Chapter: 4

Mutual Funds vis-à-vis other NBFCs

“A business that makes nothing but money is a poor kind of business.” Henry Ford
4.1 NBFCs In India

A NBFC is a business entity whether incorporated under the Companies Act, 1956 or not which devotes its resources in providing to the society the financial services of various descriptions that are distinct from normal banking services. Non Banking Finance companies are allowed to collect Deposits from General Public after complying with various provisions of the Companies Act and after filing all the requirements as per the guidelines issued by the Reserve Bank of India. It is to be noted that to raise deposits from the general public by giving an advertisement, the person soliciting deposits should file all the relevant documents with the Reserve Bank of India, obtain clearances and then only issue an advertisement. Only those NBFCs who are registered with the Reserve Bank of India and who have complied with the requirements of credit rating satisfactory grade and prudential norms are given freedom to offer interest rate (with an upper ceiling of 11.00% prescribed) on deposits exceeding the period of one year and not exceeding the period of 5 years. The above rate is applicable to those deposits accepted or renewed by the NBFCs after 4\textsuperscript{th} March 2003. NBFCs are free to offer lesser rate of interest also at their convenience. NBFCs raise deposits from the general public by issuing advertisements and thereafter invest the same in various businesses for which the companies are formed.

NBFCs comprise the business organizations carrying on activities like --

- Hire Purchase Finance
- Investment Activity
- Loan granting activity
- Mutual fund finance
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- Equipment Lease finance
- Housing Finance
- Insurance Business

NBFCs not falling under the above categories are called RESIDUARY NBFCs

The following are the Books and Records normally maintained by a Non Banking Finance Company –

- Cash Book & Bank Book
- Depositors’ Ledger
- Due Date & Renewal Register
- Interest Register
- Loan Ledger
- Investment Ledger
- General Ledger

4.2 PUBLIC DEPOSIT ACCEPTANCE NORMS

- An NBFC having Net Owned Funds of Rs. 200.00 lakhs and above only can accept Public Deposits
- It has obtained Minimum Stipulated Credit Rating from any one of the approved Credit Rating Agencies at least once in a year
- Copy of the Credit Rating should be sent to the RBI along with the Return on Prudential Norms. If the Credit Rating is either down graded or
upgraded, the NBFC is required to report this fact to the RBI within 15 days from the date when it receives such information.

- It is to be noted that the deposits taken by the NBFCs are repayable on demand and the Minimum period for which Public Deposits can be accepted is not less than 12 months with a maximum period of 84 months.

- There is a ceiling provided for the quantum of deposits accepted by NBFCs.

- Hire Purchase & Leasing Companies: 1.5 times of their Net Owned Funds or Rs. 10.00 Crores whichever is less. Such companies can accept or renew deposits up to 4.00 times of their Net Owned Funds provided they obtain minimum investment grade of credit rating.

- Loan Companies and Investment Companies: 1.5 times of their Net Owned Funds.

### 4.3 Receipt to be issued to Depositor

NBFCs are required to issue a receipt to each depositor in respect of each deposit accepted. This receipt is required to be signed by the authorized official of the Company. The receipt should consist the following particulars:

- Date of Receipt
- Name of the Depositor
- Amount of Deposit in words and figures
- Rate of Interest
• Maturity Date

NBFCs are required to maintain a Register of Deposits consisting of the details of the depositor and the deposits along with all particulars.

Payment of Brokerage

NBFCs are not allowed to pay more than 2% of the deposit amount in the form of any brokerage to any broker on the public deposits collected by or through him and reimbursement of expenditure shall be given to a maximum extent of 0.5% of the deposits collected by or through him.

ADVERTISEMENT

NBFCs are required to issue an advertisement for acceptance of public deposits and this should be informed to the Reserve Bank of India.

4.4 ACCEPTANCE OF DEPOSITS BY UNINCORPORATED BODIES

1. Individuals, Firms or an unincorporated Association of Individuals shall not accept any deposits if his or their business wholly or partly includes any of the activities mentioned in Section 45 I of the RBI Act.

2. Such people cannot accept deposits if his or its principal business is that of receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner.

3. Existing Registered Unincorporated Bodies and Individuals who carry out eligible business can accept deposits from a maximum of 25 depositors in the
case of an Individual and 25 depositors per partner in the case of a Partnership Firm.

DEFAULTS MADE BY COMPANIES

Generally Companies commit frauds by receipt of deposits in contravention of Chapter IIIB and in issuance of advertisements / prospectus by violating provisions of Section 45NA. The penalty is Rs. 5.00 lakhs or double the amount of deposits received in contravention of the provisions, whichever is higher. In addition, various other penalties are provided for various offences, which were already provided elsewhere

- **Leasing Company** – A leasing company enters into arrangement, which provides

  an enterprise with the use and control over assets without receiving title to them. This arrangement could be oral or written allowing the use of assets for a specified period of time. The lessee does not get the final ownership. Leasing involves the use of an asset without assuming or intending to assume, ownership.

Frauds committed by Leasing Companies – Leasing Companies follow dubious practices in providing lease assets to customers. They provide accommodation papers and furnish documents to various customers who require the same for obtaining loans from banks and financial institutions. The customers who obtain loans in such a fashion would in most of the cases be fraudulent and would not repay the monies. The Leasing Companies show losses in such peoples name and
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eat away the public deposits. Unless the investigating officer goes in to the details of the customers who obtained leased assets from the Leasing Company, it is impossible to trace out the frauds done by the Leasing Company from the documents maintained by it.

- **Investment Company etc.** – Investment companies assume different shapes and perform different activities although their sole objective is to invest the collected funds in securities on behalf of their clients. Generally, these companies do investment portfolio management and are licensed by SEBI as portfolio managers. These companies deal directly in both primary and secondary capital markets and invest collected funds in units of mutual funds and money market instruments. It may be noted that though they are licensed by SEBI it cannot be an accepted rule that these companies do not commit frauds.

**Mutual Funds** – Mutual Funds are corporations, which accept monies from savers and then use these monies to buy stocks, long-term bonds, short-term debt instruments issued by business units or government units, and these corporations pool funds and thus reduce risk by diversification. Mutual funds, after collecting monies from the general public, to defraud with the monies accepted, invest the monies in non-government instruments and securities, at the prices, which are far more than the market prices or the real value of the securities. Making a tie-up with the management of the companies seeking funds does this. As the real value is far lesser than the investment, the funds are misappropriated and hence, the funds of the general public are utilized for making personal profits by the
management of the Mutual Funds. It may be noted that the transactions of a Mutual Fund can be kept track of by observing the movements in the net asset value of the units of the Fund and the portfolios held by them and also from the areas of business in which the Funds have invested the monies of the general public.

*Acceptance Credit and Bill Discounting* – One of the major activities taken up by various NBFCs is Acceptance Credit and Bill Discounting. The activity can be explained by an example – A is a company supplying materials to B. i.e. A raises a bill against B and A has to get the monies of sale from B. A comes to an NBFC for discounting the bill and receiving the payments before B has actually paid the same. When B pays the monies, the NBFC receives the money and charges interest or services charges for discounting the Bill.

When an NBFC pools up funds from general public and wishes to misappropriate the same, bills from various companies, which are either non-existent or duplicate bills are discounted without bothering about the credit worthiness of the company or person seeking funds. Thus, the funds of the general public are at stake.

*Residuary NBFCs* - A Residuary NBFC not falling in any of the 7 categories explained, on and from 01-04-2003, will have to pay to the depositors deposited amounts on and from the above date, the interest, premium, bonus or any other advantage whatever name may be given, a minimum of 5% p.a. on the amounts deposited in lump-sum or at monthly or longer intervals and 3.5% p.a. on the amounts deposited under daily deposit schemes. Whereas, the NBFCs does
not account for the deposits in a proper fashion and show lesser rates of amounts payable to the depositors.

RNBFCs can charge an amount of Rs. 80/- fixed, for every deposit of more than Rs. 500/- and not exceeding the amount specified. For deposits less than Rs. 500/-, the amount of Rs. 80/- shall be reduced proportionately.

The role of NBFCs in our economy needs to be emphasized. They have supplemented the role played by the Banks. While functioning as financial intermediaries between the savers and the users, they cater to the different segments of the society. RBI allowed them to have a high gearing of ten times. This led to the promotion of finance companies by people who had nothing to do with finance business. They only want to collect money under the grab of NBFC for diversion. The directions governing the finance companies are not comprehensive enough. So, something was bound to happen and what happened was not pleasing. Some companies promise unrealistic things. Some unscrupulous elements dupe the gullible people of their hard earned money. Hence, the reaction by the regulators becomes inevitable. Until the reaction comes in to effect and the NBFCs and finance companies are regulated properly, it is everybody's duty to take precautions and go further in matters relating to dealings with NBFCs.

The service sector activities are substantially financed by non-banking financial companies (NBFCs) which constitute engines of credit growth. For instance, the share of trade in the national income in 2002-03 at factor cost at current prices was 13.3 per cent at Rs 3 lakh crore (out of Rs 22.5 lakh crore). Of this, the share of the non-corporate sector was nearly 80 per cent (National
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Accounts Statistics 2004) or approximately Rs 2.4 lakh crore. If 75 per cent needs to be financed (which could be an under-estimation as we are looking at value addition and not sale) by outside institutions, then Rs 1.8 lakh crore is the credit need of the trade sector. Bank financing of trade (non-food credit plus food credit) totalled Rs 72,057 crore in 2003 or about 40 per cent of the credit absorbed by the sector (RBI Annual Report 2004). In other words, more than 60 per cent of the financial requirement of the non-corporate sector in trade is met by NBFCs. This again is an under-estimation as a substantial amount of the food credit by banks goes to government organisations such as the Food Corporation of India.

A similar analysis suggests that in un-registered manufacturing, the gross value addition was Rs 1,19,015 crore in 2002-03. Going by the estimate of 50 per cent from the Annual Survey of Industry (ASI) data, the share of short-term borrowing would be Rs 59,508 crore. Bank credit to small-scale industries was Rs 60,394 crore in 2003 (of which at least 50 per cent would be to registered category. This means more than 50 per cent of the borrowing requirement of unregistered manufacturing is met by non-bank sources.

The share of the construction industry in gross value addition in 2003 was Rs 1,38,443 crore. Lending by commercial banks for housing activities in 2003 amounted to Rs 36,587 crore or around 35 per cent of the aggregate borrowing needed (75 per cent of value addition) by this industry. Thus, nearly 65 per cent of the private construction activity is financed by the non-banking sector. The P&P (proprietorship and partnership) sector has a large presence, more than 60 per cent in this industry.
One must remember that the truck financing activity is the most innovative and efficient symbol of the NBFC sector. Second-hand truck financing has created a fascinating backbone for the transport industry by focusing on the small man and this has been one of the major contributions of the NBFC sector to the economy.

One can, therefore, say that the role of NBFCs in the credit delivery system in both manufacturing and service sectors is significant *per se* and compared to the commercial banks also.

But, unfortunately, the planners, instead of nurturing and enhancing their credit delivery mechanisms, are focusing more on control and regulation. The failure of some NBFCs has shifted the focus to their liability side while the asset, or lending, side is more important for an emerging market like India.

Under the current RBI regulations, a butcher, barber or baker can borrow money but not a moneylender (Section 45-S of the RBI Act). A moneylender can lend but not borrow except from relatives. In the context of safe-guarding the interest of the depositors, we have gone to the other extreme impacting the credit market particularly pertaining to retail trade and restaurants which are dependent on the un-incorporated money-lender for their working capital. It is also possible that the deposit-taking activity has gone in to the `veil' of unincorporated activities and it is much more difficult to "unveil" the un-incorporated situation than that of the organised sector.

According to the latest Economic Survey, "Internationally, acceptance of public deposits is restricted to banks alone and non-banks including NBFC's can
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raise resources from institutional sources or by accessing the capital market only.

The RBI is planning to hold discussion with the NBFCs in regards to their plan of action for voluntarily phasing out acceptance of deposits in line with the international practices" (Economic Survey 2004-2005).

This does not fully reflect the situation as there are thrift institutions and financial companies in the US, and partnership firms, building societies and credit unions in the UK, which are similar to our NBFCs, and they play a large role in taking deposits as well as lending. They meet the requirements of what are called the mid-market households and small businesses. Also, remember that the structure of our economy is non-corporate (having a share of more than 40 per cent) compared to that of the US or the UK where more than 60 per cent of the economy is corporatised while in India it is around 12 per cent. The number of NBFCs has drastically declined in the last few years due to the RBI's regulatory steps in terms of registration, rating, etc. As at the end of June 2004, a total of 38,050 applications were received for the grant of Certificate of Registration (CoR).

Of this, the RBI approved 13,671, including 584 applications of companies authorised to accept/hold public deposits. It is possible that a substantial number of them, which did not get the CoR, have become active as unincorporated bodies.

In 2003, the public deposits with the NBFCs totalled Rs 20,000 crore (less than 2 per cent of that with scheduled Commercial banks). Of this, 75 per cent or Rs 15, 000 crore was with five Residuary Non-Banking Financial Companies (RNBCs) such as Sahara (RBI's Trend and Progress of Banking 2003-2004). The
NBFCs' capital risk weighted asset ratio (CRAR) improved substantially in the last decade, with quite a few showing above 30 per cent. The net NPAs of the NBFCs have declined substantially, from a high of 7 per cent in March 1999 to 2.9 in September 2003.

The Planners may have some concerns about the RNBCs and even for that stringent investment norms have been introduced in June 2004.

In a large country like India seeing substantial growth in service activities where the share of P&P firms is significant, it is important that the role played by NBFCs in credit provision is recognised. They have extensive network and credibility among their constituents, both borrowers and lenders. Their ability to access public deposits is the meeting point for their customers, since both are usually un-incorporated entities. Banks must treat the NBFCs as channel partners and provide them credit. But, at the same time, they should have the flexibility to access deposits from the public like any other financial institution.

Being a lender without being a borrower from the public is like asking a teacher to only teach (output) and not study (input).

Financial systems are fascinating learning tools where the input/throughput/output mechanism in terms of borrowing/processing/and lending enhances and enriches the institutions. If any one node is missing, then there is failure. A developing country like India needs multiple institutions catering to different segments and capable of accessing funds from the public, the market or from institutions. A prudent lender is one who borrows efficiently. It is actually two sides of a coin. Making institutions to lend without borrowing from the
public will weaken the learning curve and goes against the cannon of the "Triple Nodes" of a financial intermediary namely borrow, analyse/process and lend. Not the least, it may create moral hazards — if institutions only lend without borrowing from the public — in a country like ours.

THE LAST couple of years have seen significant developments in the financial sector that have raised competition across-the-board. Non-banking finance companies (NBFCs) have perhaps felt the pressure most. Consequently, top-rung NBFCs are changing tack, and initiating moves to become financial supermarkets. They are seeking to provide as many services as possible, and their fate will be decided by how successful they are. Supermarkets in the making

Leading NBFCs have gradually extended their product portfolio to include asset management companies (AMCs), housing finance firms and are now readying to enter insurance. This trend seems different from that of the early 1990s when most NBFCs rushed to launch a merchant banking subsidiary. But this could not be sustained with the poor business in the primary market and the industrial slowdown. Most such merchant banking subsidiaries have been wound up.

But the NBFCs' latest moves to increase the lines of business may be of a more permanent nature despite the growing competition from the resource-rich banks and financial institutions in core and emerging areas. The last few years saw the traditional boundaries between different categories of financial intermediaries disappear. Thus, the NBFCs had to contend with heavy competition even in areas that were their preserve. Working capital loans were traditionally the preserve of banks, and term lending that of the financial
institutions. Now these sets of institutions move in and out each other's areas freely. And both have also moved into retail financing, the traditional preserve of the NBFCs.

4.5 The NBFC pillars...

Traditionally, the NBFCs have dominated the market for retail finance. Their forte has been credit delivery to areas not covered by banks and FIs. Thus, NBFCs are perhaps better acquainted and more sensitive to the latent needs of the retail customer. With such new areas as insurance being opened up, top-rung NBFCs are presented with an opportunity to grow. But these areas fall outside the NBFCs' traditional sphere of competence and raise questions about the sensibility of their move.

A financial intermediary's business is dominated by the attendant risk. Given the banks' ability to access low-cost funds, they are likely to service the relatively top-end clients, leaving others with the riskier customers. The issue assumes greater significance considering that the average NBFC will be pushed down to relatively untouched or untapped areas where credit information may be scarce. But this perception does not hold water when one considers that the top NBFCs have one of the lowest levels of non-performing assets (NPAs) in the financial sector.

Some areas where the NBFCs are showing interest are insurance -- recently opened up for private participation -- and housing finance. Sundaram Finance has started an associate company that disburses housing loans. This is a good example of the recent trend to diversify because traditionally housing
finance has been the domain of HDFC and LIC Housing Finance. The long duration of housing loans and the necessity to access large quantities of funds has reduced the other finance companies to relatively marginal players. Recently, one such firm, Home Trust Finance, that was not backed by institutional money, merged with HDFC. Now, Sundaram Finance has opted to enter this area.

The positive outcome of such a lateral move into other areas should be a diversification of the company's revenue stream. That is, reduce the risks by not putting all the eggs in one basket. Kotak Mahindra, for instance, benefits from a stream of 'other income'. Consequently, its revenues are likely to be among the least volatile because it derives a significant income from its thriving group companies engaged in merchant banking, asset management, etc. Not all NBFCs are entering new areas of asset-based finance. Ashok Leyland Finance, for instance, plans to launch a finance portal that would be used to sell the products of the other financial intermediaries. Also it plans to use its skill in collection to derive a pure service income.

### 4.6 Critical parameters

In the emerging scene, the market for retail customers is where all action is. Each kind of intermediary brings to the market a unique advantage. Banks, of course, come with the advantage of being able to access resources at the lowest cost.

Financial institutions -- mainly ICICI -- access funds at a slightly higher cost, but unlike banks they are not burdened by higher operating costs. NBFCs have the biggest disadvantage -- highest cost of funds. The market for financial loans,
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however, is not determined solely by the cost of finance. Service -- which may be loosely described as the convenience offered to the customer in terms of speed, and product features -- plays a critical role in volume growth. In such a case, the profitability of operations will hinge on the ability to keep costs low as also the adaptability of the players.

4.7 NBFCs' strengths

NBFCs that succeed are likely to do so by making the most of their ability to contain risk, adapt to changes and tap demand in markets that are likely to be avoided by the bigger players. Risk containment is critical in the financial sector. For a category supposed to cater to the relatively riskier areas, top-rung NBFCs have proved the most adept at containing risks. The industrial slowdown of the late 1990s saw the NPAs increasing sharply in the portfolio of banks and financial institutions. Top-rung NBFCs which contained risk better were helped by two factors: Lower proportion of loans to corporates and a more effective recovery mechanism.

The large size of a corporate loan means that a single default has a bigger impact. NBFCs that lent mainly to the commercial vehicle segment were perhaps aided by the low proportion of loan to each customer vis-a-vis the total disbursement. A default would, therefore, have limited impact. The small size of the loans coupled with a better collection mechanism resulted in effective risk containment by the NBFCs. This was further aided by the greater flexibility of the NBFC structure. The flexibility also enables the NBFCs to act with despatch.
when they sense an opportunity. The other area where the NBFCs have an edge is the long experience in accessing fixed deposits which gives them access to a database. Lack of reliable data has often tripped big names in the corporate world.

**4.8 The churning within**

While the breakdown of the traditional barriers has led to every player trying to move into retail finance, there has been a major churning within the NBFC industry over the last few years. Triggered by a combination of quickly changing regulatory guidelines and the industrial slowdown, this has eliminated many weaker players. One of the most significant regulatory changes for the NBFCs in the mid-to-late-1990s was the level of unsecured public deposits that could be mobilised. After the liberalising deposit mobilisation rules in 1996, the Reserve Bank of India suddenly tightened the norms in 1998. This move, which came in the backdrop of industrial slowdown, adversely impacted the weaker NBFCs. Most stronger ones curtailed asset creation concurrently in the absence of safe investments. Following that phase, just a handful of NBFCs, with a balance-sheet size exceeding Rs. 1,000 crores, is left. Recent developments pertaining to expanding business opportunities have come from the handful of the big NBFCs that survived the turbulent late-1990s.

**4.9 A long haul ahead**

The top-rung NBFCs have equipped themselves for the fast-changing environment where all intermediaries are competing for retail finance. An outcome of the increased competition is that profit margins of the NBFCs will
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decline. Moreover, with a huge resources committed to such areas as insurance, which may take years to attain profitability, profit levels are unlikely to be as high as they were.

Last year, the share price of quite a few NBFCs rose sharply only to fall rapidly. Share prices are unlikely to witness any significant, sustained rise this year in the light of the low premium the stock market attaches to financial services, in general, and especially with the prospect of a decline in returns on investment in the near term.

Investors with exposures in such top-rung NBFCs as Sundaram Finance, Tata Finance or Kotak Mahindra may stay invested as there are possibilities of moderate gains in the medium term. However, fresh exposures may be avoided.

4.10 Size, the double-edged sword

WHILE the evolutionary process of the NBFCs has made them nimble, their main handicap is the small size of their balance-sheet. An NBFC's access to resources is limited vis-a-vis other financial intermediaries. Their small size and, thereby, the limited cushion available to them in times of difficulties pose a risk to their very survival. The smaller size also restricts their opportunities to grow. But size is simply not only about the balance-sheet and access to resources. As ICICI's acquisition of two NBFCs in the past has shown, size is also about the distribution reach of a financial intermediary. Of the various categories of intermediaries, financial institutions have the smallest reach. Their structure is not suitable for large-scale retail operations. However, by expanding their range of financial
operations through commercial banks and also through understanding with other entities, the NBFCs, ICICI in particular, have tried to improve their reach.

Commercial banks, especially the nationalised ones, have a major advantage in terms of reach. The presence of a large number of branches spread across the country gives them a platform to carry on a variety of businesses. However, this advantage is perhaps offset by the culture of the nationalised banks that prevent them from exploiting their advantages. The NBFCs have the reach, though it may largely be region-specific. But the presence of their reach in the retail market, coupled with the powerful brand name that NBFCs such as Sundaram Finance and Tata Finance have, make for a good platform to launch new products. Size, when looked at in terms of the reach, is something that the top-rung NBFCs have.

Size, looked at from the standpoint of resources, is where NBFCs may face a problem. Already the regulations governing seed capital for the NBFCs wanting to enter insurance may have upset the calculations of even some of the stronger firms. Size, or the lack of it, presents a big threat for the NBFCs. It is the lack of size that appears to have acted as a catalyst in the recent development where four smaller NBFCs -- Apple Finance, Apple Credit, Srei International and Alpic Finance -- have announced that they will explore the option of a merger. The need to attain size may trigger more such developments in the future.

Both NBFC as well as mutual funds mobilize funds from investors to the corporate world. The emphasis of our analysis is on the comparative roles played by both NBFC as well as mutual funds as a mobiliers of funds. The number of
applications received by RBI for grant of certificate of registration CoR) as NBFCs till end-March 2006 was 38,244, out of which, 13,141 applications (net of cancellation), including 423 applications (net of cancellation) of public deposit accepting companies (NBFCs-D), were authorised to accept/hold public deposits. At end-June 2006, the total number of NBFCs registered with RBI was 13,014 (net of cancellation). With the exit of many NBFCs from the public deposits taking business, the number of NBFCs-D has steadily declined. As at end June 2006, NBFCs-D were 428. The number of Residuary Non-Banking Financial Companies (RNBFCs) remained unchanged at 3 at end-March 2006. During 2005-06, assets and public deposits of reporting NBFCs increased by Rs. 2,394 crore and Rs.2,316 crore, respectively. Net owned funds of NBFCs increased by Rs.562 crore during 2005-06. despite a decline in the number of reporting NBFCs. Deposits of reporting NBFCs at end-March 2006 were marginally lower at 1.1 per cent of aggregate deposits of SCBs compared to 1.2 per cent at end-March 2005. Total assets/liabilities of NBFCs (excluding RNBFCs) at end-March 2006 were Rs.35,561 crore, down marginally by 1.2 per cent from Rs.36,003 crore at end-March 2005. Such assets/liabilities had increased by 9.9 per cent during 2004-05. There were major changes in the composition of assets and liabilities as well in 2005-06. On the liability side, paid-up capital as well as public deposits of these companies declined by 11.7 per cent and 32.1 per cent, respectively, during 2005-06. On the asset side, Bill Discount business in 2005-06 registered a substantial decline of 90.4 per cent compared to an increase of 7.8 per cent during 2004-05; their SLR investment declined by 41.3 per cent during
2005-06 compared to an increase of 31.0 per cent during 2004-05 and decline of loans and advances was 27.8 per cent compared to an increase of 3.1 per cent in the previous year.

In 2005-06, a significant decline in fee based income (61.2 per cent) and only a marginal increase in fund-based income (5.3 per cent) resulted in stagnancy of the overall income of NBFCs (marginal decline of 0.1 per cent) compared to an increase in overall income of 5.8 per cent in 2004-05. Concomitantly, expenditure registered an increase of 13.0 per cent in 2005-06 mainly because of an increase of 31.6 per cent in operating expenses. Net profit after tax of NBFCs in 2005-06 was only Rs. 152 crore compared to Rs. 572 crore in 2004-05, representing a decline of 73.4 per cent compared to an increase of 7.7 per cent in 2004-05. Gross NPAs as a proportion of gross advances as well as net NPAs as a proportion of net advances of reporting NBFCs (excluding RNBFCs, Mutual Benefit Companies (MBCs) and Miscellaneous Non-Banking Companies (MNBCs)) at end-March 2006 declined sharply to 2.4 per cent and 0.4 per cent, respectively, compared with 8.2 per cent and 2.4 per cent, respectively at end-March 2005. The number of NBFCs (excluding RNBFCs, MBCs and MNBCs) with less than the minimum regulatory CRAR of 12.0 per cent declined from 64 at end-March 2005 to 19 at end-March 2006. The number of NBFCs with CRAR more than 30 per cent also declined from 280 at end-March 2005 to 252 at end-March 2006.

A robust banking and financial sector is critical for activating the economy and facilitating higher economic growth. Financial intermediaries like NBFCs
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have a definite and very important role in the financial sector, particularly in a developing economy like ours. They are a vital link in the system. After the proliferation phase of 1980s and early 90s, the NBFCs witnessed consolidation and now the number of NBFCs eligible to accept deposits is around 600, down from 40000 in early 1990s. The number of asset financing NBFCs would be even lower, around 350, the rest are investment and loan companies. Almost 90% of the asset financing NBFCs are engaged in financing transportation equipments and the balance are in financing equipments for infrastructure projects. Therefore, the role of non-banking sector in both manufacturing and services sector is significant and they play the role of an intermediary by facilitating the flow of credit to end consumers particularly in transportation, SMEs and other unorganized sectors. NBFCs due to their inherent strengths in the areas of fast and easy access to market information for credit appraisal, a well-trained collection machinery, close monitoring of individual borrowers & personalized attention to each client as well as minimum overhead costs, are in a better position to cater to these segments.

Now, unlike in the past, NBFCs are very well regulated and supervised. Just like banks they are required to be registered with RBI, follow stringent prudential norms prescribed by RBI in the matters of capital adequacy, credit/investment norms, asset-liability management, income recognition, accounting standards, asset classification, provisioning for NPA and several disclosure requirements. Besides this, RBI also supervises the functioning of NBFCs by conducting annual on-site audits through its officials. Such a rigorous
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regulatory framework ensures that NBFCs function properly and follow all the guidelines of RBI. Thus in all respect the monitoring of NBFCs is similar to or in some case more stringent than banks. The role of NBFCs in creation of productive national assets can hardly be undermined. This is more than evident from the fact that most of the developed economies in the world have relied heavily on lease finance route in their developmental process, e.g., lease penetration for asset creation in the US is as high as 30% as against 3-4% in India. A conducive and enabling environment has been created for the NBFC industry globally, which has helped it grow and become an essential part of the financial sector for accelerated economic growth of the countries. This is not the case in our country. It is, therefore, obvious that the development process of the Indian economy shall have to include NBFCs as one of its major constituents with a very significant role to play. NBFCs, as an entity, play a very useful role in channelising funds towards acquisition of commercial vehicles and consequently, aid in the development of the road transport industry. Needless to mention, the road transport sector accounts for nearly 70% of goods movement and 80% of passenger movement across the length and breadth of the country and the role of NBFCs in the growth and development of this sector has been historically acknowledged by several committees set up by the Government and RBI, over the years. In fact, RBI's latest report titled "Report on trends on progress of banking in India 2002-2003" observes: "Notwithstanding their diversity, NBFCs are characterised by their ability to provide niche financial services in the Indian economy. Because of their relative organisational flexibility leading to a better
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response mechanism, they are often able to provide tailor-made services relatively faster than banks and financial institutions. This enables them to build up a clientele that ranges from small borrowers to established corporates. While NBFCs have often been leaders in financial innovations, which are capable of enhancing the functional efficiency of the financial system, instances of unsustainability, often on account of high rates of interest on their deposits and periodic bankruptcies, underscore the need for reinforcing their financial viability.” The report further adds, “The regulatory challenge is, thus, to design a supervisory framework that is able to ensure financial stability without dampening the very spirit of manoeuvrability and innovativeness that sustains the sector.”

4.11 NBFC Allowed to Operate Mutual funds

Non-banking financial companies (NBFCs) play a critical role as an instrument of credit delivery, particularly in the small scale and retail sectors. The Reserve Bank has been continuously emphasising on developing NBFCs into financially strong entities with skill levels necessary to cater to the needs of the common people. In order to strengthen the NBFC sector by diversifying their area of business, it is proposed to allow NBFCs: to issue co-branded credit cards with banks without risk sharing; and to market and distribute mutual fund products as agents of mutual funds. In order to strengthen the NBFC sector by allowing diversification in their area of business, it has been decided to allow NBFCs, selectively, to market and distribute mutual fund products as agents of mutual funds, with prior approval of Reserve Bank, for an initial period of two years and
a review thereafter. NBFCs fulfilling the following minimum requirements are eligible to apply:

i) Minimum net owned fund of Rs.100 crore;

ii) The company should have made net profit as per last two years audited balance sheet;

iii) The percentage of net NPAs to net advances of the NBFC as per the last audited balance sheet should not be more than 3%;

iv) The non-deposit-taking NBFCs (NBFCs-ND) should have CRAR of 10% and deposit-taking NBFCs (NBFCs-D) should have CRAR of 12% or 15%, as applicable to the company.

In addition, the NBFCs would be required to adhere to the following stipulations:

i) Operational Aspects

a) The NBFC should comply with the SEBI guidelines/regulations, including their code of conduct, for distribution of mutual fund products.

b) The company should not adopt any restrictive practice of forcing its customers to go in for a particular mutual fund product sponsored by it. The customers should be allowed to exercise their own choice.

c) The participation by a company's customer in mutual fund products is purely on a voluntary basis and this information should be stated in all publicity material distributed by the company in a prominent way. There should be no 'linkage'
either direct or indirect between the provisions of financial services offered by the company to its customers and distribution of the mutual fund products.

d) The company should only act as an agent of the customers, forwarding the investor's applications for purchase/sale of MF units together with the payment instruments, to the Mutual Fund/the Registrars/the transfer agents. The purchase of units should be at the customers' risk and without the company guaranteeing any assured return.

e) The company should neither acquire units of mutual funds from the secondary market for sale to customers, nor should it buy back units of mutual funds from their customers.

f) In case the company is holding custody of MF units on behalf of customers, it should ensure that its own investments and the investments belonging to its customers are kept distinct from each other.

ii) Other Aspects

a) The risks, if any, involved in mutual fund agency business should not get transferred to the business of the NBFC.

b) The NBFC should have put in place guidelines on fair practices code;

c) The company should be adhering to Know Your Customer Guidelines and provisions of prevention of Money Laundering Act;

d) The company must be complying with Non-Banking Financial Companies Acceptance of Public Deposits ( Reserve Bank) Directions. 1998 and/or Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions. 1998
and any other instructions / provisions of RBI Act, 1934 to the extent applicable to the NBFC concerned;
e) The NBFC should comply with other terms and conditions as the Bank may specify in this behalf from time to time.