Origin and Development of Non-Banking Financial Companies in India with a Focus on Housing Finance Companies
Capital market is the market for long term capital, it refers to all facilities and institutional arrangements for borrowing and lending medium-term and long term funds. The four important segments of capital market are gilt-edged market, industrial securities market, development financial institutions and financial intermediaries. The last one includes merchant banks, mutual funds and a host of non-banking financing companies (NBFCs). Earlier there was no difference between merchant bankers and the NBFCs. Both were permitted to undertake fund based and non fund based activities. Merchant bankers are being supervised by the SEBI and the NBFCs by the RBI. Since the RBI supervised entities are supposed to undertake fund based activities, the role of merchant bankers, and NBFCs has got differentiated. In other words, merchant bankers are supposed to undertake only non-fund based activities and NBFCs only fund based activities. Fund based activities are equipment leasing, hire purchase, bill discounting, loans/investments/venture capital, housing finance, factoring, short term loans, inter corporate loans, equity participation, corporate financing, etc. The non-fund based activities are issue management, portfolio management, corporate counseling, project counseling, loan/lease syndication.

arranging foreign collaboration, advising on acquisitions and mergers, placement services, capital restricting, corporate financial advise, corporate structuring, and mobilizing foreign capital.

Thus, the functions of NBFCs are different from the functions of merchant bankers as merchant bankers are not permitted to undertake fund based activities which are taken up by NBFCs.

Evolution of Regulations for Non-Banking Financial Companies (NBFCs):

Non-banking financial companies have been operating for quite a long time in India but an attempt to regulate them started only in the sixties. In 1963 the Banking Laws (Miscellaneous Provisions Act) was introduced to incorporate a new chapter (i.e., Chapter IIIB) in the Reserve Bank of India Act, to regulate the NBFCs. 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. Some of the studies and regulatory mechanisms interested by the Govt are briefly discussed in the following sections.

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Bhabatosh Datta Study Group (1971)

Bhabatosh Datta Study group was appointed by RBI in 1971 to examine the role and operations of such NBFCs as hire purchase finance institutions, investment companies, chit funds/kuries, mutual benefit funds and finance corporations. It was observed that NBFCs usefully supplemented the activities of banks in the fields of both deposit mobilisation and lending and thus they were able to play a dynamic role in the economy. The group also felt a need to regulate the activities of NBFCs for ensuring the safety of depositor's funds and efficacy of the credit policy on the one hand and encouraging their orderly growth on the other.

The specific and main recommendations of the Committee are as follows:

(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.

(ii) The RBI or any other regulatory authority which might be set up, should build up and strengthen its inspection machinery so that NBFCs could be inspected at least on a sample basis; and

(iii) NBFCs should be classified into 'approved' and 'no-approved' categories and the regulation should be centered primarily on the 'approved' (i.e., those which satisfy certain additional requirements such as adequate amount of capital, reserves, liquid assets, etc.).

James Raj Study Group (1974)

In 1974, another study group was constituted under the chairmanship of Shri James S Raj for the purpose of reviewing the provisions of the RBI Act relating to NBFCs. After assessing the performance of NBFCs, the study group recommended that the situation as prevailing at the time called for regulations and not prohibition of deposit acceptance by NBFCs. In other words, the regulatory framework suggested by the study group aimed at keeping the magnitude of deposits accepted by NBFCs within monetary and credit policy. The major recommendations of the study group were as follows:

1. The housing finance companies could continue to be exempted from such a ceiling as regards ndhns, menses received from their members;

2. All NBFCs should be required to transfer to reserve fund, a sum equivalent to not less than twenty per cent of their annual profits before declaring any dividend, as long as the amount in the reserve funds was less than the paid-up capital of the company. It was also prescribed that all NBFCs should maintain liquid assets equivalent to not less than ten per cent of their deposits;

3. Loans and advances by NBFCs to their directors and to firm in which they were interested as partners, managers, etc., should be prohibited. No NBFCs, except hire-purchase finance companies (HPFCs), should be allowed to form any subsidiary, except for the purpose of carrying on the same line of business as that of the holding company;

(iv) The minimum period of deposits should be retained at six months and maximum period should be fixed at three years in the case of hire-purchase, equipment leasing, investment, loan and miscellaneous financial companies and five years in the case of housing finance companies (HFCs),

(v) The Department of Non Banking Companies (DNBC) of RBI should work in close liaison with the Department of Company Affairs and that the DNBC should be strengthened and recognised so as to ensure effective implementation of the proposed regulatory measures

Directions of RBI to Regulate NBFCs

The RBI issued certain directions to regulate NBFCs in 1977. These directions remained in force for a little more than two decades. The directions were quite comprehensive ranging from rules relating to acceptance of deposits, filing of documents to payment of interest. These directions were modified from time to time depending upon developments in the industry mainly from the view point of protecting the interests of depositors. The major features of directions are as follows.

(i) The companies were broadly divided into two categories i.e., registered and unregistered. The registered companies were required to observe certain norms like prudential norms, credit rating, etc. These companies also enjoyed certain privileges over the unregistered companies like self-determination of interest rate and no ceiling on quantum of deposits.

(ii) There was no distinction between private and public limited company as far as deposit acceptance was concerned. The deposits received, whether from general public, shareholder or from the directors of the company, would receive the same treatment.

(iii) The RBI would supervise the companies by doing both on-site and off-site inspections.

(iv) An aggrieved depositor can approach the company Law Board.

(v) Credit rating was not mandatory for acceptance of deposits.

Chakravarty Committee (1985)

The Chakravarty committee was appointed in 1986 by RBI to examine the genuine operations of NBFCs in promoting trade and commerce. The committee attributed the emergence and growth of NBFCs to the need for provision of finance to activities which were not served by the organised banking system. The committee was of the view that NBFCs had a role to play in the economic development of the country. The major recommendations of the committee were as follows:

(i) Regulations among 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

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 attain a licence.

Vaghul Committee (1987)

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

Narasimham Committee (1991)

A committee under the chairmanship of Narasimham was appointed to examine the framework for streamlining the functioning of the NBFCs. The observations and recommendations of the committee are as follows.\textsuperscript{4}

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

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

Shah Committee (1992)

The Working Group on financial companies was set up by RBI 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. The observation and recommendations of the committee are as under.⁹

(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, however 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 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.
(vm) 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 borrowing 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

**Liberalised/Rationalisation Measures (1996)**

In July 1996 the Reserve Bank introduced liberalisation/rationalisation measures for NBFCs which are as follows\(^{10}\)

(i) The registered company having minimum stipulated credit rating and observing prudential norms was given sweeping freedom in terms of maximum quantum of deposit that it could accept and interest that it could pay to the depositors. Further, the liquidity requirement in respect of these companies was reduced from 15 per cent to 12.5 per cent,

(ii) The deposit ceiling of all other types of companies was reduced. Disincentives to the companies which were not registered with RBI were also announced

\(^{10}\) *Report on Trend and Progress of Banking in India, (Mumbai: Reserve Bank of India, 1998-99)*, p 186
Khanna Committee (1996)

The Khanna Committee was appointed by RBI in 1996 to design a supervisory framework for NBFCs. The major observations and recommendations of the committee are given in the following paragraphs:

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

(ii) The Group recommended that effective steps should be taken to coordinate the exchange of information between the various offices of ROCs and the Bank to ensure prompt updation of the Bank's mailing list.

(iii) The Group recommended that the existing statutory powers vested in RBI in chapter IIIB 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) fulfillment 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 funds, etc.

(iv) Introduction of a comprehensive supervisory framework towards achieving the regulatory and supervisory objectives was also recommended.

(v) For exercising prudential supervision and for focussing supervisory attention of varying intensity, the RBI should stratify the NBFCs as under

- Unregistered NBFCs
- Registered NBFCs with asset size
  1. Up to Rs 25 crore
  2. Above Rs 25 crore but less than Rs 500 crore
  3. Rs 500 crore and above

(vi) The Group suggested 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

(vii) The Group suggested 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 13 A of the Directions applicable to NBFCs should also be widened.

(viii) In order to broaden base and supplement the supervisory exercise undertaken through off-site surveillance/on-site inspection, the Group felt that the fast-changing developments that take place in the financial services sector must also be captured.

(ix) The Group recommended that 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.
(x) The Group recommended that introduction of a supervisory rating system for the registered NBFCs

(xi) 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

(xii) The Group recommended 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.

(xiii) The Group recommended 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

Reserve Bank of India (Amendment) Act 1997

An ordinance was issued by the Government in January, 1997 to bring in effective comprehensive changes in the provisions of the Reserve Bank Act, 1934. This was subsequently replaced by the RBI (Amendment) Act, 1997. The salient features of the amended provisions are as follows

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(i) The entry point norm of Rs 25 lakh as minimum not owned fund (NOF), (which can be raised to Rs 2 crores by the Reserve Bank),

(ii) Compulsory registration with Reserve Bank of India,

(iii) Maintenance of certain percentage of liquid assets in the form of unencumbered approved securities,

(iv) Creation of reserve fund and transfer there to every year an amount not less than 20% of the net profit,

(v) Determination of policy and issuing of directions by the Bank on prudential norms,

(vi) Prohibition of NBFCs from accepting deposits and file winding up petition for violation of directions,

(vii) Unincorporated bodies like partnership firms and sole proprietorship firms were borrowed from accepting deposits. However, they could take loans from their relatives (as defined in the Companies Act),

(viii) The Company Law Board has been empowered to direct a defaulting NBFC to repay any deposits. Stringent penal provisions have also been included empowering the Bank to impose, inter alia, pecuniary penalty for violation of the provisions of RBI Act.

Insurance companies, stock broking companies and stock exchange companies have been granted exemptions from certain provisions of the Amended Act. Nidhi companies and chit fund companies have also been exempted from certain core stipulations including maintenance of percentage of assets and reserve fund.
New Set of Regulatory Measures (1998)

Exercising the powers derived under the amended Act and in the light of the experience in monitoring of the activities of NBFCs, a new set of regulatory measures was announced by the Reserve Bank in January 1998. As a result, the entire gamut of regulation and supervision over the activities of NBFCs was redefined, both in terms of the thrust as well as the forces. Consequently, NBFCs were classified into three categories for purpose of regulation, viz (i) those accepting public deposits, (ii) those which do not accept public deposits but are engaged in the financial business, and (iii) core investment companies which hold at least 90 per cent of their assets as investments in the securities of their group/holding/subsidiary companies. While NBFCs accepting public deposits will be subject to the entire gamut of regulations, those not accepting public deposits would be regulated in a limited manner. Therefore, the regulatory attention was focussed primarily on NBFCs accepting public deposits. In respect of new NBFCs (which are incorporated on or after April 20, 1999 and which seek registration with the Reserve Bank), the minimum net owned fund has been raised to Rs 2 crores.

Consequent on the amendment to Reserve Bank of India Act, the liquidity requirement for the NBFCs was enhanced. Accordingly, loan and investment companies, which were earlier maintaining liquid asset at 5.0 per cent were directed to maintain 7.5 per cent and 10 per cent of their deposits in Government and other approved securities, effective January 1 and
April 1, 1998 respectively. For other NBFCs, the percentage of assets to be maintained by them as statutory reserves was increased to 12.5 per cent and 15.0 per cent of their deposits respectively to be effective from the above mentioned dates. Besides, with a view to ensuring that NBFCs can have resource to such liquidity assets in times of emergency, the custody of these assets with designated commercial banks was also prescribed. Keeping in view the risk profile of NBFCs, the capital adequacy ratio was also raised in a phased manner to 10 per cent and 12 per cent by the end of March 1998 and 1999 respectively.

To ensure the adherence of the NBFCs to the regulatory guidelines, a three-tier supervisory framework was put in the place by Reserve Bank of India for monitoring of NBFCs. The nature and extent of supervision of NBFCs, prepared in the backdrop of the provisions of the RBI (Amendment) Act, 1997, and the recommendations of the Khanna committee (1996), were based on three criteria viz, (i) the size of a NBFC, (ii) the type of activity performed, and (iii) the acceptance or otherwise of public deposits. To this end, a comprehensive supervisory model based on CAMEL (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems) has been designed. The CAMEL approach re-orientates the on-site inspection process towards examining intensively the assets of NBFCs, besides their liabilities. The methodology for conducting on-site inspection under the revised model has been manualsed. Further, a suitable off-site reporting system with emphasis of profitability and balance sheet related parameters has been introduced to exercise intensified surveillance over the NBFCs having assets.
of Rs 100 crore and above. Steps have been initiated to resort to extensive use of information technology for scrutiny of all off-site returns to reduce the degree of dependence on on-site inspection process. Apart from these, external auditor will be used as special vehicle. They will be asked to certify important returns of NBFCs. To import greater efficacy to this supervisory set up, representatives of the Reserve Bank and the Institute of Chartered Accountants of India (ICAI) have formed a panel to devise a new format of balance sheet to reflect the true position relating to the financial health of NBFCs. The process of regulatory strengthening has been reinforced with the creation of an independent department, viz., Department of Non-Banking Supervision (DNBS), for focused attention to the supervision of NBFCs. To facilitate closer and continuous monitoring of NBFCs, the Department has opened 16 Regional Offices to supervise the NBFCs having their registered offices under their respective jurisdiction.

The 1998 Directions - 'The New Concept of 'Public Deposit'

The new set of regulations covered the following areas,13 most of which were new

(i) The RBI virtually banned deposit-taking activity by the small companies. Deposit acceptance was made a multiple function of credit rating and net owned fund. A new term "public deposit" replaced the old term "deposit".

13 Navneet Jyothi and Rajesh Gupta, Op Cit., pp 4-5
(u) All the companies which were either unrated or rated below the minimum investment grade were deemed access to public deposits.

(iii) Even for the rated companies the ceiling was reduced. The companies could now accept deposits depending on the extent of credit rating its deposits enjoyed (technically called what ‘symbol’ it had for its deposits).

(iv) The deposits accepted from the shareholders by a private limited company, deposits from directors and the deposits accepted by a company from another company were taken outside from the purview of public deposits.

(v) The guidelines relating to prudential norms were overhauled completely. Compliance with the Accounting Standards issued by the Institute of Chartered Accounts of India were made mandatory, wherever applicable.

(vi) For the first time, the accountability of the Auditors of NBFCs was fixed and erring auditors were made liable to penal action.

(vii) Companies were asked to regularise their deposits within a period of three years with a stipulation that at least one-third of excess of deposits held on the commencement of the new directions (2-1-1998) was to be regularised every year.

The Task Force on NBFCs (1988)

The Finance Minister had announced in July 1998 the setting up of a Task Force of reviewing the regulatory framework for non-banking finance companies. The recommendations of the Task Force, submitted in October 1998, have been guided by the twin considerations of creating an environment
for healthy growth of sound NBFCs, while at the same time, providing an enhanced degree of comfort to the depositors in NBFCs. The recommendations of the Task Force are as follows:  

(i) Delinking of credit rating with quantum of deposits. All hire purchase finance companies and equipment leasing companies having at least minimum investment grade of credit rating to be allowed to have four times of net owned fund as public deposits.

(ii) All unrated or underrated hire purchase finance companies and equipment leasing companies having net owned fund of at least 25 lakhs to be allowed to have 1.5 times of NOF or 10 crores whichever is lower as public deposits provided they attain a higher capital adequacy ratio of 15 per cent.

(iii) SLR to be maintained at 25 per cent.

(iv) Investments in marketable securities, other than the liquid assets already maintained, to be made at the rate of 25 per cent of reserves.

(v) Increase in the minimum capital requirements for entry.

(vi) Increased protection of interests of depositors by constituting Depositors' Grievances Redressal Authority, first charge of unsecured depositors on liquid assets maintained, formation of information cells by State Governments etc.

(vii) Rejection of deposit insurance.

(viii) Unincorporated bodies to be allowed to take loans from companies.

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The recommendations of the Task Force were accepted by the Government of India and the Reserve Bank of India in December 1998. The RBI said in its press release that it was proposed to give effect to the recommendations as early as possible.

**Important Policy Developments Relating to NBFCs**

(i) In the Monetary and Credit Policy statement for 1999-2000, it was proposed that in respect of new NBFCs, which were incorporated on or after April 20, 1999 and which sought registration with the Reserve Bank, the requirement of minimum net owned fund would be Rs 2 crore. This stipulation will not apply to NBFCs which were already registered with the Reserve Bank or whose applications are presently under consideration. In terms of section 45-1A of the RBI Act, registration of an NBFC with the Reserve Bank has been made mandatory. The companies existing on January 9, 1997 were given time up to 8, 1997 to make an special audit of the companies having asset base of Rs.5 crore and above to expedite the process of registration of NBFCs.

(ii) In May 1999, the Reserve Bank removed the ceiling on bank credit prescribed for all registered NBFCs engaged in the principal business of equipment leasing, hire purchase, loan and investment activities.15

(iii) In November 1999, NBFCs were advised to give at least 3 months public notice prior to the date of closure of any of its branches/offices and sale/transfer of ownership by an NBFC in at least one leading national newspaper and a leading local vernacular language newspaper indicating therein the purpose and arrangement being made to service the depositors.

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(iv) In January 2000, the Reserve Bank effected several amendments to NBFC regulations which are as follows

1) NBFCs, which are (a) engaged in micro-financing activities, (b) licensed under section 25 of the Companies Act, 1956 and (c) not accepting public deposits, were exempted from the purview of registration, maintenance of liquid assets and transfer of profits to reserve fund.

2) The mutual benefit companies in existence as on January 9, 1997 and having NOF of Rs. 10 lakh were exempted from the requirement of registration, maintenance of liquid assets, creation of reserve fund and also from certain provisions of NBFC Directions on acceptance of public deposits and prudential norms as applicable in the case of notified Nidhi Companies.

3) The Reserve Bank introduced certain regulations in respect of opening and closing of branches, with an obligation of the auditors to report non-compliance of these directions. NBFCs have also been directed to constitute Audit Committees, consisting of not less than three members of their Board of Directors, if they have assets of more than Rs 50 crore, as per the last audited balance sheet. NBFCs would be required to follow a uniform accounting year of March 31 every year with effect from the accounting year ending March 31, 2001. NBFCs not holding public deposits were exempted from submitting returns on liquid assets. NBFCs, which are required to maintain liquid assets at 15 per cent of public deposits in the form of government securities, were permitted in January 2000 to maintain a part (up to 5 per cent) in the form of unencumbered bank term-deposits with scheduled commercial banks.
(v) In accordance with the announcement in the Monetary and Credit Policy of April 2000 regarding entry / participation of NBFCs in insurance business, final guidelines for NBFCs specifying certain eligibility criteria to be fulfilled for undertaking insurance business as a joint venture participant, act as agent of insurance companies on fee basis, without any risk participation and invest in equity of insurance companies, were issued in June 2000. The regulations for NBFCs and Reinsuarary Non-Banking Companies (RNBCs) were further rationalised in June 2000.

(vi) In October 10, 2000, in terms of guidelines issued by the Reserve Bank, acceptability NBFCs acceptance of public deposits (Reserve Bank) Directions, 1998 would not be to receipt of money by NBFCs by issuance of commercial paper in accordance with the guidelines.

(vii) In March, 2001, taking into account the market conditions and changes in other interest rates in the system, the maximum rate of interest that NBFCs can pay their public deposits, was reduced from 16 per cent to 14 per cent per annum with effect from April, 2001. The ceiling on interest rate was brought down to 14 per cent per annum on deposits accepted by miscellaneous non-banking Companies (chit fund companies) and mid/mi companies also in terms of directions prescribed by RBI.

Types of Non-Banking Finance Companies:

The non-banking financial companies are classified as follows:

(i) Loan Company (LC),

(ii) Investment Company (IC),

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17 Ibid, p 124
(iii) Equipment Leasing Company (ELC),
(iv) Hire Purchase Finance Company (HPFC),
(v) Residuary Non-Banking Company (RNBC),
(vi) Mutual Benefit Finance Company (notified Nidhis) (MBFC),
(vii) Mutual Benefit Company (Potential Nidhis) (MBC),
(viii) Miscellaneous Non-Banking Company (Chit Fund Company) (MNBC),
(ix) Insurance Company (IC),
(x) Stock Exchange, Stock Brokers, Merchant Banking Company,
(xi) Housing Finance Company (HFC),
(xii) Micro Finance Company (MFC).

For the loan company, investment company, equipment leasing company, hire purchase finance company and residuary non-banking company, the registration is compulsory and they are subject to regulations by Reserve Bank of India. Mutual benefit finance company, mutual benefit company and miscellaneous non-banking company need not register with Reserve Bank of India, but RBI issues direction relating to deposit acceptance activity. Insurance company, stock exchange, stock brokers, merchant banking company, housing finance company and micro finance company regulated by other regulatory authorities are exempted from RBI regulations including requirement of registration. Housing finance company is regulated and supervised by the National Housing Bank (NHB). The classification of NBFCs is also presented on Chart-1.1.
Chart - I.1

Classification Of The Non-Banking Financial Companies

Non-Banking Financial Company

- Registered with and regulated by RBI @+
- Not registered with RBI, but RBI issues direction, relating to deposit acceptance activity
- Exempted from RBI regulations including requirement of registration*

Mutual Benefit Finance Company (notified Nidhis)

- Mutual Benefit Company (Potential Nidhis)
- Miscellaneous Non-Banking Company (Chit Fund Company)

- Insurance Company
- Stock Exchange, Stock brokers, Merchant Banking Company
- Housing Finance Company
- Micro Finance Company

- Loan Company
- Investment Company
- Equipment Leasing Company
- Hire Purchase Finance Company
- Readvancy Non-Banking Company

Note 1 - @ Primary Dealers are registered with RBI and regulated by RBI as such irrespective of whether they accept public deposits or not
Note 2 - * NBFCs who accept public deposits are subject to a regulatory framework prescribed for the purpose
Note 3 - * As they are regulated by other regulatory authorities
Principles of Business of Non-Banking Finance Companies

The Principles of business of non-banking financial companies are as follows

<table>
<thead>
<tr>
<th>Non-Banking Financial Companies</th>
<th>Principal Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-Banking Financial Company</td>
<td>In terms of the Section 45-I(f) of the RBI Act, 1934 as amended in 1997, their principal business is that of receiving deposits or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing.</td>
</tr>
<tr>
<td>Equipment Leasing Company (ELC)</td>
<td>Equipment leasing or financing of such activity.</td>
</tr>
<tr>
<td>Hire Purchase Finance Company (HPFC)</td>
<td>Hire purchase transaction or financing of such transactions</td>
</tr>
<tr>
<td>Investment Company (IC)</td>
<td>Acquisition of securities and trading in such securities to earn a profit.</td>
</tr>
<tr>
<td>Loan Company (LC)</td>
<td>Providing finance by making loans or advances, or otherwise for any activity other than its own, excludes equipment leasing companies/hire purchase companies/housing finance companies.</td>
</tr>
<tr>
<td>Residuary Non-Banking Company (RNBC)</td>
<td>Company which receives deposits under any scheme or arrangement, by whatever name called, in one lump-sum or in instalments by way of contributions or subscriptions or by sale of units or certificates or other instruments, or in any manner. These companies do not belong to any of the categories as stated above.</td>
</tr>
<tr>
<td>Non-Banking Financial Companies</td>
<td>Principal Business</td>
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<tr>
<td>---------------------------------</td>
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</tr>
<tr>
<td>Mutual Benefit Financial Company (MBFC) i.e., Nidhi Company</td>
<td>Any company which is notified by the Central Government under Section 620 A of the companies Act 1956 (1 of 1956)</td>
</tr>
<tr>
<td>Mutual Benefit Company (MBC) i.e., potential Nidhi Company</td>
<td>A company which is working on the lines of a Nidhi company. However, it has not yet been so declared by the Central Government, has minimum net owned fund of Rs. 10 lakh, has applied to the Reserve Bank for COR and also to Department of Company Affairs (DCA) for declaration as Nidhi company and has not contravened direction / regulations of Reserve Bank / DCA</td>
</tr>
<tr>
<td>Miscellaneous Non-Banking Company (MNBC), i.e., Chit Fund Company</td>
<td>Managing, conducting or supervising as a promoter, foreman or agent of any transaction or arrangement by which the company enters into an agreement with a specified number of subscribers that every one of them shall subscribe a certain sum in instalments over a definite period and that every one of such subscribers shall in turn, as determined by lot or by auction or by tender or in such manner as may be provided for in the arrangement, be entitled to the prize amount.</td>
</tr>
<tr>
<td>Housing Finance Company (HFC)</td>
<td>The financing of the acquisition or construction of houses including the acquisition or development of plots of land. These companies are supervised by the National Housing Bank.</td>
</tr>
</tbody>
</table>
Sources of Funds of NBFCs:

The central function of non-banking financial companies is to accept deposits and/or borrow and to lend. In other words, the NBFCs mobilise their resources from different entities and under different modes and then employ the funds in their core activities, be it leasing or hire purchase or investments or granting loans. As NBFC is a financial intermediary, it should understand the risks involved in meeting the entire or substantial funding requirements through one source. The diversity of items appearing in the liability side of the balance sheet of NBFC provides flexibility to increase or decrease its reliance over any particular source.

The total sources for non-banking financial company can be broadly divided into two parts (i) owned funds consists of equity capital, preference share capital, reserves and surplus, etc, (ii) borrowed funds consists of public deposits, debentures, bonds, commercial papers, bank borrowings, inter-corporate deposits, etc.

Housing Finance Companies (HFC)

Shelter as a basic human need ranks next only to food and clothing. Housing has been primarily self-help activity for the majority of the

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households. Increasing population pressure on land and infrastructure and associated high cost have made proper housing inaccessible to the poorer segments of the population, necessitating state intervention initially as a welfare activity and now recognised as a social and economic imperative. In a developing country like India, problems of urban housing have been more evident, both because of exponentially increasing land and construction cost and deteriorating quality of life in congested urban packets. This obviously led to high demand for dwelling units. The year 1987 was declared as International Year of Shelter. It was estimated by the National Building organisations that by the year 2000 there could be demand for 4.1 crore dwelling units. Financing and construction of housing units to meet the needs of people is a big task in itself. Only a part of financial requirements is coming from the organised sector comprising banks, housing finance companies, and other organisations.

Meaning and Regulatory Framework of Housing Finance Companies (HFC):

A housing finance company is a company incorporated in India which transacts the business of providing long-term finance for housing. Unlike the other non-banking finance companies which are governed by the Reserve

Bank of India (RBI), the housing finance companies are governed by the National Housing Bank (NHB). The National Housing Bank Act, 1987 confers powers on the National Housing Bank in dealing with housing finance companies. The National Housing Bank has issued Directions applicable to HFCs in 1989 known as housing finance companies Directions, 1989. The directions mainly covered the acceptance of deposits by HFCs and other incidental matters. The directions were drastically amended in September 1997. The amendments were quite similar to the one made in the case of NBFCs in January, 1997. The housing finance companies which accept deposits and having at least 25 lakhs net owned funds are now required to apply and obtain a certificate of registration from the NHB before accepting/renewing any deposit. The quantum of deposits and the methods of maintaining liquid assets have also been changed. These directions have been further amended on January 1, 1999 in respect of acceptance of public deposits, compulsory credit rating for acceptance of public deposits, more disclosure in the application for soliciting public deposits, etc. The National Housing Bank Act, 1987 was also been amended as National Housing Bank (Amendment) Act 2000 to enable the National Housing Bank to safeguard the interests of depositors and promote healthy and universal growth of housing finance companies in the country. The Act was further amended on September 27, 2001 as it was considered necessary in the public interest and to enable the National Housing Bank to regulate the housing finance system of the country more effectively.\(^{20}\)

NHB's Directions to Housing Finance Companies

As the principal housing finance agency in the country, the NHB is authorised to give directions to housing finance companies (HFCs), which primarily transact or have as their principal object the transacting of business of providing finance for housing whether directly or indirectly. The main elements of the National Housing Bank directions are as follows.

(i) Registration of HFCs

The National Housing Bank issued an advertisement in PB dated 19-10-2000 indicating that the certification of registration was compulsory for housing finance companies, without which they would not be able to carry the business of housing finance. This condition was applicable to those HFCs which have net owned funds of Rs. 25 lakhs or more and those which would be incorporated after 12th June 2000. If the given housing finance company was already in existence on 12th June 2000 and had net owned funds less than Rs. 25 lakhs, then the same housing finance company would have to attain the level of Rs. 25 lakhs before 12th June 2003. The companies incorporated after 12th June 2000 would have to take the certification of registration from NHB without which they cannot commence business.
The following aspects are examined in the process of registrations of housing finance companies:

(i) Maintenance of books of accounts
(ii) Financial soundness of the housing finance company in paying its depositors
(iii) Manner of conducting affairs
(iv) General character of the management
(v) Adequacy of capital structure and earning prospects

The National Housing Bank can also cancel the certificate of registration on the following grounds:

(i) If the company ceases to carry on the business of housing finance company in India.
(ii) If the company fails to comply with the conditions which were imposed by National Housing Bank at the time of granting registration certificate
(iii) If the company is not in a position to pay its depositors
(iv) If the company conducts its affairs which are likely to be against the interests of depositors
(v) If the character of the management of the company is prejudicial to the public interest
(vi) If the capital structure and earning prospects of the company are not adequate
(vii) If the public interest is not served by the grant of certificate of registration

(viii) If the grant of certificate of registration is prejudicial to the operation and growth of the housing finance sector of the country

(ix) If any other condition, which in the opinion of the NHB, is necessary to safeguard the public interest or the interest of depositors, is not fulfilled by the HFC

(x) If the company fails to comply with any direction issued by NHB under the provisions of Chapter V of the National Housing Bank Act, 1987

(xi) If the company fails to maintain accounts in accordance with any other law or any direction or order issued by the NHB. If the housing finance company maintains its accounts according to the directions issued by the NHB but violates the provisions of any other law, say Companies Act, Income Tax Act, etc., the housing finance company will be said to have contravened the provisions of this clause consequent to which the certificate could be cancelled

(xii) If the company fails to submit or offer for inspection its book of account and other relevant documents when so demanded by the inspecting authority of the NHB.

(xiii) If the company has been prohibited from accepting deposit and prohibition has been in force for at least three months.
(ii) Acceptance of Public Deposits by Housing Finance Companies

The stipulations contained in the National Housing Bank directions apply to acceptance of Public deposits. A public deposit means deposit which does not include the following:

(i) Any amount received from the Central Government/State Government/any other source whose repayment is guaranteed by the Central or State Governments or any amount received from a local authority/public housing agency/foreign government/foreign citizen,

(ii) Any amount received from National Housing Bank and other financial institutions like IDBI, LIC, GIC, SIDBI, UTI etc.,

(iii) Any amount received from company,

(iv) Application money received for allotment of shares/stock/debentures/bonds,

(v) Call money received in advance in respect of shares in accordance with the Articles of Association of the company so long as they are not refundable,

(vi) Deposit from directors in the case of both private as well as public limited company;
(vii) Deposit from shareholder in the case of private limited company or deemed public company provided its members do not exceed 50.

(viii) Debentures/bonds secured by mortgage of immovable property of the company or any other assets if the total outstanding amount of debentures/bonds does not exceed the market value of the securities;

(ix) Optionally convertible (into equity as well as preference) debentures,

(x) Any amount brought in by the promoters by way of unsecured loan in pursuance of stipulations of lending institutions subject to the fulfilment of the following conditions,

(a) The loan is brought in pursuance of the stipulation imposed by the lending public financial institution in fulfilment of the obligation of the promoters to contribute such finance,

(b) The loan is provided by the promoters themselves and/or by their relatives, and not from their friends and business associates, and

(c) The exemption under this sub-clause shall be available only till the loan of financial institution is repaid and not thereafter

(iii) Restrictions on Acceptance of Deposits by Housing Finance Companies

(i) No housing finance company having netowned funds of less than Rs 25 lakhs shall accept public deposits.
(n) No housing finance company having Netowned Fund of Rs 25 lakhs and above shall accept or renew public deposits except to the extent specified below

(a) Not exceeding five times of its net owned funds, where the housing finance company has obtained credit rating for fixed deposits not below Grade 'A' from any one of the approved rating agencies at least once a year and a copy of the rating is sent to the National Housing Bank and it is complying with all the prudential norms, and

(b) In the absence of credit rating as specified in (a) above, not exceeding two times of its net owned funds or Rs 10 crores, whichever is lower including any amount remaining outstanding in its books as on the data of acceptance or renewal of such deposit, subject to (i) it is complying with all the prudential norms, and (ii) having capital adequacy ratio of not less than 15 per cent as per the last audited balance sheet

(iii) No housing finance company shall have deposits inclusive of public deposits, the aggregate amount of which together with the amounts, if any, held by it which are referred in clauses (iii) to (vii) of sub-section (bb) of Section 45 I of the RBI Act, 1934 as also loans or other assistance from the National Housing Bank, is in excess of ten times of its net owned funds.
(iv) In the event of down gradation of the credit rating to any level below Grade 'A' from the level earlier held by the housing finance company, it shall

(a) Report the position within 15 working days to the National Housing Bank,

(b) With immediate effect stop accepting any fresh deposit and not renew existing deposit after the expiry of one year form the date of down gradation, and

(c) Repay the amount of excess deposits within three years/such further period as may be extended by the NHB

(iv) Period of Deposit

The housing finance companies can accept/renew public deposits for a minimum period of 12 months and a maximum period of 84 months. They are prohibited from accepting public deposits repayable on demand/notice. Where a public deposit is in instalments, the period of such deposits would be computed from the date of receipt of the first instalment.

(v) Maintenance of a Minimum Percentage of Liquid Assets

The following are the requirements for maintenance of minimum percentage of liquid assets by the housing finance companies
(a) Every housing finance company should invest and continue to invest in India in unencumbered approved securities, up to 25 per cent, as the NHB may from time to time specify, of the public deposits outstanding at the close of business on the last working day of the second preceding quarter, that is, the period of three months ending on the last day of March, June September and December. While approved securities mean securities of any state government/central government and bonds fully and unconditionally guaranteed as to repayment of principal and payment of interest by the government, unencumbered approved securities include the approved securities lodged by a housing finance company with another institutions for an advance/any other arrangement to the extent to which they have not been drawn against/availed of/encumbered in any manner,

(b) Every housing finance company should maintain in India (i) in an account with a bank in term deposits/certificates of deposits (both free of charge/hcn), (ii) in deposits with the NHB, (iii) by way of subscription to the bonds issued by the NHB, a sum which, at the close of business on any day, together with the investment made under clause (a) above, would not be less than 12.5 per cent or higher percentage up to 25 per cent, as the NHB may, from time to time, specify, of the public deposits outstanding at the close of business of the last working day of the second preceding quarter.
For the purpose of ensuring compliance with these provisions, the NHB may require every housing finance company to furnish a return to it in such form, in such a manner and for such period as may be specified by it.

If the amount maintained/invested by a housing finance company falls below the rate(s) specified above, it would be liable to pay to the NHB a penal interest at a rate of three per cent per annum above the bank rate on such shortfall, and where the shortfall continues in the subsequent quarters, the rate of penal interest would be 5 per cent per annum above the bank rate for each subsequent quarter.

The penal interest would be payable within a period of 14 days failing which penalty may be levied on an application by the NHB by a direction of the principal civil court having jurisdiction in the area where an office of the defaulting housing finance company is situated. When the court makes a direction, it would issue a certificate specifying the sum payable by the housing finance company, which would be enforceable in the manner as if it were a decree made by the court in a suit. However, if the NHB is satisfied that the defaulting housing finance company had sufficient cause for its failure to comply with these provisions, it may not demand the payment of the penal interest.
The housing finance companies should entrust to one of the banks designated by it on that behalf, in the place where its registered office is situated, the unencumbered approved securities required to be maintained by it. These securities should continue to be entrusted to such designated bank for the benefit of the depositors and not withdrawn / encashed / otherwise dealt with by the housing finance company except for repayment to the depositors. However, it would be entitled to withdraw a portion of such securities proportionate to the reduction of its deposits dully certificated to that effect by its auditors and where it intends to substitute such securities, it may do so by entrusting substitute securities of equal value to the designated bank before such withdrawal.

(vi) Reserve Funds

Every housing finance company should create a reserve fund and transfer therein at least 20 per cent of its net profit every year before any dividend is declared. Any special reserve created by a Housing Finance Company in terms of Section 36(1) (iii) of the Income-Tax Act, may take into account any sum transferred by it for the year to such special reserve for the purposes of this reserve. Appropriation of any sum from the reserve fund can be made by a housing finance company only for the purpose as may be specified by the NHB from time and each appropriation / withdrawal will have to be reported to it with in 21 days. However, the NHB may, in any
particular case and for sufficient cause being shown, extended this period by such further period as it thinks fit or condone any delay in making such report.

The RBI may, however, on the recommendations of the NHB and having regard to the adequacy of the paid-up capital and reserves (i.e. when the balance in the reserve fund together with the balance in the share premium account is not less than the paid-up capital) of a housing finance company in relation to its deposit liabilities, make the requirement of creation of reserve fund and transfer 20 per cent profit mappable to it for a specified period.

(vii) Copies of Balance Sheet and Accounts together with the Director's report to be furnished to NHB

The housing finance companies are required to deliver to the NHB an audited balance sheet as on the last date of each financial year, and audited profit and loss account in respect of that year as passed by it in general meeting together with a copy of the report of the Board of Directors within 15 days of such meeting as also a copy of the report and notes on accounts furnished by its auditors

The study relating to origin and development of NBFCs in India reveals that NBFCs are operating in India for quite a long time but they were
brought under control only from the sixties. In 1963, the Bank Laws (Miscellaneous Provisions) Act was introduced to incorporate a new chapter in the RBI Act to regulate the NBFCs. In 1971, the RBI appointed a Study Group called as Bhabatosh Dutta Study Group to examine the role and operations of NBFCs. The Committee observed that NBFCs usefully supplemented the activities of banks in the field of both deposit mobilisation and lending and thus played a dynamic role in the economy. The Committee felt the need for regulating the activities of NBFCs. In 1974, the James Raj Committee recommended that the magnitude of deposits accepted by NBFCs to be brought within the monetary and credit policy. The Chakravarthy Committee (1985) felt the need for licensing of NBFCs protecting the interests of depositors and also suggested the need for a suitable cut of point with regard to their level of business. The Vaghul Committee (1987) recommended that NBFCs should be encouraged to provide factoring services and bill discounting. The Narasimham Committee (1991) suggested involving NBFCs in hire purchase, leasing activities. The Committee suggested norms to be fixed for capital adequacy, debt-equity ratio, credit concentration ratio, provision for doubtful debts etc. It also suggested eligibility criteria for NBFCs, their entry, growth and exit. The Shah Committee (1992) recommended an integrated regulatory framework which, while monitoring and supervising the operations of NBFCs, recognised and even encouraged the emergence of a new type of financial services and products. The Khanna
Committee (1996) designed a supervisory framework for NBFCs. It suggested that the statutory powers of RBI should be enhanced to equip the RBI for achieving macro level goals ensuring healthy and orderly functioning and growth of NBFCs. In 1997, 1998 the RBI introduced a number of regulations to monitor the activities of NBFCs.

The NBFCs are classified as loan companies, investment companies, equipment leasing companies, hire purchase finance companies, residuary non-banking companies, mutual benefit finance companies, insurance companies, housing finance companies etc.

Housing finance companies are governed by the National Housing Bank. The National Housing Bank is authorised to give directions to housing finance companies which primarily transact in the business of providing finance for housing. The regulations include rules regarding acceptance of deposits by these companies their obligation and lending programmes.

The NBFCs including housing finance companies are thus working under too many regulations like RBI, SEBI, NHB etc. The study groups also have suggested the need to regulate the activities of NBFCs for ensuring the safety of deposits and efficacy of the credit policy on the one hand and encouraging their orderly growth on the other.