935.3	11501.2**	17436.5●	30.8	39122.2	56558.7	69.2

* The money received in the form of a) borrowings from foreign governments or any other authority (Rs.5504.6 Crores), b) borrowings from banks and other financial institutions (Rs.12415.9 Crores) and c) money raised by issue of secured or convertible debentures (Rs.3861.4 Crores) aggregating Rs.21781.9 Crores which were excluded from computation of exempted borrowings till 1992 were included in the computation of exempted borrowings from 1993 onwards.

** The money received by way of inter-corporate deposits and secured/non-convertible debentures which were hitherto forming part of exempted borrowings were categorised as regulated deposits in 1993-94.

● Of the regulated deposits of Rs.17436.5 crore reported by the NBFCs as on 31.3.1994, the regulated deposits mobilised by 7 large size companies namely ICICI, ICICI - Securities, Power Finance Corporation, Indian Railway Finance Corporation, Rural Electrification Corporation, HUDCO and HDFC alone aggregated to as high as Rs.8703.0 crore constituting 49.9 per cent. The exempted borrowings of these companies at Rs.26623.7 crore constituted a still higher percentage of 68.1 of the exempted deposits (Rs.39122.2 crore) of all the reporting companies while the aggregate deposits of these companies constituted 62.5 per cent of the aggregate deposits of all the reporting companies.

TABLE II

Aggregate Deposit Growth of NBFCs

(Amts.in Crore of Rs.

Fiscal Year	LCs	ICs	HPFCs	ELCs	MBFCs	MNBCs	HFCs	Total
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	11,142.1	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	6,808.1	1,862.1	1,224.2	2,420.5	193.1	956.4	1,178.6	14643.0
	(46.5)	(12.7)	(8.4)	(16.5)	(1.3)	(6.5)	(8.0)	
1991	7,313.3	2,155.0	1,596.1	3,716.5	242.9	911.6	1,300.8	17236.2
	(42.4)	(12.5)	(9.3)	(21.6)	(1.4)	(5.3)	(7.5)	
1992	9,044.6	2,305.2	1,971.0	3,769.9	362.1	1134.1	1851.6	20438.5
	(44.2)	(11.3)	(9.6)	(18.4)	(1.8)	(5.5)	(9.1)	
1993	22,567.0	3,189.8	4,071.6	6,958.9	584.9	1509.9	6074.3	44956.4
	(50.2)	(7.1)	(9.1)	(15.5)	(1.3)	(3.4)	(13.5)	
1994	26,749.5	4,034.1	5,968.1	8,692.2	1089.0	990.6	9035.2	56558.7
(provisional)	(47.3)	(7.1)	(10.5)	(15.4)	(1.9)	(1.8)	(16.0)	

Note : LC - Loan Company
IC - Investment Company
HPFC - Hire Purchase Finance Company
ELC - Equipment Leasing Company
MBFC - Mutual Benefit Finance Company
MNBC - Miscellaneous Non-Banking Company
HFC - Housing Finance Company

Figures in brackets indicate percentage to total deposits.

TABLE III

Share of Aggregate Deposits of the Companies which have reported aggregate deposits of Rs.25 lakh each & above

(Amounts in crore of Rs.)

Fiscal Year	No.of reporting companies	Aggregate deposits	Companies reporting aggregate deposits of Rs.25 lakh and above					
			No.of companies	% of col.4 to col.2	Aggregate deposits	% of col.6 to col.3	Exempted deposits	% of col.8 to col.6
1	2	3	4	5	6	7	8	9
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	7784	14643.0	1805	23.2	14295.7	97.6	12590.8	88.1
1991	7758	17236.2	1970	25.4	16900.5	98.1	14926.5	88.3
1992	8923	20438.5	2445	27.4	20062.6	98.2	17315.8	86.3
1993	8634	44956.4	2845	32.6	44611.8	99.2	40388.1	90.5
1994 (provisional)	8835	56558.7	2464	27.9	56246.2	99.4	39003.9	69.3

• TABLE IV

Growth in Aggregate deposits of Financial Companies vis-a-vis Scheduled Commercial Banks (SCBs)

(Amount in crore of Rs.)

Fiscal Year	Amount of Regulated deposits with Fin. Companies	Amount of aggregate deposits with Fin. Companies	Growth rate in %	Amount of deposits with SCBs	Growth rate in %	% of col.3 to col.5	% of col.2 to col.5
1	2	3	4	5	6	7	8
1984	275.6	3161.3	30.1	60732.0	18.3	5.21	0.45
1985	409.5	4356.0	37.8	72571.0	19.5	6.00	0.56
1986	485.5	4959.6	13.9	85704.0	18.1	5.79	0.57
1987	832.3	5941.6	17.8	102938.4	20.1	5.77	0.81
1988	1136.9	7499.7	26.2	118678.0	15.3	6.32	0.96
1989	1495.9	10410.2	38.8	140150.0	18.1	7.43	1.07
1990	1773.4	14643.0	40.7	175441.0	25.2	8.35	1.00
1991	2040.7	17236.2	17.7	204773.9	16.7	8.42	1.00
1992	2824.1	20438.5	18.6	230758.0	12.7	8.86	1.22
1993	4287.8	44956.4	120.0*	274562.3	19.0	16.4	1.56
1994	17436.5	56558.7	25.8	324720.7	18.3	17.4	5.37

* See the notes in Table I.

3.2.2 A study of the quantum of aggregate deposits consisting of regulated deposits and exempted borrowings (Table I) mobilised by the NBFCs revealed that the amounts received by them from the public, corporates and the banking system have been registering consistent growth.The aggregate deposits which stood at Rs.3,161 crore as on March 31, 1984 increased to a phenomenally high level of Rs.20,438 crore as on March 31, 1992. Consequent upon inclusion of certain additional items[viz.a) borrowings from foreign governments, b) borrowings from banks and other financial institutions and c) money raised by issue of secured or convertible debentures] in the coverage of aggregate deposits from 1992-93 onwards towards better measuring the amounts mobilised by the NBFCs from external sources, the aggregate deposits of NBFCs registered a sharp increase from Rs.20,438 crore in 1991-92 to Rs.44,956 crore(120 per cent) in 1992-93 and further to Rs.56,559 crore (25.8 per cent) in 1994. The aggregate deposits of Rs.56,559 crore as on March 31, 1994 constituted 17.4 per cent of the total deposits of Rs.324,720 crore held by the scheduled commercial banks.

3.2.3 It may be observed further that the increase in the aggregate deposits was largely on account of the inclusion of certain additional components representing exempted borrowings as stated above. As such, the quantum of exempted borrowings as a ratio of the aggregate deposits was by and large in the range of 85 to 91 per cent during the 10 year period ended 1992-93. The subsequent reduction in the relative percentage to 69.2 was due to a change in the definition of deposits.

3.2.4 The regulated deposits both in terms of quantum and as a percentage to the aggregate deposits has, however, not grown substantially as yet into assuming significance as the percentage of the regulated deposits to the aggregate deposits/borrowings was ranging only between 9 and 15 during the decade ended 1992-93. The regulated deposits of all the reporting NBFCs at Rs.17,436 crore as on March 31, 1994 (the quantum jump was mainly due to change in definition of deposits) formed 5.4 per cent of the deposits with the SCBs while the deposits accepted from the public alone at Rs. 5,935 crore formed 1.8 per cent of the deposits with the SCBs. Nevertheless, it must be noted that although the volume of regulated and aggregate deposits mobilised by NBFCs is still small in comparison with total bank deposits, the annual growth rate has been significant vis-a-vis the corresponding average growth rate of bank deposits.

3.2.5 The regulated deposits of a few selected large size companies (Table I) at Rs. 8,703 crore and their exempted borrowings at Rs.26,624 crore constituted 50% and 68% of the regulated and exempted deposits of all the reporting companies respectively.

3.2.6 The analysis of the aggregate deposits (Table II) of the companies classified activity-wise, revealed that the Loan companies, Hire purchase/Equipment leasing companies and Housing finance companies together accounted for as high as 89.2 per cent of the aggregate deposits of all the reporting companies as on March 31, 1994.

3.2.7 Furthermore, it may be observed from Table III that out of the total companies which have reported deposits (8,835), 2,464 companies alone (constituting 28 per cent) accounted for 99.4 per cent of the aggregate deposits. An asset wise classification of the reporting registered companies revealed that the number of companies whose total assets were less than Rs.50 crore stood at 417 while those with total assets exceeding Rs.50 crore stood at 93 as on December 31, 1995. The foregoing analysis reveals that there is a definitive concentration amongst a smaller number of NBFCs both in terms of aggregate deposits mobilised and deployment of funds. Accordingly, the supervisory attention should be focussed mainly to these companies.

3.3 It may be added that with the incidence of opening up of the financial system and introduction of measures towards integrating the Indian economy with the global system, the Financial System is in the process of witnessing multiplication of activities of the existing NBFCs and new para-banking entities coming into being. In addition, the financial services and products offered by NBFCs have increasingly become diverse in nature with some of them setting up dedicated institutions/subsidiaries such as Venture Capital Funds, Mutual Funds, Portfolio Management Services, etc.

CHAPTER IV

OBJECTIVES OF SUPERVISION & RESPONSIBILITIES

4.1 The supervisory responsibilities of the Bank may broadly consist of ensuring that

a) NBFCs, as a segment of the Financial System, carry on their business in conformity with the monetary and credit policy and in a manner not detrimental to the overall health of the economy and that the funds raised from the public, corporate bodies, banks and other financial institutions are deployed in a productive manner and does not create any disequilibirium; and

b) these function on sound, solvent and healthy lines so that these are in a position to meet their liabilities to depositors and other creditors as and when their claims accrue.

SUPERVISORY POWERS

4.2.1 The powers to regulate the deposit acceptance activities of the NBFCs and the concurrent powers to enforce prohibition imposed on the unincorporated bodies from accepting deposits in excess of the ceilings prescribed are vested in the Bank by virtue of provisions contained in Chapter III B and Chapter III C of the RBI Act, 1934 respectively.

4.2.2 The broad quantitative stipulations of the present regulatory framework as applicable to financial companies are as under:

Category	Ceilings				Prescribed Liquid assets
	Public deposits incl. NCDs/Bonds.	ICDs	Bank and institutional borrowing	Period (Months)	
Loan and Investment Companies					
-Registered & rated	100% of NOF	2 times of NOF. (Period not to exceed 12 months)	Equal to NOF from each	12-60	Not<15% of deposits
-Unregistered	40% of NOF	-do-	-do-	-do-	Not<7.5% of deposits
Hire Purchase/ Leasing Companies	10 times of NOF	-do- (Sub limit under 10 times)	3 or 2 times of NOF (depending on predominance of business) from each. This is a sub limit of 10 times of NOF.	-do-	Not<15 % of deposits
Miscellaneous Non-banking Companies (Chit Funds)	40% of NOF	Not prescribed	Not prescribed	6-36	Not prescribed
RNBCs	No ceiling	Not prescribed	Equal to NOF from each	12-84	80% of deposi liabilities t be kept invested in deposits witł public sector banks and in approved securities

Chapter III B of the Act

4.3 The existing provisions of Chapter III B are regulatory in character and the directions framed thereunder, inter-alia, centre around restricting the deposit raising capacity of the NBFCs. In order to ensure proper and healthy functioning of the NBFCs, Shah Working Group suggested a shift of focus of regulation from liability side regulation to asset side. Having regard to the fact that the powers inherent in the existing legislative/regulatory framework towards exercising supervision over the NBFCs in their entirety are lacking in depth and are not pervasive in content, certain amendments to the legislative framework are being considered by the Bank in consonance with the Shah Working Group recommendations. In the light of the observations of the Shah Working Group, the Group recommends enhancement of the powers to be vested in the Bank as under:

a) The Group observes that the reform process set in motion during 1991 towards liberalising the Indian financial sector and integrating it with the global financial system has given way for many entrepreneurs to promote non-banking financial companies besides permitting the enlargement of the range and volume of operations of the existing entities in this segment.

The experience in regard to promotion of new entities in the NBFCs segment reveals that the certificates of incorporation are issued by the ROCs as a matter of course to anybody/ group of promoters willing to start a non-banking financial company and that the existing system does not envisage scrutiny/fulfilment of any conditionalities on promoters' equity/track record etc. before issuance of the certificates. As such, the entry of any individual/group of individuals into the financial services sector is far less rigorous as compared to the conditions which are required to be fulfilled/satisfied before incorporating a banking company. Furthermore, in the changing scenario, the financial services sector is seen to be a highly lucrative area as the lendable resources of the NBFCs are not subjected to any mandatory requirements such as lending to priority sectors, maintenance of relatively high levels of liquid assets etc. Given the unconditional freedom of entry into the sector encouraged by the prospects of earning better yields and non-existence of stringent punitive measures against erring companies/promoters, the promoters of an existing company whose deposit taking activities have already been prohibited by the Bank, can still venture to promote yet another NBFC without any hindrance within the same State or elsewhere and continue to solicit/accept deposits from the public. The Group, therefore, suggests that necessary steps including amendment of the Reserve Bank of India Act governing the incorporation of new entities in the Financial Services Sector, enforcement of <u>entry point checks/conditionalities</u> may be initiated to ensure incorporation and continuance of only healthy and viable entities. The Group has observed that such conditionalities are applicable in several other countries.

b) The Group, therefore, feels that there is a need to discourage unfettered growth of new entities promoted with nominal quantum of equity funds but intending to carry on the business primarily by accessing deposits/raising bank credit. The entry point NOF norm suggested by Shah Working Group has been fixed at Rs.50 lakh and above. However, taking into account the existing scenario and the market conditions, the Group recommends that the Bank may be empowered to stipulate a minimum equity of Rs.100 lakh to be brought in by the promoters of a new entity in the organised sector. The Bank may simultaneously be empowered to increase the stipulated minimum to Rs.500 lakh as and when deemed necessary in the larger interest of upholding the monetary policies announced by the Bank and retaining the effective supervision capability of a large number of entities and ensuring depositor protection.

c) The existing regulations do not mandate the requirement of registration of all NBFCs including the existing entities with NOF of Rs.50 lakh and above. The requirement of registration being optional, some of the companies may prefer to remain outside the purview of prudential norms/ discipline and may cause systemic aberrations. The Group suggests that necessary authority should be vested in the Bank to enforce registration requirements and prudential norms over all the companies with NOF of Rs.100 lakh and above.

d) The Group, therefore, recommends early amendments to the existing provisions of the RBI Act, 1934, some of which have already been mooted as shown below:

i) No new financial company should be allowed to commence operations unless it has obtained a certificate of registration from RBI.

ii) The promoters of new entities incorporated as NBFCs should be required to bring in minimum equity of Rs.100 lakh and the Bank should be empowered to raise the minimum equity to be brought in to Rs.500 lakh when deemed necessary.

Furthermore, the Bank should be empowered to

iii) require the existing NBFCs to get themselves registered with it;

iv) prescribe the extent of investments to be made by NBFCs in approved securities and vary the same from a minimum of 5 per cent to a maximum of 25 per cent of the deposit liabilities of the NBFCs;

v) require the NBFCs to create a Reserve Fund and transfer an amount of not less than 20 per cent of their disclosed net profit every year to the Fund;

vi) determine the lending policies to be followed by the NBFCs and issue directions relating to income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, capital adequacy and deployment of funds. The Bank may also issue directions to NBFCs stating the purpose for which advances may not be made;

vii) issue directions relating to the Balance Sheets and Profit and Loss account of NBFCs and also cause special audit of any NBFC, where considered necessary;

viii) issue an order prohibiting an NBFC from accepting deposits if the NBFC violates any of the provisions of the statute or fails to comply with any direction or order given by the Bank under any of the provisions of Chapter III B of the Act;

ix) initiate proceedings for liquidation/winding up of any NBFC whose financial position is found to be weak for safeguarding the interests of depositors;

x) furnish information regarding NBFCs to other regulatory bodies such as SEBI, ICAI etc; and

xi) enforce repayment of deposit/interest by defaulting companies on the lines of the Companies Act as applicable to non-financial companies.

Chapter III C of the RBI Act, 1934

4.4.1 Unincorporated bodies such as individuals, association of individuals, partnership firms have been prohibited from accepting deposits except to a limited extent [i. e.(i) an individual from not more than 25 depositors (ii) a partnership firm from not more than 25 depositors per partner and not more than 250 depositors in all and iii) unincorporated association of individuals from not more than 25 depositors per individual and not more than 250 depositors in all] as specified under Chapter III C of the RBI Act. The deposit acceptance activities of these bodies do not require to be regulated inasmuch as the extant provisions are prohibitory in nature. Although concurrent powers have been vested in both the Bank and the State Governments to enforce these provisions, it was in spirit intended that having regard to the constraints of manpower and infrastructure of the Bank, the concerned State Governments which are better placed vis-a-vis their network of administrative set up and other infrastructural facilities would primarily attend to the task of enforcement of the provisions. The Group feels that while the Bank could not afford to ignore the need for enforcement of the prohibitory provisions on such entities in the unorganised sector, it may not, however, be possible for the Bank to ensure compliance of regulations by such bodies. The issues arising on account of unincorporated bodies could,therefore, be best left to be addressed only by the concerned State Government machineries and the Bank may extend support to Governments when warranted and called for.

4.4.2 The Group observed that there had been a mushroom growth of unincorporated bodies in certain parts of the country and that these bodies were soliciting deposits from the public at exhorbitantly high rates of interest which could not possibly be sustained, besides offering various incentives and gifts such as gold coins. The Group feels that fly-by-night unincorporated bodies are coming up in large numbers as the regulatory machinery of the State Governments has not put in place any proper system to effectively monitor the growth and functions of these entities. The Group feels that the existing legal provisions are inadequate to instil sufficient degree of discipline in regard to deposit mobilisation by unincorporated bodies inasmuch as the provisions do not restrict the quantum of deposits that could be mobilised by such bodies nor the interest rate payable by them. There also does not seem to be any justification for resorting to advertisements by such bodies for soliciting deposit from public having regard to the limited number of depositors from whom deposits can be accepted by them. As such, issuing of advertisement in any form by such bodies should be banned.

4.4.3 The Group recognises that the prohibitory provisions relating to number of depositors could well be circumvented by the entities by forming multiple partnership firms. The Group, therefore, recommends that the existing provisions governing the functioning of the unincorporated bodies need to be strengthened.

JURISDICTION

4.5 While the rationale of regulating the NBFCs, prima facie, aims at ensuring that the NBFCs function as an adjunct to the monetary and credit policy, protection of depositors' interest remains as its yet another objective. It has become onerous on the part of the Bank to prevent misuse of the financial system by these para banking institutions. The Group feels that all the bodies incorporated as Non-Banking Financial Companies and engaged in accepting deposits from the public, corporates, banks etc. must, therefore, be brought under the supervisory net of the Bank regardless of the capital base of the entities. However, the number of reporting companies being large, coupled with the skewed distribution of the deposits accessed by the total population of non-banking companies, the Group feels that there is a need to exercise selectivity insofar as the intensity of deployment of supervisory resources is concerned. Thus, the supervisory attention and focus could be directed in a comprehensive and elaborate manner only on such of those NBFCs having NOF of Rs.100 lakh and above which account for substantial portion of the aggregate deposits mobilised by the NBFCs segment of the Financial System.

Geographical Coverage

4.6 The Group observed that the Financial, Miscellaneous and Residuary Non-Banking Companies located across the country were placed under the geographical jurisdiction of four regional offices of the erstwhile Department of Financial Companies for the purpose of regulation. The Regional Offices of the Department of Financial Companies have since been merged with the Department of Supervision (DoS) which has wider network of Regional Offices. The Group suggests that in order to exercise better and effective supervision over the NBFCs, the existing jurisdiction of the regional offices should undergo change and the NBFCs should be brought under the respective jurisdiction of each office of DoS.

CHAPTER V

PRUDENTIAL SUPERVISION - PURPOSE, SCOPE AND STRATEGY

5.1. The central objective of prudential supervision is to ensure financial safety, soundness and solvency of the NBFCs. Depositor protection is a related goal which is ensured by fostering the development of financially sound and well managed NBFCs. In other words, supervisory efforts must strive at ensuring that the NBFCs conduct their affairs as prudent entities i.e.not indulging in excessive risk taking and violating regulations in pursuit of profit or other owner/promoter related goals jeopardising their solvency and liquidity.

Supervision strategy

5.2.1 The Group feels that the focus of supervision over NBFCs should be shifted from their liability to asset side management as emphasised by Shah Working Group in this regard. As a step towards this approach, the Bank has already introduced the system of enforcing asset related financial discipline through prescription of prudential norms such as income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, concentration of credit and investments and capital adequacy in respect of registered NBFCs. The other elements of supervisory strategy have, therefore, to be tailored towards the revised approach and the extent of supervision required over different categories of NBFCs.

5.2.2 As stated earlier, the number of NBFCs on the mailing list of the Bank for regulatory/supervisory purposes is phenomenally high. Furthermore, the volume of deposits accepted/asset size vary widely among the various categories of NBFCs as well as within a particular category. The Group, therefore, recommends the following strategies:

<u>Stratification</u>

5.3 The Bank should stratify the NBFCs for focussing supervisory attention of different intensity as under:

A. Unregistered NBFCs.

B. Registered NBFCs with asset size

i) upto Rs. 25 crore

ii) above Rs. 25 crore but less than Rs. 500 crore

iii) Rs. 500 crore and above.

<u>Off-site surveillance system</u>

5.4.1 The Group suggests that in view of the large number of entities falling under the regulatory jurisdiction of the Bank and as a long term strategy, all the NBFCs should be supervised mainly through off-site surveillance mechanism regardless of whether the entities are registered with the Bank or otherwise. The off-site surveillance mechanism should structurally be an in-house review and analytical system based on receipt of various statutory returns and other statements from the supervised entities at fixed intervals.

5.4.2 The process of stratification of NBFCs accordingly needs to be dovetailed into the off-site surveillance mechanism to determine the frequency and intensity of statutory and other reporting by the NBFCs to the Bank as under:

- -the unregistered NBFCs may be required to submit only the statutory return in First Schedule/Schedule A togetherwith financial statements at annual intervals.

- -the registered NBFCs may be required to submit, in all, three returns/statement (i.e.First Schedule/ Schedule A once a year, a half yearly statement on prudential norms and an annual statement of comparative position of operational data as on the date of balance sheets) for capturing more elaborate and critical sets of data by the surveillance mechanism towards exercising intensified supervisory attention and control.

<u>Computerised corporate memory/profile</u>

5.5 The Group feels that as a part of the off-site surveillance mechanism, a system of building up computerised corporate memory/profile should be introduced for NBFCs. The summary of both qualitative and quantitative observations generated out of review and analysis of the various returns/ statements togetherwith balance sheet parameters and supervisory ratings should form the core contents of the memory system.

<u>Market Intelligence</u>

5.6 The Group suggests that the Bank should put in place a system of capturing the developments that take place in the financial services sector through various channels including press, electronic media. The Group feels that the system needs as a part of the strategy, to be well-structured and broad-based so as to also a) capture information from additional sources viz. association/federation of NBFCs, rating-watch charts published by various credit rating agencies and b) put the information flowing in from all these sources to proper use with utmost sensitivity so that the Bank remains pre-emptive in its actions.

Supervisory rating

5.7.1 The Group suggests introduction of supervisory rating process to distinguish between registered NBFCs with different levels of a) regulatory/supervisory compliance, b) financial soundness, c) ratings awarded by credit rating agencies and, d) managerial effectiveness.

5.7.2 The supervisory rating process may be used for determining the supervisory concern which the registered NBFCs may require and the periodicity for conducting the on-site inspections.

5.7.3 The analysis and review reports relating to i) off-site returns/statements, ii) corporate memory/profile base, iii) supervisory rating and iv) market intelligence should be effectively utilised as instruments for triggering the process of on-site inspections.

On-site inspection

5.8.1 The Group feels that although the supervision over the entire NBFCs segment is intended to be exercised mainly through off-site surveillance route, there is a need to conduct on-site inspection of both registered and unregistered entities in this sector on the basis of observations/findings of the off-site process of the supervisory framework. The on-site inspection should essentially be directed towards assuring the supervisory authority that an NBFC which is subjected to on-site inspection-

i) is complying with regulatory stipulations and supervisory guidelines;

ii) has adequate capital and liquidity;

iii) is being properly managed; and

iv) has adequate systems and controls in place.

5.8.2 Accordingly, the on-site inspection should be structured into a process of verification and a fact-finding exercise in relation to four major aspects of the functioning of the NBFCs as under:

i) compliance with the directions and guidelines issued by the Bank from time to time;

ii) financial soundness and solvency;

iii) quality of management and systems; and

iv) violations/deficiencies requiring corrective actions.

5.8.3 The Group recommends that the periodicity for conducting such on-site inspections must be determined on the basis of supervisory rating system to render the exercise as one of need-based activity. Furthermore, the intensity of on-site inspection should be directly proportionate to the asset size of the NBFCs.

5.8.4 The Group further recommends that a process of on-site inspection with moderate intensity as set out in Chapter VIII be applied over all the registered NBFCs with asset size upto Rs.500 crore. However, in the case of very large size NBFCs with asset size exceeding Rs.500 crore, the process should be more elaborate in character with special emphasis on managerial aspects and it should be akin to that focussed on the banking system as these relatively large size NBFCs are potentially capable of causing systemic aberrations.

5.8.5 The Group suggests that the Bank should enhance the role of statutory auditors for supervisory purposes. Further, the core return viz. First Schedule/Schedule A should also be required to be certified by the statutory auditors to ensure better diligence of data contained therein for exercising off-site surveillance.

Follow up

5.9 The Bank should put in place a proper system for promptly initiating appropriate action depending upon the nature of violations and/or deficiencies observed during the course of on-site inspections.

5.10 It needs to be mentioned that no system of inspection/ surveillance can be a total fail-safe for all contingencies that may arise in the NBFC segment or for that matter in most endeavours. However, the efforts should be to respond to events and contain damage and exposures as quickly as possible in order to ensure remedial measures in individual cases as also to guard against systemic aberrations.

It may be pertinent to mention that the spirit behind the objective of exercising control/surveillance over the banking and non-banking sectors was summed up as follows by the Governor of the Bank of England in his address to the annual convention of the Institute of Directors, soon after the sensational failure of the group of companies controlled by Robert Maxwell:

"The response must be balanced. We all enter into many economic transactions every day. Most of them rely on some presumption of ethical behaviour and goodwill. We rely also on a mixture of track record, of instinct and of other people's demonstration of trust. We can create various safeguards but we will never have a fail-safe system. The price of freedom both for individuals and for enterprises seeking to be successful in creating prosperity is eternal vigilance, not eternal reporting. To stifle economic enterprise by too much control would be a disastrous over-reaction".

CHAPTER VI

OFF-SITE SURVEILLANCE SYSTEM

6.1.1 The Group feels that depending exclusively on the process of on-site inspection as a major instrument of supervision would render the Bank fraught with supervisory risks/weaknesses such as belated detection of non-compliance with the directions by the NBFCs. Further, the Bank also may not always be in a position to promptly detect early warning signals emanating from the NBFCs segment as it is virtually impossible to take up at regular intervals, on-site inspection of all the NBFCs which are too large in number.

6.1.2 The Group also feels that the results by way of any actual improvement in the working of NBFCs are unlikely to be totally commensurate with the time, labour and expense involved in subjecting all the NBFCs to the process of on-site inspection. The Group, therefore, suggests that the Bank should adopt the strategy of exercising supervision over the NBFCs segment extensively through an off-site surveillance system. The off-site surveillance system would structurally be a return/statement oriented analytical exercise to be performed in-house by the analysts; such returns should be required to be certified by the auditors to ensure credibility and provide for an oversight review. As such, the off-site surveillance system should be operated on an on-going basis and it should be capable of capturing the critical events that go into each major segment of the business cycle of the NBFCs.

6.2.1 In order to facilitate exercising continuous vigilance over the NBFCs at the instance of supervisory and policy related compulsions, the Group feels that the Bank may receive core and critical data from the NBFCs supervised as mentioned hereafter. The data thus received should be computerised to facilitate, inter-alia, maintenance of data base and corporate profile of the NBFCs.

6.2.2 The Group also suggests that the entire process of capturing data from the returns for the purpose of annual survey/industry study and detailed scrutiny thereof for ensuring regulatory compliance should be completed within a maximum period of three and six months respectively from the due date prescribed for submission of the annual return.

Unregistered NBFCs

6.3.1 The unregistered NBFCs are required to submit every year a statutory annual return in the existing set of format viz. First Schedule/Schedule A and the Balance Sheets which primarily seek details of regulated deposits, exempted borrowings, net owned funds, deployment of funds. The above information sought by the Bank is basically intended to serve the purpose of ensuring compliance with the regulatory stipulations and compilation of industry data for review of the same at macro-level from policy angle.

6.3.2 The Group suggests that the annual returns and the balance sheets should be scanned and scrutinised largely to ascertain the degree of compliance of these entities with the regulatory stipulations while the information pertaining to utilisation of funds as furnished in the return/balance sheet also could be studied for tracking "exceptions" and warning signals, if any, to alert the on-site machinery for taking up inspection or special scrutiny, when felt necessary.

6.3.3 The Group feels that in view of the proposed compulsory registration of NBFCs with entry point NOF of Rs.50 lakh and above (recommended to be increased to Rs.100 lakh), the number of unregistered NBFCs is not expected to grow as fast as in the past. Furthermore, the quantum of aggregate deposits mobilised by the unregistered NBFCs do not constitute any significant share of the aggregate deposits of the NBFCs as a whole. The Group, therefore, recommends that detailed supervisory attention need not be focussed on the unregistered companies and ensuring receipt of the annual returns, balance sheets from them and scrutiny thereof is considered to be adequate for the purpose.

6.3.4 It was brought to the notice of the Group that in certain cases the reports of the statutory auditors and directors of the NBFCs are not appended to the Balance Sheets filed with the Bank and hence the Group feels that the matter needs to be examined as to whether it could be made incumbent on the part of the directors to compulsorily furnish their reports together with the auditors' report on Balance Sheets and Profit and Loss Accounts so that the Bank has access to the qualifications and notes recorded by the auditors in respect of all the NBFCs supervised.

6.3.5 The Group suggests that the scope of the certification required to be furnished by the statutory auditors under para 13 A of the directions applicable to NBFCs could be widened to include their comments on the degree of compliance by the companies with the various regulatory stipulations.

<u>Registered NBFCs</u>

6.4.1 The registered NBFCs may be required to submit the following comprehensive returns for the purpose of in-house analysis and creation of corporate memory/profile by the department as a part of its off-site surveillance strategy:

i) Annual return in First Schedule/Schedule A as on 31st March,

ii) Half-yearly return on prudential norms as on 31st March and 30th September,

iii) Annual statement showing the comparative position of operational data as on the date of balance sheet.

6.4.2 The Group while recommending submission of the above returns has ensured, to a large extent, availability of adequate critical data particularly operational data through such returns for exercising off-site surveillance over the NBFCs registered with the Bank.

6.5 In order to enhance the efficacy of utilisation of the statutory returns viz. First Schedule/Schedule A which form the nucleus of the Bank's regulatory and supervisory systems, the Group recommends the following procedural refinements:

i) The prescribed returns in First Schedule and Schedule A at present are to be compiled with reference to the financial position of the NBFCs as on 31st March each year and submitted to the Bank within three months and that the returns are required to be signed only by the authorised officials of the NBFCs. The past experience, however, revealed that the detailed scrutiny of these returns was invariably held up on account of inconsistencies in the figures furnished by large number of NBFCs and that such aberrations were subsequently reconciled with the Balance sheets which were being received much later i.e. between July and October. The Bank may, therefore, eliminate the time-loss in reconciliation of the figures etc. by stipulating afresh that the statutory returns be henceforth certified by their auditors to ensure better diligence of data contained therein.

ii) Revise the format of the returns to provide for furnishing data regarding core assets/income *vis-a-vis* total assets/income, alongwith their percentages, ratios of certain other essential parameters such as regulated deposits to net owned funds, liquid assets to regulated deposits by the NBFCs themselves; alternatively, the existing capability of data processing systems should be improved in such a way that the violations/aberrations are automatically brought out instead of manual exercises undertaken to verify the same.

iii) Review the proforma of the returns at periodical intervals for realigning the coverage and content of the data sought for therein in tune with the changes that take place in the financial services sector.

iv) Assign the work of data entry in respect of the statutory returns to outside agencies to avoid delay, if any, caused by internal constraints.

v) Redistribute the operational work relating to regulatory and supervisory functions to all the regional offices of DoS.

vi) Complete the entire task of data capturing and analysis in respect of all the statutory returns within a maximum period of six months.

vii) Initiate steps to receive the statutory returns through floppy media in the long run from at least all the registered NBFCs supervised.

6.6.1 The Group feels that the half-yearly return relating to compliance of prudential norms such as income recognition, accounting standards, provisioning for bad and doubtful debts, capital adequacy and concentration of credit/investments recently prescribed by the Bank may be continued in its present form and the coverage therein could be refined after watching the quality of data received and the promptness of submission thereof over the next 2-3 years. The data received through such returns at half-yearly intervals should be subjected to critical examination by the

Bank from the supervisory angle with special reference to capital adequacy and accounting standards adopted by the registered NBFCs.

6.6.2 The Group took note of the pilot attempt made by one of the Regional Offices of DoS for receiving the prudential returns through floppy media from the registered NBFCs for facilitating expeditious data capturing and subsequent analysis at the Regional level. The Group suggests that similar system should be introduced in all the offices of DoS. Furthermore, the Group feels that the floppy should be accompanied by hard copies of the return duly signed by the Chief Executive Officer and auditors of the company. There is a need to carry out a sample check of the data contained in the floppy vis-a-vis the hard copies to ensure the integrity/authenticity of data. The Group further suggests that the prudential return should be analysed and such analysis should be capable of bringing out "exception reports" resulting in follow-up actions including on-site inspection/portfolio scrutinies.

6.7.1 The registered NBFCs may also be required to submit an off-site surveillance statement (Annexure II) showing comparative position of operational data every year which is envisaged to solicit important financial parameters of the registered NBFCs, such as summarised profit and loss accounts, balance sheets, business statistics and key ratios for three consecutive years. The registered NBFCs could be expected to submit this statement as soon as the annual accounts are adopted by their Board of Directors and in any case not later than six months from the close of the accounting year. The statement may be certified by the company's C.E.O. and auditors' certification need not be insisted upon as these are only different versions/ combinations of the audited accounts. The Group suggests that this statement be subjected to extensive data analysis including entity-study, peer group comparison of solvency/ soundness analysis. The "standards" for comparison with peer group could be set as bench marks by the Bank after evolving appropriate parameters and conducting a comprehensive study either by in-house personnel or an external consultancy organisation.

6.7.2 The Group suggests that the information picked up from the analysis of the returns/statement be used appropriately at the time of assigning supervisory ratings to NBFCs.

6.8.1 The Group is of the opinion that the effectiveness of the off-site surveillance system would only lie in prompt receipt and scrutiny of the returns/statement referred to above and subsequent generation of MIS to serve as input for the other wings of the supervisory framework within a given time frame.

6.8.2 The Group emphasizes the need on the part of the Bank to introduce suitable systems to ensure that submission of these returns/statements by both registered and unregistered NBFCs is ensured on a continuous basis; otherwise, the very regulatory/supervisory control would undergo dilutions in its effectiveness.

MARKET INTELLIGENCE

6.9.1 The Group observes that the NBFCs segment is marked by fast-changing developments with innovation and specialisation in financial services dominating their growth strategies. Such developments need to be captured into the off-site surveillance mechanism in order to broad-base and supplement the supervisory efforts. The Group, therefore, recommends an in-house market intelligence outfit which will, inter-alia, undertake the following tasks:

i) interact with the representatives of the associations of NBFCs at regular intervals;

ii) scan the newspapers;

iii) scan the 'rating watch' published by the credit rating agencies;

iv) review complaints of misdeeds;

v) collect information regarding advertisements offering interest rates/facilities not permitted under the extant regulations; and

vi) introduce a system of reporting by the inspectors after completion of each on-site inspection on peripheral matters having relevance to the intelligence unit.

6.9.2 Any company-specific material information gathered through these channels must be verified for its integrity, and fed into the off-site monitoring wing as well as the corporate memory base. In case, the information gathered is found to be of systemic relevance, special studies could be taken up for further analysis and creating better understanding/awareness among the supervisory officials.

6.9.3 The Bank should introduce the market intelligence system by creating cells for the purpose both at Central

Office and Regional Offices level. Further, the processing of market intelligence data should be computerised to facilitate prompt follow-up actions on adverse features picked up by the intelligence cells. The cells attached to the Regional Offices should be required to submit monthly reports to the Central Office of DoS which, in turn, may apprise the top management at regular intervals.

Maintenance of corporate memory/
profile of registered NBFCs

6.10 The Group recommends introduction of a computerised corporate memory/profile to be built with reference to the observations generated from off-site surveillance system, market intelligence, complaints, supervisory rating system, record of compliance with the directions and inspection findings. The system could be so structured that it is manned by trained personnel who would, *inter-alia*, analyse and scan through the notes and special features including qualifications recorded by the statutory auditors in the balance sheets and create a memory base. The corporate memory could facilitate analysis and screening of data pertaining to profile of the promoters, capital adequacy ratio, pattern of credit disbursal, extent of credit concentration, if any, recovery percentage, income and expenditure ratios, yield analysis, ranking of the NBFCs supervised *vis-a-vis* the peers in the industry besides indicating the extent of their compliance with the Bank's directions/guidelines or otherwise. The corporate memory system should be ensured to be available on on-line basis covering a period of three consecutive years. The profiles so generated should be updated continuously and form a part of the Management Information System emanating from the off-site surveillance wing.

CHAPTER VII

SUPERVISORY RATING SYSTEM

7.1.1 In order to make the supervision more effective, purposeful and to initiate prompt action, the Group recommends introduction of a supervisory rating system for the registered NBFCs. The supervisory rating system is envisaged to be an exercise aimed at ascertaining i) the extent of adherence by the registered NBFCs of the mandatory requirements including the directions issued by the Bank from time to time and ii) the solvency and soundness of the NBFCs including networth, capital adequacy, incidence of non performing assets. Besides, the process of supervisory rating is envisaged to be used towards efficiently modulating the supervisory resources and its focus of attention.

7.1.2 The Group while observing that the existing regulations require the registered NBFCs and RNBCs to get themselves rated by any one of the credit rating agencies on an annual basis, felt that the Bank may reckon the ratings accorded to the NBFCs by the credit rating agency as one of the quantitative parameters constituting the supervisory rating system. As such, the financial and non-financial parameters that are looked into by the rating agencies at the time of according their ratings will be taken cognizance of for the purpose of supervisory rating. Furthermore, the supervisory rating mechanism shall take into account certain other factors which are materially relevant to the supervisory authority but not forming part of the study carried out by the rating agencies.

7.2.1 It is understood that rating is assigned by the credit rating agencies to NBFCs based on the total amounts proposed to be mobilised by the NBFCs from the public at any given point of time and hence the process of rating is amount-specific. The proposed amounts for which the rating is sought could be less than the amounts that the NBFCs are eligible to raise otherwise from the public/corporates as per Bank's directions. As the ratings naturally vary in relation to the quantum of deposits, the registered NBFCs may henceforth be required to obtain the rating for the maximum amounts eligible to be mobilised by them as per Bank's directions and the same may be built into the supervisory rating system.

7.2.2 The supervisory rating system should accordingly entail a broad list of quantitative/qualitative but critical elements which could be assigned weights depending upon the position as under:

a) Level/degree of compliance with regulatory stipulations relating to acceptance of deposits, payment of interest and commission, maintenance of liquidity, prudential and other norms/directions etc(weightage to range from -2 to 10) .

Different levels	Weightage points
Companies which have complied with all the provisions of directions.	10
Companies which have not complied with	
-quantum & period	4
-quantum, period, interest, brokerage/ commission	2
-quantum, period, interest, liquidity, submission of returns/balance sheets etc.	-2
b) submission of data/returns/statements prescribed under the supervisory system (weightage to range from -2 to 10)	
-prompt and accurate submission	10
-occasional delay and minor inconsistencies	5
-chronic delay and major inconsistencies	0
-non-submission	-2
c) Adherence to prudential guidelines (weightage to range from -5 to 15)	
-adherence to all norms including minimium prescribed credit rating	15
-adherence to only capital adequacy norms i.e. 8% but violated other norms/stipulations	10
-capital adequacy between 6% to 7.99%	5
" 4% to 5.99%	2
-not adhered to any norms	-5

d) Ratings assigned by credit rating agencies (weightage to range from -5 to 15)

Rating Symbols

CRISIL	ICRA	CARE	
FAAA (Highest Safety)	MAAA (Highest Safety)	AAA (Best Quality)	15
FAA +	MAA +	AA +(High quality)	14
FAA	MAA	AA	13
FAA - (High Safety)	MAA - (High Safety	AA -	12
FA +	MA +	A (Adequate Safety)	11
FA	MA	A -	10
FA - (Adequate Safety)	MA - (Adequate Safety)	BBB (Sufficient Safety)	9
FB +	MB +	BBB -	0
FB	MB	BB (Inadequate protection and Speculative)	0
FB - (Inadequate Safety and Speculative Grade)	MB -	BB -	0
FC +	MC +	B +	-2
FC	MC	B (High Risk)	-2
FC - (High Risk)	MC - (Risk prone)	B -	-2
FD (Default)	MD (Default)	C (Default)	-5

7.2.3 The supervisory rating to be assigned to NBFCs will be lineated and spread over a 5 point scale as under:

The NBFCs which have secured composite points

i) between 45 and 50 will be rated as A

ii) between 35 and 44 will be rated as B

iii) between 25 and 34 will be rated as C

iv) between -14 and 24 will be rated as D

SUPERVISORY RATING Gr A (45 to 50)

7.2.4 Entities in this group are perceived to be basically sound in every respect. Such companies appear to be well managed and are in compliance with all the regulatory and supervisory requirements. Any findings or comments relating to these companies would be of a minor nature and can be handled in a routine manner. As a result, the NBFCs rated as Gr.A may not give cause for supervisory concern. These companies may, therefore, be placed on watch-list of NBFCs of 'LOW RISK' from the supervisory angle and be subjected to the on-site inspection once in every three years.

SUPERVISORY RATING Gr. B and C (35 to 44 and 25 to 34)

7.2.5 The NBFCs rated as Gr. B & C could be considered to be generally complying with the regulatory stipulations and/ or meeting the supervisory requirements. However, the supervisory exercises would have revealed certain weaknesses, such as marginal erosion in capital funds compared to previous years, increase in the quantum of non-performing assets, managerial lapses/inadequacies, slip back in credit ratings etc. which when not addressed promptly might crystallise into serious deficiencies. The NBFCs rated as Gr. B & C would accordingly warrant a higher degree of supervisory attention than those rated as Gr. A. These companies, therefore, would be parked in the watch list of NBFCs of 'MEDIUM RISK' and subjected to the process of on-site inspection once in two years and one year respectively.

SUPERVISORY RATING Gr.D (-14 to 24)

7.2.6 The NBFCs rated as Gr.D are those which have developed serious deficiencies including non-compliance with regulatory/supervisory requirements. These companies would, in the normal course, trigger immediate and decisive corrective measures including drastic actions such as issuance of prohibitory orders/initiation of prosecution and/or liquidation proceedings. These NBFCs would, therefore, require to be placed on the most sensitive watch-list of NBFCs of 'HIGH RISK' and subjected to immediate on-site inspection followed by other action as deemed necessary.

7.2.7 When a registered NBFC has been rated by more than one rating agency, the rating assigned by such agencies and communication from them to the company in this regard should be made available to the Bank.

7.2.8 The process of assigning supervisory rating to the registered NBFCs must be an on-going exercise. The ratings assigned to NBFCs will primarily be the tool for triggering on-site inspections at various intervals. The Group feels that the Department must resort to a high degree of computerisation for processing of data pertaining to the supervisory rating model to operationalise the same as a supervisory tool.

CHAPTER VIII

FRAMEWORK FOR ON-SITE INSPECTION

8.1.1 Under the existing guidelines, the inspection of large size Financial, Miscellaneous and Residuary Non-Banking Companies having aggregate deposits of Rs.25 lakh and above is to be taken up once in two years. Subject to this broad criterion, the selection of companies is to be done by the regional offices of DoS keeping in mind the default in submission of annual return/balance sheet, holding of excess deposit or incidence of complaints for non-payment of deposit, mismanagement, etc. It has, however, been observed that the Regional Offices very seldom are able to stick to the inspection programme chalked out in advance due to staff constraints and other special assignments which are undertaken by them.

8.1.2 The Group feels that it will be ideal to undertake on-site inspection of all NBFCs every year. However, having regard to aforesaid constraints and keeping in view the large number of the reporting NBFCs, including registered NBFCs, combined with the fact that the distribution of deposits accessed by the NBFCs together is skewed in character, it may be necessary to exercise selectivity insofar as intensity of deployment of supervisory resources is concerned. Furthermore, it is also felt that the supervisory exposure will be addressed adequately by the various other steps proposed e.g. certification of the prescribed returns by the statutory auditors and a market intelligence system which would continuousl feed information/aberrations in the functioning of the NBFCs.

PERIODICITY

Unregistered NBFCs

8.2.1 The Group observes that although the unregistered NBFCs form bulk of the reporting NBFCs, the quantum of aggregate deposits mobilised by them is insignificant. As such, the task of carrying out on-site inspection of unregistered NBFCs would not be commensurate with the cost and manpower resources deployed. Nevertheless, inspection of these companies may be taken up only when deemed necessary based on prima facie violation of directions, market information and complaints. The Group, therefore, recommends that the supervision over them should be exercised largely through the off-site surveillance mechanism.

Registered NBFCs

8.3.1 The Group emphasises that a good part of the task of exercising supervision over the registered NBFCs also should be accomplished mainly through off-site surveillance mechanism. Since the exposure of registered NBFCs, as stated earlier, forms a large majority of the resources raised and utilised, any aberrations (which could escape the attention of the off-site mechanism) in the functioning of some of the registered or relatively large size NBFCs might entail systemic imbalances such as withdrawal of deposits beyond sustainable levels from well-run NBFCs, defaults in repayment of inter-corporate borrowings. There is, therefore, a need to verify the veracity of the various returns/statements submitted by them at the control site of the supervised entities besides examining certain other relevant aspects. As a prelude to determining the periodicity for taking up on-site inspection, the registered NBFCs may be stratified into three different watch-lists based on supervisory ratings as under:

List 1 - NBFCs of 'HIGH RISK'
(i.e. NBFCs which are assigned supervisory rating Gr.D)

List 2 - NBFCs of 'MEDIUM RISK'
(i.e. NBFCs which are assigned supervisory rating Gr.C and B)

List 3 - NBFCs of 'LOW RISK'
(i.e.NBFCs which are assigned supervisory rating Gr.A)

8.3.2 The NBFCs in watch-list 1 (i.e. High Risk) should be taken up for on-site inspection immediately and other action should follow forthwith; NBFCs with supervisory rating of Gr.B and Gr.C in watch-list 2 (i.e. Medium Risk) should be taken up for on-site inspection once in two years and one year respectively while those in watch-list 3 (i.e. Low Risk) need be taken up for on-site inspection once in three years. Longer periodicity of inspection of such companies is suggested because these companies, prima facie, comply with the directions/prudential norms, have been well rated and they function on sound lines.

8.3.3 The above periodicity should be continuously modulated based on upward/downward shift of the NBFCs in the watch-lists. The position of NBFCs in the watch-list should be changed based on the findings of on-site inspection and off-site surveillance/market information review.

8.3.4 Notwithstanding the general guidelines suggested as above, instantaneous on-site inspection /special scrutinies could also be ordered if serious or important signals are noticed through the off-site surveillance system or the market intelligence outfit.

COVERAGE

8.4.1 The objectives of on-site inspection of NBFCs are to -

A. verify the position of compliance by the NBFCs with the regulatory stipulations;

B. evaluate the financial safety, soundness and solvency of the entities supervised;

C. appraise, in general, the quality of Board and management;

D. identify areas where corrective action is required to strengthen the entities supervised and improve the quality of its performance; and

E. determine the supervisory rating.

8.4.2 Accordingly, these objectives require the on-site inspection process to -

i) review compliance with regulations as well as supervisory guidelines pertaining to deposit acceptance activities, prudential norms etc;

ii) provide an appraisal of the quality and category of the assets of the NBFCs and analyse key financial indicators such as capital, earnings and liquidity and determine in general, the company's solvency and ability to pay to its depositors and other creditors; and

iii) assess the quality of its management team and evaluate the company's policies, systems of management, internal operations and controls.

A. COMPLIANCE REVIEW

8.5.1 The assessment of regulatory compliance should uncover or focus on deviations from/violations of -

i) Regulatory directions and
ii) Supervisory guidelines

8.5.2 The on-site inspection must clearly bring out the violations, if any, relating to the deposit-taking activities of NBFCs with special reference to quantum of deposits, period, interest, brokerage/commission, liquid assets and the prudential guidelines issued by the Bank from time to time.

8.5.3 Further, the compliance review must also relate to verification of integrity of the supervisory and regulatory reporting by the registered NBFCs i.e. the correctness and reliability of the data furnished in the statutory returns and statements submitted to the Bank during the year under review. The review should distinguish between i) incorrect, distorted and manipulated reporting and ii) poor management information systems that make the data provided unreliable or deficient in credibility.

B. FINANCIAL ASSESSMENT

8.6.1 The key element of supervision is to make sure that the NBFCs have sufficient capital at all times and comply with capital adequacy norms prescribed by the Bank. Assessment of solvency and capital adequacy is thus central to the process of supervisory examinations. Solvency is based on and is the end-product of assessment of asset quality, provisioning and earnings performance. The quality of assets and efficiency in earnings largely influence the rate of internal capital generation which strengthens or impairs an entity's capital and solvency.

8.6.2 The financial assessment will cover the operating elements of the company which will be obtained from the information furnished in Annexure II. The Inspecting Officer should scrutinise the veracity of the data provided therein more particularly the key ratios and profitability. Any major variation in the ratios should be examined in depth.

Asset Quality

8.6.3 The Group feels that a major part of the on-site inspection process should be devoted to examination of the quality of assets of the entities supervised. The inspector should examine this aspect in conformity with the guidelines issued by the Bank in this regard. The on-site inspection process must, *inter-alia*, verify and ensure correctness of the following aspects with reference to source records *vis-a-vis* the relevant statements compiled by the inspector during the inspection:

a) the quantum of assets classified by the registered NBFCs into four categories i.e.standard, sub-standard, doubtful and loss assets based on their risk perceptions and other relevant factors;

b) the extent of adherence to accounting standards prescribed for recognition of income based on record of recovery;

c) the quantum of provisons created against sub-standard, doubtful and loss assets in terms of prudential guidelines issued by the Bank; and

d) adherence to norms relating to concentration of credit/ investments.

8.6.4 The on-site inspection must highlight the variations, if any, between the data furnished in the latest half-yearly return on prudential norms submitted to the Bank and the observations made during the on-site inspection. The process may also be envisaged to offer comments on the following key ratios:

i) Non-performing assets (NPAs) to total assets for each major category of assets such as leased, hire purchase, loans and advances and investments.

ii) Provisioning in respect of each category of assets (viz. sub-standard, doubtful and loss assets) vis-a-vis the quantum of NPAs in that category and adequacy or shortfall thereof.

iii) Quality of receivables based on agewise-analysis and a comparative position of the same with the industry average.

iv) Industry-wise analysis of credit exposure to total assets of the supervised entities. Further, the industry-wise exposures should be checked for concentration of credit to any single industry and bring out the risk perceptions of the concerned NBFC in this regard.

8.6.5 Further, the on-site inspection must focus its attention on some of the business-specific aspects which have a direct bearing on the quality of management of assets of the NBFCs as illustrated below :

Investment companies	- Investment policy - Security analysis and research - Physical verification of investments - Valuation of securities.
Loan companies	- Evaluation of credit proposals - Verification of securities - Recovery management.

Leasing & Hire Purchase companies	- Evaluation of credit proposals - Physical verification of underlying assets - Monitoring of receivables.

Solvency and Capital Adequacy

8.7.1 An NBFC is deemed solvent if the estimated realisable value of its assets is greater than the amount of its outside liabilities. On a going-concern basis, it is the adequacy or otherwise of this amount which is critical. The larger the networth, or in other words, the larger the excess of assets over outside liabilities, the better is the solvency.

8.7.2 The level of solvency is determined in terms of estimated realisable value of assets. In the case of NBFCs with a consistent track record of business growth and profitability, the task of valuation of assets may not be hard to carry out while the same may be rendered difficult in the case of others with less consistency in their operations. The exercise of valuation of assets, therefore, might be required to be more intensive in relation to the latter category of NBFCs. The on-site inspection should cover all categories of assets, including fixed/real estate assets, for determining the realisable value of assets for ultimately matching the same with outside liabilities.

8.7.3 Capital adequacy should be examined in accordance with the guidelines issued by the Bank in this regard. Capital is divided into two tiers. While Tier I capital is the core capital which provides the most permanent and readily available support against unexpected losses. Tier II capital will consist of elements that are not so permanent in nature or are not readily available.

Tier I capital will consist of paid up equity capital, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of assets but not reserves created by revaluation of assets. From the aggregate of these items will be deducted accumulated loss and book value of intangible assets, if any, to arrive at owned fund. Investment in shares of other NBFCs and in shares, debentures of subsidiaries and group companies and loans and advances to and deposits with subsidiaries and companies in the same group in excess of 10 per cent of the owned fund mentioned above will be deducted to arrive at the net owned fund i.e. Tier I capital.

Tier II capital consists of Preference shares, revaluation reserves, general provisions and loss reserves, hybrid debt capital instruments, etc. The total of Tier II elements will be limited to a maximum of 100 per cent of total of Tier I elements for the purpose of determining capital adequacy ratio.

8.7.4 While examining the aspect of capital adequacy, the inspector must determine the extent to which the ratio of net owned funds to risk weighted assets and off-balance sheet exposures stands modified after taking into account the difference, if any, between the quantum of assets/ exposures reported by the NBFCs under various categories *vis-a-vis* the relative statement compiled by the inspector during the on-site inspection. The analysis must be supported by sufficient reasoning.

Earnings

8.8.1 It is also necessary for the inspector to look into the quality of earnings of the NBFCs including the composition of earnings. Illustratively, an NBFC whose product profile is dominated by equipment leasing/hire purchase activities would have a steady stream of earnings by way of lease rentals/finance charges to be realised over the contractual period. If the quality of its major assets are "standard" by categorisation, then the actual earnings would be generally in tune with the schedule of receivables or vice-versa.

8.8.2 In the case of NBFCs which are engaged significantly in investment business, the process of on-site inspection should focus at whether the income received is from short term trading, long term gains, dividend or interest income. Aberrations, if any in the income pattern should be critically commented upon based on the following parameters:

i) Average size of investment holdings	:	i.e. monthly average of purchase and sale of investments i.e. **A**.
ii) Turnover	:	i.e. aggregate of sale & purchase transactions during a given accounting year. i.e. **B**
iii) Turnover ratio	:	$\frac{B}{A}$

8.8.3 The turnover ratio at 1 would indicate that the investment portfolio has turned over once within one year. The higher the ratio, the more the trading activity which could be reflective, in some cases, of adoption of speculative strategies.

8.8.4 Apart from the activity-specific analysis of earnings, the on-site inspection process must examine the overall yield pattern including return on risk assets, return on networth, dividend pay out ratio and rate of accretion to networth. Ideally, these ratios are best measured based on audited annual accounts of the NBFCs as explained below:

a) Return on risk assets : $\frac{\text{Profit after tax}}{\text{Risk assets}}$

b) Return on networth : $\frac{\text{Profit after tax}}{\text{Tangibe networth}}$

c) Dividend payout ratio : $\frac{\text{Dividend paid}}{\text{Profit after tax}}$

d) Rate of accretion to networth : $\frac{\text{Amount transferred to various reserves}}{\text{opening reserves}}$

8.8.5 Further, a qualitative analysis of income generated from fee-based activities such as merchant banking, advisory services etc. may also be attempted during the on-site inspection.

C. <u>MANAGEMENT APPRAISAL</u>

8.9.1 Assessment of the quality of management of the entities supervised assumes key position in the on-site inspection process as the quality of management has a direct bearing on the overall health of the NBFCs. The on-site inspection process must cover various aspects of the management.

Board and Senior management level

8.9.2 Assess the quality and adequacy of the Management and Board with reference to

- organisational structure;
- profile including experience base of the senior and middle management personnel at the corporate level and at major branches, if any;
- profile of the members of the Board of Directors;
- frequency of the Board meetings held and matters discussed as disclosed in the minutes (i.e. whether the deliberations covered only statutory issues or business matters were also included).

Management Process

8.9.3 The on-site inspection must also assess the process of management with special reference to credit/investment decisions, delegation of powers, branch control and determine as to whether

- the system of credit appraisal, follow-up, recovery management is adequate;
- there is adequate safeguards such as credit/review committees to exercise control over the relative decisions involving large exposures;
- delegated levels of responsibility exist; and
- the extent and quality of control exercised over branches, if any, is adequate.

Systems & Procedures

8.9.4 The inspector must examine, in general, the various systems and procedures adopted by the NBFCs, including Management Information System and similar other reports generated for different purposes, and assess the quality of such reports and the quality of utilisation of such reports.

<u>Internal Control and House keeping</u>

8.9.5 The on-site inspection process must also focus on the internal audit systems put in place by the NBFCs both for branches and Head Office (H.O.). including audit of the computerised records. Further, efforts also must be made to ascertain the position of reconciliation of accounts at the H.O. level and between branches and H.O. Similar exercise also may be carried out in relation to reconciliation of accounts maintained with banks and financial institutions.

8.10.1 The Group recommends that an elaborate supervisory model akin to that which is applied over the banking sector should be developed in-house for overseeing the large sized NBFCs with asset size exceeding Rs.500 crore each. This model could be based on the concepts contained in the report.

8.10.2 The Group suggests that the on-site inspection process should have a qualitative difference both in intensity and coverage in accordance with the asset size of NBFCs as stratified earlier.

8.11 Based on the findings of the on-site inspection, a composite supervisory rating may be assigned to the registered NBFCs by the Inspecting Officers. If the composite rating so assigned undergoes a downward shift, upward revision should not be made until the next on-site inspection is carried out and in such cases, the next inspection should be taken up the very next year.

8.12 The Group recommends that the Bank should also undertake special scrutinies in response to warning signals/ market intelligence and the scrutinies may relate to specific areas such as deposit acceptance activities, investment activities, lending to group companies, bank borrowings, etc. The special scrutinies/portfolio examinations should be in response to unfolding events and reflect the Bank's pro-active endeavour to ensure that the aberrations in the NBFC sector are promptly dealt with.

8.13 An illustrative check list of items pertaining to compliance review, financial soundness and management to be examined in detail during the on-site inspection is furnished in Annexure III.

CHAPTER IX

EXTERNAL AUDITS AS A RESOURCE FOR SUPERVISION

9.1 The Group reviewed the role played by the external/ statutory auditors of the financial companies *vis-a-vis* the regulation of NBFCs by the Bank. The Group suggests that the statutory returns (viz. First Schedule/Schedule A) which form the nucleus of regulatory control should henceforth be required to be certified by the auditors, as in the case of prudential returns, before being submitted to the Bank. The returns when received with certification of auditors would facilitate availability of authentic data and prompt scrutiny thereof without having to depend on the balance sheets, submission of which is generally delayed in many cases, for verifying the correctness of the figures furnished in the return.

9.2 The Group took cognizance of the existing provisions under Section 45MA of RBI Act, 1934 which envisages, *inter-alia*, that the auditors should furnish a report to the Bank indicating the aggregate amount of deposits accepted by NBFCs when it is found during the course of audit that the NBFC concerned has not reported such matter nor submitted the prescribed returns to the Bank. The Group, however, notes that the auditors seldom report such figures to the Bank in respect of NBFCs which have defaulted in submission of the statutory returns. The Group, therefore, recommends that effective steps should be taken in co-ordination with Institute of Chartered Accountants of India to create the required degree of awareness of these provisions among the audit professionals.

9.3 The existing set of directions as applicable to the NBFCs, inter-alia, stipulate that the NBFCs shall furnish to the Bank, a certificate from the auditors 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. The Group recommends that the above provisions relating to auditors' certification should also be extended to companies classified as RNBCs and MNBCs as well.

9.4 Furthermore, the Group while exploring the possibility of utilising the audit professionals for supervisory inspections suggests that the Bank may resort to outsourcing for supervisory purposes when there is shortage of manpower or when the incidence of special scrutinies/portfolio studies to be taken up is quite high.

9.5 The Group recommends that in order to utilise "external audit" as a source for prudential supervision the Bank may take necessary steps including amendment of the relative provisions of the RBI Act to make it obligatory on the part of the auditors to report to the Bank immediately if during the course of audit,the auditor learns of facts which a) might warrant qualification or withholding of the certificate of audit, b) endanger the existence of the entities audited, or c) that the company has severely infrigned the regulatory provisions/supervisory guidelines. Furthermore, auditor's report appended to the Balance sheet should clearly indicate as to whether the NBFC concerned has complied with all the reporting requirements viz. submission of various returns and statements.

CHAPTER X

POST-EXAMINATION AND OFF-SITE REVIEW/FOLLOW UP

10.1 The Group recommends that the supervisory framework must crystallise at the end of each cycle of supervisory exercise the nature of actions which are required to be initiated. In case clear violations of regulatory framework/ directions have been observed, the Bank should straightaway initiate steps towards issuing show cause notices/ prohibitory orders/initiation of prosecution proceedings as warranted.

10.2 The Group recommends that the Bank may introduce a system whereby the names of NBFCs which have not complied with the regulatory framework/directions of the Bank or have failed to submit the prescribed returns consecutively for two years should be published in newspapers in those states where the defaulting NBFCs are operating. Furthermore, the names of such NBFCs may also be removed after complying with the legal requirements of issue of show cause to them from the mailing list maintained by the Bank under advice to the R.O.Cs concerned and such companies should also be prohibited from carrying on financial business including deposit taking.

10.3 When the supervisory system brings out disturbing trends/signals capable of causing aberrations in the credit delivery system or posing imminent threat to the solvency of the entities supervised, the Bank may initiate immediate steps within a time frame.

10.4 In selective cases, particularly where the NBFCs are very large sized, the serious violations/deficiencies requiring immediate corrective action may be addressed, inter-alia, through a process of discussion by the senior officials of the Bank with the chairmen/C.E.Os of the NBFCs.

10.5 The Group, emphasises the imperative need to ensure consistency in perceptions and the nature of actions to be initiated towards various types of NBFCs by the regional offices. The details of the follow up actions taken against the erring NBFCs may also be incorporated into the computerised corporate memory base built as a part of the MIS of the supervisory mechanism.

CHAPTER XI

TRAINING AND COMPUTERISATION

11.1.1 The supervisory framework being proposed would entail an increase in the quantum of critical data which are required to be received from the registered NBFCs on an on-going basis. The data thus received should be subjected to a process of critical review/analysis to i) ascertain the position of compliance with regulatory stipulations and supervisory guidelines issued by the Bank, ii) assess the financial soundness and solvency, iii) examine whether deployment of the investible funds is being done in consonance with the overall framework of the credit system, iv) assign supervisory rating, and v) trigger further actions, including on-site inspection/special scrutiny, which might be considered necessary.

11.1.2. In view of the intricacies involved in the data analysis, the Group feels that the purpose can be better achieved by computerising as much data analysis of the Department as possible to facilitate expeditious processing of both financial and non-financial information to be received from a large number of NBFCs supervised.

11.2 As a part of long term strategy, it is suggested that the Bank may undertake the following initiatives:

- Arrange for training programmes for scrutiny of various returns required to be submitted by the NBFCs including an exposure for analysing comparative ratios of performance as well as the audit reports and financial notes attached to the audited accounts received by the Bank.

-Arrange for appropriate and adequate training programmes on the usage of computers for in-house receipt and analysis of data through various off-site reports viz. i) Annual return in First Schedule/Schedule A, ii) half-yearly return on prudential norms, and iii) statement showing the comparative position of operational data (annual).

-Train adequate number of off-site analysts/inspectors on appropriate computer-related programmes so that they are better equipped for exercising off-site surveillance/ conducting on-site inspection of especially large size NBFCs whose books of account/management information system are largely computerised and hence involve a relatively high degree of technological sophistication.

-Upgrade the quality of staff towards achieving greater degree of efficiency and promptness in house-keeping and data processing so that the Bank is in a position to initiate suitable actions against erring NBFCs and adverse market developments/ warning signals.

-Arrange for regular inter-face of the supervisory staff with the associations/federations of NBFCs and ICAI etc. so that they are able to keep pace with the fast changing developments in the industry.

11.3 It is understood that the Department of Supervision (Financial Companies Division) has a large volume of literature to facilitate the task of supervision. It is suggested that all these are reviewed quickly in the light of the Group's suggestions. These should then be manualised in a comprehensive manner both for exercising off-site surveillance/analysis/review and conducting on-site inspection.

CHAPTER XII

Other Related Aspects and Emerging Issues

12.1.1 The Group understands that a separate Division has been created in DOS to supervise the NBFCs. This Division should each year prepare a time bound plan of action covering various aspects/matters including the following :

- Off-site surveillance
- Market surveillance
- On-site inspection
- Ad-hoc scrutinies/portfolio examination
- Training programmes
- Interaction with other departments of the Bank and other bodies such as ICAI, Trade and Industry Associations.

12.1.2 The Division at Central Office will also have to ensure coordination of the functions to be performed by Regional Offices, which will cover some of the above areas. It should be the endeavour to delegate most of the work to the Regional Offices so that prompt action is taken. At the same time, the Central Office would have to be kept informed of the progress and unusual features observed in any region which can have repercussions at other places so as to ensure consistency of approach as referred to earlier in this report.

12.2.1 The Group feels that a number of issues with potential for causing regulatory/supervisory concerns have been arising. Some of the issues which need to be addressed by the Bank are discussed below.

12.2.2 The Group took note of the increasing liberalisation towards opening up the Indian financial system to international competition with special reference to permitting the multinational corporations to make in-roads into the Indian financial services sector. Given the large resources available at the command of these corporations and the comparatively low-profile nature of the Indian counterparts, the Group feels that there is a need to exercise caution and ensure in the process that the level playing field is maintained to the extent required.

12.2.3 Some of the NBFCs are venturing, through subsidiary units, into undertaking allied financial services viz. stock broking, investment banking, asset management, portfolio management, bill discounting, merchant banking etc. As the operations of the subsidiary units have financial implications and a direct bearing on the promoter-NBFCs, the Bank may examine as to what extent its surveillance system should scan through the financial parameters of the subsidiaries of the NBFCs supervised.

12.2.4 Furthermore, those NBFCs which undertake multifarious financial activities either directly or through subsidiaries are subjected to regulatory control of both the Bank and

SEBI. As such, these NBFCs are subjected almost on a continuous basis to various kinds of audit/inspection such as statutory audit, tax audit, inspection by SEBI, RBI, DCA. There is, therefore, a need to devise suitable system for co-ordinating the task of on-site inspection of the NBFCs by the Bank in tandem with other regulatory authorities so that they are subjected to one-shot examination by different regulatory authorities, to the extent possible.

12.3 The NBFCs are required to furnish information in accordance with the provisions of the Companies Act, Income-tax Act and RBI directions/guidelines. It is felt that there is a need to explore the possibility of introducing standardisation of accounts with the help of Institute of Chartered Accountants of India to facilitate compilation of unified information/statements to cater to the requirements of various authorities.

12.4 Some of the non-banking non-financial companies (viz. industrial/manufacturing units) are also undertaking more and more financial activities including acceptance of deposits, investment operations, leasing etc. to a sizeable extent. The adequacy or otherwise of the existing regulatory control may be examined with a view to guarding against the possibility of misuse of the financial system by such companies.

12.5 Some of the plantation companies not falling under the regulatory control of either Department of Company Affairs or the Bank have been soliciting monies from the members of public repayable in kind after long periods stretching upto as long as 20 to 25 years. Likewise, there has also been instances of certain other types of companies soliciting moneys from the public against offer of animal husbandry based returns. Although the quantum of moneys received till now by these companies may not be considered substantial, there is a need to identify an appropriate authority to regulate the activities of these companies insofar as their mobilisation and use of public deposits is concerned.

12.6 The Group recognises that a comprehensive system of ensuring financial discipline and soundness through prudential norms has been brought into force in respect of registered NBFCs. However, the NBFCs may still continue to follow the conventional method of accounting which does not envisage a system of classification of assets, provisioning against various categories of assets, income recognition based on record of recovery etc. for preparation of balance sheets/profit and loss accounts. As a result, the financial position as revealed through the half-yearly return based on prudential norms could be different from that presented to the public, including the depositors and the share holders. In order to reflect a correct and consistent financial position, the Bank may, therefore, explore whether the balance sheet compilations could be done in tandem with the prudential norms/guidelines in the larger public interest.

12.7 The minimum capital adequacy norm prescribed by the Bank for registered NBFCs presently stands at 8 per cent.

Having regard to the expanded and diversified activities of such companies and as there is no insurance protection to their depositors, it may be examined whether there is a need to raise the minimum capital adequacy requirement over the next two/three years.

12.8 Instances are not lacking where there have been maturity mismatches between sources and uses of funds in respect of some of the relatively large size NBFCs. The Group, therefore, recommends that a study should be carried out in this regard to consider whether there is any need to stipulate any specific norm/guidelines by the Bank.

12.9 As stated earlier, the NBFCs have been registering a fast growth in terms of volume and nature of activities which are akin to banking activities. In fact, the rubicon between banks and non-banking institutions is getting thinner and it is very difficult to know at what point of time, an NBFC crosses it.The proposed amendments to RBI Act are expected to take care of the process of regulatory and supervisory requirements for some time to come. However, having regard to the long term objective of ensuring sound and healthy growth of NBFCs, there is a need for enactment of a separate comprehensive legislation in place of Chapter IIIB of the RBI Act covering the entire gamut of functioning of the NBFCs as recommended by the Shah Committee. Proposed enactment should encompass various aspects such as minimum capital requirements, licensing/ registration and revocation thereof, management, restriction on opening of branches, built-in safeguards such as reserve requirements, dividend payment and liquidity, preparation of financial statements, regulation of business, inspection and supervision, role/responsibility of auditors, issue of moratorium, merger, liquidation.

(P.R. KHANNA)
CHAIRMAN

(J. GOSWAMI)
MEMBER

(K.M. ELAVIA)
MEMBER

(G.S.R.K. RAO)
MEMBER

(G.K. RAMAN)
MEMBER

(S.D. NADKAR)
MEMBER

(V.S. SRINIVASAN)
MEMBER

(T. BANDYOPADHYAY)
MEMBER SECRETARY

Mumbai

April 17, 1996

ANNEXURE I

LIST OF REPRESENTATIVES OF VARIOUS ASSOCIATIONS/NBFCs WHICH WERE INVITED TO SHARE THEIR EXPERIENCES AND SUGGESTIONS WITH THE EXPERT GROUP

1.	Shri P.S.Balasubramaniam	Federation of Indian Hire Purchase Associations.
2.	Shri N.C.Vijayaraaghavan	-do-
3.	Shri S.S.Kulkarni	Equipment Leasing Association (India)
4.	Shri Dhiren D. Mehta	-do-
5.	Shri C.P.Shah	-do-
6.	Deepak Gupta	Association of Leasing & Financial Services Cos.
7.	Shri Dilli Raj	-do-
8.	Shri Nagendra Rao	-do-
9.	Shri P.C.Sen	Peerless General Finance & Investment Co. Ltd, Calcutta
10.	Shri Subrata Roy	Sahara India Financial Corporation Ltd., Lucknow
11.	Shri C.K.Thanawala	Industrial Investment Trust Ltd., Bombay
12.	Shri F.N.Subedar	Tata Sons Ltd., Bombay
13.	Shri N.Jayakumar	Prime Securities Ltd., Bombay
14.	Shri P.M.Thomas	Credit Analysis & Research Ltd. , Bombay
15.	Shri P.K.Choudhury	Investment Information & Credit Rating Agency of India, New Delhi
16.	Shri S.K.Shah	Credit Rating Information Services of India Ltd., Bombay
17.	Shri D. Thyagarajan	-do-
18.	Shri J.L.Mukherjee	Hire Purchase and Lease Association, Calcutta
19.	Ms. Usha Moreas	-do-

ANNEXURE II

Statement showing the comparative position of operational data for the last three years including current year (annual)

Company Name : **RBI Registration No.**

(Amount in lakh of Rs.)

PROFIT AND LOSS ACCOUNT	1995-96			1994-95			1993-94		
	X	Y	X/Y(%)	X	Y	X/Y(%)	X	Y	X/Y(%)
FUND BASED INCOME.									
Lease income									
Less: Lease Depreciation									
Net lease income		Avg. leased assets *							
Hire Purchase income		Avg.net stock on hire **							
Bills Discounting income		Total bills discounted							
Interest income - loans		Avg. loans							
Investment income - SLR		Avg. Investments							
Other Investment income									
- Interest									
- dividend									
- capital gains/losses									
Other fund based income									
TOTAL FUND BASED INCOME									
Less: Provisions									
Less: Write offs									
NET FUND BASED INOME (A)		Avg. assets deployed							

	1995-96			1994-95			1993-94		
	x	y	x/y(%)	x	y	x/y (%)	x	y	x/y (%)
INTEREST & OTHER FINANCING COSTS									
Interest paid on FDs		Avg. FDS							
Brokerage, Incentives, etc		Avg.FDs							
Other financing costs		Avg.other borrowings							
TOTAL INTEREST COSTS (B)									
INTEREST SPREAD (C=A-B)									
FEE BASED INCOME									
Income from merchant banking									
Income from broking in bills/ICDs/lease									
Miscellaneous income									
TOTAL FEE BASED INCOME (D)									
OPERATING MARGIN (E=C+D)									
OPERATING EXPENSES									
Employee costs									
Other administrative costs									
TOTAL OPERATING EXPENSES (F)		Avg.assets deployed							

	1995-96			1994-95			1993-94		
	X	Y	X/Y(%)	X	Y	X/Y(%)	X	Y	X/Y(%)
GROSS MARGIN (G=E-F)									
Depreciation on own assets									
Intangible assets amortised									
TOTAL OTHER EXPENSES (H)		Avg.assets deployed							
REPORTED PROFIT BEFORE TAX(I=G-H)		Avg.assets deployed							
Tax (J)									
REPORTED PROFIT AFTER TAX (K=I-J)		Avg.assets deployed							
Less: Underprovision of depreciation									
Less: Overrecognition of HP income									
Less: Penal interest recognised before receipt									
Less: Expenses capitalised									
TOTAL ADJUSTMENTS (L)									
ADJUSTED PROFIT AFTER TAX (M=K-L)		Avg.assets deployed							

Note: * Avg. leased assets is to be computed based on the weighted average lease disbursements for the current yer and the previous year.

**** Avg. net stock-on-hire is to be computed based on the weighted average hire purchase disbursement for the current year and the previous year.**

COMPANY NAME : **RBI Registration No.**

(Amount in lakh of Rs)

SUMMARISED BALANCE SHEET AS ON	31-3-1996 % to Total	31-3-1995 % to Total	31-3-1994 % to Total
ASSETS			
Gross Leased Assets			
Accumulated Depreciation			
Net Leased Assets			
Gross Own Assets			
Accumulated Depreciation			
Net Own Assets			
INVESTMENTS			
- SLR securities			
- Non SLR Securities			
Investments - Equity (quoted)			
- Associate Cos/Subsidiaries			
- Other Short Term invst.			
- Long Term invst.			
Investments - Equity (Unquoted)			
Investments - Debt			
- Associate Cos/Subsidiaries			
- Other Short Term invst.			
- Long Term invst.			
Stock on Hire (net of unmatured finance charges and hire purchase overdues)			
Lease Receivables > 6 months			
Lease Receivables < 6 months			
HP Receivables > 6 months			
HP Receivables < 6 months			
Other Receivables > 6 months			
Other Receivables < 6 months			
Total Receivables			

	31-3-1996 % to Total	31-3-1995 % to Total	31-3-1994 % to Total
Secured Loans & Advances			
- Against marketable securities			
- Against real estate			
- Against other securities			
Unsecured Loans & Advances			
Security Deposits			
Intercorporate deposits			
Bills discounted			
Loans & Advances (interest bearing)			
Loans & Advances (non interet bearing)			
Other Current Assets			
Cash & Bank balances			
TOTAL ASSETS			

COMPANY NAME :

RBI Registration No.

(Amount in lakh of Rs)

SUMMARISED BALANCE SHEET AS ON	**31-3-1996** % to Total	**31-3-1995** % to Total	**31-3-1994** % to Total
LIABILITIES			
Equity Capital			
Preference Capital*			
Share premium Reserves			
General Reserve			
Capital Redemption Reserve			
Less: Intangible Assets			
Net Owned funds			
Secured Loans			
Debentures			
Deferred Credit			
Term Loans			
Bank borrowings/Overdraft			
Total Secured Loans			
Unsecured Loans			
Fixed Deposits			
Intercorporate borrowings			
Security deposits(from lessees/hirers)			
Total Unsecured Loans			
Creditors for goods and services			
Interest accrued and not due			
Other current liabilities			
Provisions			
TOTAL LIABILITIES			
CONTINGENT LIBILITIES			
1. Income Tax			
2. Sales Tax			
3. Guarantees			
4. Others (specify)			

* Preference capital is to be treated as an unsecured loan in cse the shares are to be redeemed within five years.

COMPANY NAME : **RBI Registration No.**

(Amount in lakhs of Rs.)

SUMMARY OF BUSINESS STATISTICS/INFORMATION	1995-96	1994-95	1993-94
Disbursements (Fund based activities)			
a) Lease & Hire purchase			
b) loans (total volume)			
c) Bills Discounted (total volume)			
d) Investments (purchases)			
Investments (sales)			
Fee Based Activities			
a) Lease/Hire purchase syndication (total amount)			
b) Bills syndicated (total amounts)			
c) Underwriting :			
- Total amount underwritten			
- Outstanding commitments			
- Amount devolved			
Billings			
a) Lease & Hire purchase			
b) Loans			
Receivables			
a) Lease & Hire purchase			
b) Loans - principal repayment			
- Interest			
c) Bills discounted			
d) Investments			
e) Others			
Debtors as days billings			
Lease & Hire purchase			

COMPANY NAME : **RBI Registration No.**

Total cash credit/overdraft limits from banking system			
a) Amounts (Rs. lakh)			
b) No. of banks			
Shareholding Pattern (% of equity capital)			
a) Promoters & Management (incl. directors and their relatives, friends, associates and affiliates)			
b) Domestic Financial Institutions			
c) Domestic Mutual Funds			
d) Foreign Institutional Investors (incl. multilateral agencies)			
e) Other Corporate bodies			
f) Public			
TOTAL	**100%**	**100%**	**100%**
Investors (Nos.)			
Shareholders			
Dipositors			
Employees (Nos.)			
a) Average During the year			
b) Ceased to be employees during the year			
c) Newly employed during the year			
Total number of Branches			
Capital adequacy as per RBI guidelines (%)			
Average amount financed - Lease			
Single largest exposure - (Rs. lakh)			
No. of transactions where finance amount exceeds average amount financed			
Total of the amounts where the finance amount exceeds avg.amt financed (A)			
(A) as a percentage of the total amount disbursed under lease			
Average amount financed - Hire Purchase			
Single largest exposure - (Rs. lakh)			
No.of transactions where the finance amount exceeds average amount financed			
Total of the amounts where the finance amount exceeds avg.amt financed (A).			
(A) as a percentage of the total amount disbursed under hire purchase.			

Average amount financed - Loan Single largest exposure - (Rs. Lakh) No. of transactions where finance amount exceeds average amount financed Total of the amounts where the finance amount exceeds avg. amt financed (A) (A) as a percentage of the total amount disbursed under loan Amount financed to a single company/ group (Lease) Percentage to total. Amount financed to a single company/group (Hire Purchase) Percentage to total Amount financed the to single company/ group (Loan) Percentage to total			

COMPANY NAME : **RBI Registration No.**

No. of cases in which RBI's prudential norms on lending are exceeded
Amounts involved thereof

KEY RATIOS AS AT	**31-3-96**	**31-3-95**	**31-3-94**
Gross Lease billings/Avg.Gross Leased Assets (%)			
Gross HP billings/Avg. Net Stock on hire (%)			
HP Receivables/HP Billings (days)			
Lease receivables/Lease rentals (days)			
Accumulated depreciation/Gross Leased Assets (%)			
Non-earning Assets/Total Assets (%)			
Interest and other financing cost/Avg.Interest bearing debt (%)			
Gross Income/Avg.Total Assets (%)			
Finance Costs/Avg.Total Assets (%)			
Operating Expenses/Avg. Total Assets (%)			
Net profit/Avg.Total Assets (%)			
Net profit/Avg.Tangible Networth (%)			
Total debt/Tangible Networth (times)			
Total liabilities/Tangible Networth (times)			
Liquidity ratio (times) *			
Interest cover			
Interest income (other than sec.)/Avg.Interet bearing Loans (%)			
Interest income on SLR securities/Avg.investment in SLR(%)			
Total investments bought and sold/Avg.quoted investments (%)			
Investment income (excl.SLR)/Avg.investments (excl.SLR)(%)			

Note:- * Liquidity ratio has been defined as : N/D where
N = Gross stock-on-hire + Gross contractual lease rentals receivable + SLR Investments at market value + short term investments (excluding investments in group/associate companies) at market value + Short Term loans and advances; and
D = Secured loans + unsecured loans + provisions.

ANNEXURE III

ILLUSTRATIVE CHECK LIST OF ITEMS TO BE EXAMINED DURING ON-SITE INSPECTION

1. Compliance with the findings of the previous inspection reports, if any.

2. Compliance with directions/guidelines issued by the Bank relating to :

   -Deposit-taking activities
   -Prudential norms

3. Scrutiny of the relevant minutes of the meetings of:
   - Share holders,
   - Board of Directors,
   - Sub-committees of Directors.

4. Report of the credit rating agency.

5. Report (including Management letters) of the statutory auditors

6. Share holding pattern

7. Review of Management systems including Organisational Chart and reporting relationships to ensure segregation of duties in critical and sensitive areas.

8. Evaluation of systems and procedures.

9. Assessment of internal control systems.

10. Sample check of documents for compliance with systems and procedures and authorisations.

11. General accounting systems:

    -Compliance with accounting conventions
    -Compliance with accounting standards e.g. revenue recognition
    -Bank reconciliation statements
    -Inter-branch reconciliation.
    -Lending to group companies, including parties related to the promoters/directors, if any, to determine whether such lending is profitable and non-prejudicia to the interest of the NBFC concerned.
    -Provision for taxation.
    -Distribution of profits by way of employee incentive schemes and dividends.
    -Off-balance sheet commitments

12. Prima facie violations of directions of SEBI and other statutory/regulatory authorities which may have a bearing on the financial health of the NBFC e.g.

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-arreas/non-payment of sales tax
-Income tax
-Provident funds and other dues.

13. Industry s cific ratio analysis.

14. Industry s cific procedures which would include asset quality verification.