CHAPTER - III

NON-BANKING FINANCIAL COMPANIES:
CONCEPTUAL FRAMEWORK
CHAPTER - III

Format financial sector comprises of Reserve Bank of India, schedule banks, financial intermediaries, capital markets and money markets. The Reserve Bank of India is a central place of financial system in India, which is the original source of security of the economy and performs the functions of providing finance and refinancing, and regulate the banks and financial institutions for protecting the interest of the public, and for monetary stability, strengthening the institutional structure and promote savings and investment of the economy. The Reserve Bank of India controls the formal financial structure at institutional level and market level as shown in the figure below:

Structure of Formal Financial Sector

- Reserve Bank of India
  - Institutional level
    - Commercial Bank
    - Cooperative Banks
    - Development Bank
    - Insurance Companies
    - Non-Banking Financial Companies
  - Market level
    - Stock Market
    - New Issue Market
    - Money Market
    - Foreign Exchange Market
    - Postal Savings
    - Social Securities Institutions
    - Other Specialized Institutions
At the institutional level are the commercial bank, co-operative bank, development bank and financial intermediaries like insurance campaign, postal saving and provident fund, non-banking financial companies and other specialised institutions like unit trust of India, mutual fund, housing finance institutions, etc. At the market level are the capital markets, i.e., stock market, new issue market, money market and foreign exchange market.

Of late, in the developing countries, the non-banking financial companies has constituted the significant element in the Indian financial systems, more specially as the financial intermediaries group. The non-banking financial companies carveout its marketing for the credit need of both wholesale and retail customers and strengthened its base over the period of time by mobilising national savings and international savings. The Reserve Bank of India controls the deposits, acceptance activities of financial, miscellaneous residuary non-banking companies. For instance non-banking finance companies are regulated by the Reserve Bank of India under non-banking financial companies (Reserve Bank) directions 1977. The miscellaneous companies are governed by the miscellaneous non-banking companies (Reserve Bank) direction 1997. The residuary non-banking companies non-banking companies (Reserve Bank) direction 1987. The Reserve Bank of India regulates the activities of non-banking financial companies under the companies (Acceptance of Deposits) Rules 1995. Keeping in view the growing importance of finance companies, the banking laws (Miscellaneous provisions) Act. 1963 was introduced to regulate the non-banking financial companies.
To enable the regulatory authorities to frame suitable policy measure, several committees were appointed from time to time, to conduct an in depth study on these institutions and make suitable recommendations for their healthier growth within a given regulatory framework. These suggestions/recommendations made on the contemporary financial scenario, by them, formed the basis for the formulation of policy measures, by the regulatory authorities/Reserve Bank of India. The committees which deserve specific mention in this regard are: Bhabatos Datta Study Group (1971); James Raj study Group (1975); Chakravarty Committee (1985); Voghul Committee on Financial System (1991); Narasimham Committee (1991); Shah Committee (1992); and Khanna Committee (1996).

A BRIEF REVIEW OF THE RECOMMENDATION OF THE COMMITTEES

(a) Bhabatosh Datta Study Group (1971)

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

The Group recommended that, keeping in view difficulties in regulating a very large number of institutions, regulation should aim at reducing the number of entities to be regulated, if possible, by inducing them to form themselves into corporate bodies. For the purpose of regulation, NBFIs may be classified into two categories: **approved** and **non-approved**. The Group also suggested that the designation of 'approved' institutions should be bestowed only on corporate bodies and these should be eligible for refinance from the banking system. Their lending operations should also be covered under the credit guarantee scheme and, at an appropriate time, deposit insurance should also be extended to the deposit insurance corporation.

The Group opined that the regulatory approach needed to be focused to the special characteristics of the different types of NBFIs.

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

(i) Hire-Purchase Finance Institutions (HPFI)

(ii) Investment Companies

(iii) Chit funds/kuries

(iv) Nidhis or Mutual Benefit Funds

(v) Finance Corporations
The group recommended that the HPFIs should be required to indicate the true rate of interest charged along with the flat rate which, in practice, was the rate at which HPFIs charged interest. With a view to encourage healthier and larger-sized units, the group recommended that permissible debt equity ratio should increase directly with the size of capital of the unit and the liquidity ratio should be higher for smaller units and lower for bigger units, and in any case, not less than 10% for any unit. Further, the group recommended that commercial banks may consider entering this field and for enabling them to promote hire-purchase subsidiaries, suitable amendments may be considered in the Banking Regulation Act. It also recommended that interest rate ceiling on hire-purchase charges be prescribed at a flat rate of 10% per annum, for new vehicles, and 12% for old ones.

They also recommended that the government could consider offering to genuine investment companies relief from inter-corporate tax, provided that the companies were prepared to have the same obligations as Unit Trust of India (UTI). The group also laid down the criteria for identifying a genuine investment company and submitted that while the number of genuine investment companies was small and as such, separate legislation on the lines of the investment companies Act of the USA, with the object of protecting the interests of the members of these companies. They also suggested that no industrial or trading company should be permitted to hold any shares in investment companies and that the Government may consider appointing its nominee on the board of directors of genuine investment companies.
As regards the working of Chit Funds in India, the group observed that although many among these institutions frequently resort to unfair methods, it may not be advisable to prohibit them because they were meeting the need of a particular sector of the economy and prohibiting their operations would leave a credit gap. The group recommended that, instead, these entities should be suitably regulated. They suggested that the ultimate solution to the problem would be that the commercial banks need to introduce schemes similar to chit funds, but without the disadvantages associated with them and, in the meantime, the state government could consider starting Chit Funds. The group also recommended that offence under the Indian penal code relating to lotteries may be made a cognizable offence so that prize chits could be prohibited.

While reviewing the operations of Nidhis or Mutual Benefit Funds, the group observed that this category of institutions was performing a useful role and their growth should be encouraged. They also pointed to other Nidhis, which may be licensed by the RBI under such norms as the minimum amount of paid-up capital reserves, minimum level of liquidity ratio, etc. Periodical inspections of these companies should also be conducted so as to make the regulation effective. The group also recommended classification of these institutions into ‘approved’ and ‘non-approved’ categories with concomitant extension of beneficial treatment to the approved category.

The group observed that finance corporations, which were para-banking institutions, depended mainly on public deposits as their source of fund. The group recommended that regulating this
category of institutions was necessary for protecting depositors interest as also for ensuring that advances were not made for undesirable purposes. A ceiling on interest rate on deposits at a rate higher than that for commercial banks may also be prescribed. These corporations should be subjected to periodical inspections on sample basis. The group also recommended that these units be classified into 'approved' and 'non-approved' categories.

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

(b) **James Raj Study Group (1975)**

In the year 1974, another Study Group was constituted under the chairmanship of Shri James S. Raj for the purpose of reviewing the provisions of the RBI Act relating to NBFCs, the directions issued thereunder, and for examining the adequacy thereof, in the light of the recommendations of the Banking Commission. The regulatory framework suggested by this study group aimed at keeping the magnitude of deposits accepted by NBFCs within reasonable limits and ensuring that they subserved the objectives of monetary and credit policy and safeguarded to the extent possible, the interest of depositors. It recommended that NBFCs should be subjected to the same type of controls, as banks are under the Banking Regulation Act, 1949. The Group suggested that for the purpose of ensuring effective regulation, it is desirable to enact a separate comprehensive legislation in place of chapter of
the RBI Act. The group considered RBI to be the appropriate authority for regulating the activities of NBFCs.

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

The group prescribed that every NBFC, other than a Nidhi, commencing business after the proposed regulatory measures, brought out into force, should have a paid-up capital of not less than Rs. 5 lacs (Rs. 2 lacs for companies connecting business only at one place with a population of less then five lacs). For existing companies, suitable regulations were prescribed in relation to their net worth. The group recommended that all NBFCs should be required to transfer to the reserve fund, a sum equivalent to not
less than 20% of their annual profits before declaring any dividend, as long as the amount in the reserve funds was less than the paid-up capital of the company. They also prescribed that all NBFCs should maintain liquid assets equivalent to not less than 10% of their deposits.

The Group further recommended that loans and advances by NBFCs to their directors and to firms in which they were interested as partners, managers, etc., should be prohibited. As regards the period of deposits, the Group suggested that the minimum period should be retained at six months and the maximum period should be fixed at three years in the case of hire purchase, equipment leasing, investment, loan and miscellaneous financial companies and five years in the case of HFCs. In the case of Nidhis, no such stipulation needed to be laid down.

The Group recommended that prize chit/benefit/savings schemes which benefit primarily the promoters and do not serve any social purpose but were, in fact, detrimental to the public interest, should be totally banned. The group strongly recommended uniform legislation throughout the country and suggested a Model Bill (as recommended by Bhabatosh Datta Group) to be enacted as a Central Act by the Parliament, as that would ensure uniformity in the provisions applicable to Chit Funds throughout the country and would also prevent Chit Fund institutions from taking advantage either of the absence of law governing Chit Funds in any state or exploit the benefit of any loans or relaxation in any state law by extending their activities to such a state. Further, it was recommended that the administration of the legislation should be
left to State Government which may seek the advice of RBI on policy matters. It also recommended that Chit Fund institutions may be prohibited from accepting deposits, and advance payment of subscriptions or deposits from the prized subscribers by way of security toward payment of their future installments.

As regards the administrative arrangements, the study group recommended that the Department of Non-Banking Companies (DNBC) of RBI should work in close liaison with the Department of Company Affairs and that the DNBC should be strengthened and reorganised so as to ensure effective implementation of the purposed regulatory measures. Decentralisation of the functions of DNBC was also suggested.

(c) Chakrabarty Committee (1985)

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

(d) Voghul Committee (1987)

The working group appointed to examine the possibilities of enlarging the scope of the money market and to recommend specific measures for evolving money market instruments made specific recommendations for liberalising the money market and for ensuring its healthier growth. The Group recommended, *interalia*, that the banks and private NBFCs should be encouraged to provide factoring services. Institutions and other units such as companies, trust, etc., which would satisfactorily demonstrate to RBI that they had a resource surplus of a monthly average of at least Rs. 5 crore per annum, should be allowed to participate in the bill discount market. These recommendation of the working group extended the scope of the activities of the NBFCs.

(e) Narasimham Committee (1991)

The committee has observed that NBFCs have helped to broaden the market and provided the saver and investor with a variety of options. The committee has made certain valuable recommendations for the healthy growth of some of the NBFCs. The committee was of the view that having regard to the important and growing role of leasing and hire-purchase institutions in the financial intermediation process and their recourse to borrowing, minimum capital requirements should be stipulated in addition to the existing requirements relating to gearing liquidity ratios.
Prudential norms and guidelines in respects 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 the prudential norms specially tailored to the conduct of their business.

The committee believed that to create conditions for sound and orderly growth of the venture capital business, the present guidelines needed to be reviewed and amended to widen the scope of eligibility criteria and impart a measure of flexibility to the operations of venture capital companies. Further, the committee suggested that well managed NBFIs like hire-purchase and leasing companies, as well as merchant banks, be permitted to operate in the money market. Regulatory framework to govern these institutions should be specified. Such framework should include norms relating to capital adequacy, debt equity ratio, credit concentration ratio, income recognition, provision against doubtful debts, adherence to sound accounting practices, uniform disclosure requirements and asset 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.
The process of evolution of the regulatory framework of NBFCs has, to a great extent, been the result of the recommendations of these committees/Groups. The foregoing analysis of the recommendations of various committees reveals that all of them recognised the importance of the role of NBFCs and emphasised the need for a well-established and healthy non-banking financial sector. Some of the recommendations of these committees hold good even in the present context. At the same time, appropriate regulations are required to be incorporated in the existing regulatory framework in view of the changed financial sector scenario. The recommendations of the present, working group aim at aligning the regulatory system with the requirements of the present time.

(f) Shah Committee (1992)

The need for bringing NBFCs under the regulatory framework arises only for ensuring their healthy growth but also for improving the efficacy of the credit and monetary policy as well as for inculcating a healthy financial discipline among both providers and users of credit.

The group recommends dismantling of the category classification of NBFCs and application of uniform regulation for all NBFCs. The Group recognises the need for effective regulation of all deposit taking entities, howsoever small they may be. However, due to the large number of operators in this field, and the limited size of administrative infrastructure, the group advocates that regulatory attention be confined to those large size companies
which accounts for a lion's share of total non-banking financial companies' deposits. Registered companies will be allowed to accept public deposits up to a multiple of their net owned funds. Unregistered companies with net owned funds of less than Rs. 50 lacs will be allowed to accept public deposits at a lower level, i.e. in accordance with provisions of section 58 A of the Companies Act, 1956.

The Group favours prescription of entry norms for all new NBFCs such as (a) minimum net owned funds of Rs. 50 lacs at the time of commencement; (b) registration with the regulators authority; (c) restriction on deposit acceptance activity at the level permitted to unregistered companies in first two full financial years of operations and (d) permission for deposit acceptance at par with the existing registered companies after completion of this period, on the basis of track record, quality of management, and methods of operation, the group is of the opinion that the function of registration and regulation be undertaken by the proposed High Powered Supervisory Board. The Group recommends that the regulatory authority, in coordination with the representatives of NBFCs, Self Regulating Organisations, and the Institute of Chartered Accountant, may complete the exercise of computing risk weights and credit conversion factors by March 31, 1994; and that capital adequacy ratio at the rate of 8% of the risk weighted assets and off-balance sheet items be introduced by March 31, 1995 until the time, capital adequacy framework is introduced. The existing limits on deposit acceptance may be a continued subject, however, to an overall debt equity ratio of 15:1.

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The group recommends placing restrictions on the portfolio management activities of these companies.

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

The group also favours that NBFCs be allowed to accept deposits for periods ranging between 12 to 84 months as against the existing range of 24 to 120 months.

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

The group recommends making credit rating compulsory for all registered companies, not in the immediate future but after a period of five years.

The group is in favour of prescription of norms regarding income recognition, disclosed or transparency of accounts,
provision for bad and doubtful debts, etc. A committee may be constituted for formulating these norms. Suitable reporting formats may also be devised so that effective supervision may be undertaken by the regulatory authority.

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

The regulatory authority should be empowered to suspend/cancel registration of these companies and even move for winding up where it so deem necessary.

As regards union corporated entities, apart from the existing restriction on the number of depositors, the group recommends prescription of ceiling on the quantum of deposits they can accept. A Standing Advisory Committee may be constituted for reviewing regulatory requirements for these bodies.

The regulatory authority should publish the list of all NBFCs periodically.

The group recommends that the regulatory authority and the self-regulating organisations may initiate a public awareness programme for educating the depositors about the risks associated in placing deposits with various kinds of non-banking financial companies.
Khanna Committee (1996)

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

--- NBFCs carry on their business in conformity with the overall framework of the monetary and credit policy; and

--- They function on sound, solvent and healthy lines so that they are in a position to meet their liabilities to the depositors and other creditors as and when the claims accrue.

The existing statutory powers vested in RBI Act 1934 should be enhanced to effectively equip it for better achieving the macro level goals of ensuring healthy and orderly functioning and growth of corporate NBFCs with special reference to (a) fulfillment of entry point conditionalities for incorporation of new entities such as track record and, minimum capital, (b) compulsory registration, (c) investment in approved securities to the extent prescribed, and (d) creation of reserve fund, etc. The number of reporting companies being large, the supervisory attention and focus should be directed in a comprehensive manner only to NBFCs having Net Owned Funds (NOF) of Rs. 100 lakh and above.

For better and effective supervision over NBFCs, the existing jurisdiction of Regional Offices of Department of Supervision (DOS) should undergo change.
For exercising prudential supervision and for focussing supervisory attention of varying intensity, the RBI should stratify the NBFCs as under

i) Unregistered NBFCs

ii) Registered NBFCs with asset size upto Rs. 25 crore, above Rs. 25 crore but less than Rs. 500 crore, and Rs. 500 crore and above.

In view of the large number of entities falling under the regulatory jurisdiction of RBI, 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 or otherwise.

As a part of the off-site surveillance strategy, the registered companies, apart from submitting prescribed annual return and half-yearly return on prudential norms, should submit an annual statement of operational data with various ratios. The data submitted should be subjected to extensive analysis including entity study, peer group comparison of solvency, soundness, etc. In order to achieve the objective and enhance the effectiveness of the prescribed statutory returns, some suggested procedural refinements should be introduced. Prudential returns may be required to be submitted in floppy media along with hard copies duly authenticated.

A supervisory rating system for the registered NBFCs should be introduced. The supervisory rating system may be designed on the basis of different levels of (a) regulatory/supervisory compliance
(b) capital adequacy and (c) rating assigned by the credit rating agencies. The rating process may assign weightage point for each parameter and arrive at the supervisory rating. Based on the rating, the NBFCs could then be placed in three different supervisory ‘Watch-lists’ of LOW, MEDIUM and HIGH RISKS. The rating assigned to NBFCs should primarily be the tool for triggering on-site inspections at various intervals.

The periodicity for conducting on-site inspection of the registered NBFCs should be modulated based on the positioning of the NBFCs in the Supervisory ‘watch-list’. Those positioned in the watch list of LOW RISK should be subjected to the on-site inspection generally once in three years, while those under the watch-list of MEDIUM RISK should be subjected to on-site inspections once in every two years and one year. The companies which fall under HIGH RISK category should be subjected to immediate on-site inspection.

While objectives of on-site inspection should consist of ensuring regulatory compliance, evaluation of financial soundness/solvency, appraisal of management and identification of areas requiring corrective action, the process should cover reviewing of compliance of regulations and supervisory guidelines, appraisal of assets quality, analysts of key financial indicators and assessment of policies, system and procedures.

On the basis of the findings of on-site inspection, a composite supervisory rating may be assigned to the registered NBFCs.
It should be made obligatory on the part of the auditors to report to the RBI immediately if during the course of audit, the auditor learns of facts which (a) might warrant qualification or withholding of certificate of audit, (b) endanger the existence of the entities audited, and (c) indicate that the NBFC has severely infringed the regulatory provisions/supervisory guidelines.

In case of large size NBFCs, where serious violation of regulation deficiencies have been observed, immediate process of dialogue should be initiated with the chairman/CEO's of the concerned NBFCs for remedial action.

The RBI should resort to extensive computerisation of its activities with special reference to analysis of statutory returns and statements received as a part of the supervisory exercise. Accordingly, it should train adequate number of its personnel of the usage of computers for the purpose. Some of the NBFCs are undertaking through subsidiary units, allied financial services viz., stock banking, investment banking, asset management, portfolio management, merchant banking, etc. The RBI may examine as to what extent its surveillance system should scan through the financial parameters of the subsidiaries of the NBFCs.

Some of the non-banking non-financial companies are undertaking more and more financial activities including acceptance of deposits, investment operations, leasing, etc., to a sizeable extent. Those should train adequate number of their personnel on the usage of computers for the purpose. Some of the NBFCs are undertaking through subsidiary units, allied financial serviced,
viz., stock banking, investment banking, asset management, portfolio managements, merchant banking, etc. The RBI may examine as to what extent its surveillance system should scan through the financial parameters of the subsidiaries of the NBFCs.

Some of the non-banking non-financial companies are also undertaking more and more financial activities including acceptance of deposits, investment separations, leasing, etc., to a sizeable extent. The adequacy or otherwise of the existing regular control may be examined with a view to guarding against the possibility of misuse of the financial system by such companies.

Some of the plantation and animal husbandry companies not falling under the regulatory control of either Department of Company Affairs (DCA) or the RBI have been soliciting money from the public repayable in kind after a long period stretching up to 25 years. There is a need to identify an appropriate authority to regulate the activities of these companies in so far as their mobilisation of public deposit is concerned.

Although RBI has introduced a comprehensive system of ensuring financial discipline through prudential norms, the NBFCs may continue to follow the conventional method of accounting in so far as preparation of balance sheet/profit and loss account is concerned. The RBI may explore whether the balance sheet, etc. could be done by the NBFCs, in tune with prudential norms/guidelines so as to have better transparency of their financial position in the large public interest.
The NBFCs have been registering a fast growth in terms of volume and nature of activities which are akin to banking activities. Keeping in view the long-term objectives of ensuring sound and healthy growth of NBFCs, there is a need for enactment of a separate comprehensive legislation in place of RBI Act 1934, covering the entire gamut of operations of the NBFCs.

**SALIENT FEATURES**

The Narasimham Committee report of 1991 could only emphasise the regulatory framework of financial sector in a diversified, efficient, and competitive financial system with improving allocated efficiency of a variable savings, increasing the returns in investment and promoting an acceleration growth of the real sector of the Indian economy. To follow up Narasimham Committee, the Shah Committee suggested a comprehensive a regulatory framework of the non-banking financial companies which recommended certain terms for protections of deposits interest making, monetary and credit policy more effective, interacting the regulatory framework and encouraging new financial services and products. Endorsing in principles of the Shah Committee framework of regulation of non-banking financial companies, the Reserve Bank of India had implemented a number of its recommendation and incorporated them in the Reserve Bank of India's deductions to regulate and supervise the working and operative of such companies. Most specifically the recommendation of Shah Committee was to:

- abolition of category wise classification of finance companies;
-- application of uniform regulation for all finance companies;
-- focussing regulatory attention on large size companies;
-- compulsory registration of all deposit taking companies providing a cut off point and emphasizing the regulation relating to the assets side;
-- setting up capital adequacy standards and prudential norms;
-- prescription of provision for bad and doubtful debts;
-- compulsory annual credit rating; and
-- auditors to discharge greater responsibilities in auditing regulatory compliance;

The guidelines issued to finance companies effective from April 12, 1993 includes:

(a) a requirement for financial services companies including residuary non-banking companies with net own fund for Rs. 50 lakhs and over, to register with RBI;

(b) a requirement for hire-purchase finance and equipment leading companies to maintain liquid assets of 10% of certain deposits, at least half of which will have to be maintained in the form of union/state government, guaranteed bond;

(c) The reduction of the minimum terms for deposits of all financial companies to 10 months from 24 months; and

(d) The reduction of the maximum term for deposits of residuary non-banking companies from 120 months to 84 months.
Later on, to monitor the non-banking financial companies, RBI amended its rules in 1997. On the basis of recommendation of the working group a set-up was established for supervising framework of non-banking financial companies under the chairmanship of P.R. Khana. The Khana Group recommended a stratified approach to supervision of NBFCs related to the size of the operations and assets, adoption of different approaches with varying emphases on site inspections and off site monitoring for different segments and introduction of super vision relating system for companies at the top and, with a comprehensive supervisory model based on CAMELS (Capital Adequacy, Asset Quality Management, Earnings, Liquidity and Systems). In fact, the first meaningful attempt that was made by RBI in 1963 when the Banking Law (Miscellaneous Provisions) Act, 1963 was introduced to incorporate a new chapter in the RBI Act, 1934 to regulate the non-banking Financial institutions. Later, on the basis of suggestions made by various study groups for strengthening the regulatory attention, the RBI (Amendment) Act, 1997 enacted in parliament got the assent of the president on 28th March 1997. While the provisions of the Act, other than section 9, shall be deemed to have come into force on 9.1.1997, section 9 of the Act came into force on 1.4.1997. Further, amendments to the RBI Act, 1934 were made regulation of non-banking institutions receiving deposits, largely governed by the Act containing provisions in sections 45H, 45I, 45K, 45J, 45M, 45MA, 45N, 45NA and 45Q, etc. Such regulatory framework broadly empowered the RBI to regulate or prohibit issue of prospectus of advertisement soliciting deposits of money, to
collect information from non-banking institutions regarding their deposits, and give directions in respect of any matters relating to receipt of deposits including rates of interest payable on such deposits and the periods for deposits and to cause an inspection for obtention of unfurnished information and for verification of furnished information. The most significant regulatory empowerment of RBI was the RBI (amendment) Act 1997 and revised set of guidelines on January 2, 1998.

The special features of the RBI (Amendment) Act, 1997 are as follows:

--- Non-banking financial company has been clearly defined. Institutions carrying on agricultural or industrial activity as their principal business are excluded from the definition.

--- The minimum net owned fund of Rs. 25 lakh and RBI registration have been prescribed as entry point norms.

--- The existing NBFCs have also to apply for registration by July 8, 1997. Their business can, however, be carried on unless registration is refused.

--- NBFCs with net owned fund of less than Rs. 25 lakh have been given three years to reach that level; the three-year periods extendable by three more years at the Reserve Bank’s discretion.

--- The Reserve Bank has powers to cancel registration but NBFCs have the right to appeal to the Central Government.
-- NBFCs have to maintain liquid assets in specified securities on a daily basis; liquid assets would have to be maintained as per the current norm of 5% and 10% of their deposits outstanding as at the end of the last working day of the second previous quarter depending on the category and regulatory status of NBFCs. The Reserve Bank would penalise NBFCs for any shortfall. The percentages have since been increased in a phased manner to 10% and 15% to be effective from January 1 and April 1, 1998, respectively.

-- NBFCs have to create reserve fund and transfer not less than 20% of their net profit to the reserve fund every year.

-- The Reserve Bank can direct NBFCs on issues relating to disclosures, prudential norms, credit, investment, etc.

-- For violation of any provisions of the RBI Act, the Reserve Bank not only can prohibit NBFCs from accepting deposits but also ask them not to sell, transfer, etc., their properties and assets without its prior permission for a period of six months.

-- The Reserve Bank can even file a winding up petition against a NBFC if it fails to pay its debt or is disqualified from carrying on business.

-- The company law board can adjudicate and pass orders in case of non-repayment of deposits/interest by NBFCs.

-- Nomination facility is made available to depositors of non-banking institutions.
-- Unincorporated bodies engaged in financial activity cannot accept deposits from April 1, 1997. They can, however, accept deposits from their relatives and borrow from specified institutions. Existing deposits have to be repaid within three years from April 1, 1997 extendable by one more year on merit.

-- Unincorporated bodies cannot issue advertisements for soliciting deposits.

-- NBFCs can be penalised for carrying on business without registration certificate and non-compliance of directions/orders of the Reserve Bank and Company Law Board. Similarly, unincorporated bodies can also be subjected to pecuniary penalty and imprisonment for committing breach of the provisions of the Act.

The revised set up guidelines announced by RBI on January 2, 1998 for protection of depositors interest and more effective supervision at the centre of new policy are summarised as follows:

-- NBFCs with rating below “A” not allowed to accept public deposits;

-- Quantum of public deposits that can be accepted is linked to credit rating of the NBFCs;

-- Wherever the norms are not met, the NBFCs have been ordered to make immediate repayment of deposits;

-- Interest rate on deposits capped at 16% p.a. and the brokerage at 2% maximum.
-- Capital adequacy stipulated at 12% and SLR stipulated at 15%, both to be reached within two years;

-- Exposure by a NBFC in the areas of credit investment to each entity and group restricted to 25% and 40% respectively.

-- Loans against the security of NBFCs own shares banned; and

-- NBFCs having public deposits must file half-year returns.

Later on RBI has also relaxed above revised set of guidelines, which are summarised as under as on January 31, 1998 and on May 12, 1998.

-- Companies with minimum investment grade [viz., A minus, BBB, BBB minus can accept deposits [as against the earlier stipulation of companies reted below A cannot accept public deposits];

-- The time frame for regularisation of excess deposits to be available till December 31st 2000 [as against the earlier time frame of December 31st 1998];

-- Unrated companies can renew maturing deposits [as against the earlier stipulation that unrated companies cannot mobilise public deposits at all];

-- Net Owned Funds to include preference share also [as against the earlier stipulation that they are not to be included];
-- Resultant excess deposit in case of down grading of rating has to be repaid or regulated within a period of 12 months;

-- Ceiling on public deposits in the case of equipment leasing and hire-purchase companies rated as minimum investment grade is restricted to half the net owned funds;

-- Companies with AAA rating can now raise deposits upto FOUR TIMES the NOF [as compared with THREE TIMES earlier];

-- Companies with AA rating can go up to 2.5 times [as against 2 times earlier];

-- Companies with A rating can go up to 1.5 times [as against 1 time earlier].

At the end it may be pointed out that activities undertaken by NBFCs are based on Funds Invested, or Fees collected; hence the activity of NBFCs can be classified into two categories:

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