CHAPTER - 3

SOURCES AND USES OF FUNDS
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3.1 SOURCES OF FUNDS

Capital

Each of the partners contributes an equal amount of capital, and shares profits and losses equally. Capital is the main source of funds for Private Finance Corporations.

Capital, invested at the beginning by the Private Finance Corporations, which are covered by this study is as follows:

<table>
<thead>
<tr>
<th>Thousands of Rs.</th>
<th>No. of PFCs</th>
</tr>
</thead>
<tbody>
<tr>
<td>20 - 60</td>
<td>9</td>
</tr>
<tr>
<td>60 - 100</td>
<td>7</td>
</tr>
<tr>
<td>100 - 140</td>
<td>6</td>
</tr>
<tr>
<td>140 - 180</td>
<td>5</td>
</tr>
<tr>
<td>180 - 500</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td><strong>30</strong></td>
</tr>
</tbody>
</table>

According to the above table the minimum capital invested is Rs. 20,000/- and the maximum is Rs. 5,00,000.
Deposits:

Another source of funds for the Private Finance Corporations is through mobilisation of Deposits. These organisations are able to attract deposits by paying a high rate of return than the banks.

As per the guidelines given by the Reserve Bank of India, at present collecting deposits from public is banned. The partners can raise deposits only from their blood relations.

The amount of capital raised through deposits by these organisations is noteworthy in Ranga Reddy District; it is estimated that the deposits of these organisations amounts to more than 10 crores.

Chits:

Organisation of Chits is another major source for the mobilisation of funds of Private Finance Corporations. Legally, for running chits, every chit should be registered with the Registrar by depositing 50% of the chit amount. The commission normally taken by the Private Finance Corporations on chits is around 5%.

It has been observed that, the Private Finance Corporations are running the chits without any registration as such. The average annual income derived
by the Private Finance Corporations through the organisation of chits is Rs. 10,000/- to Rs. 1,00,000/-.

Lottery Schemes:

Even though legally lottery schemes are banned, the PFCs are running many lottery schemes. Through this source they are able to raise funds.

3.2 COSTS INVOLVED IN ACQUIRING FUNDS:

To raise the funds the Private Finance Corporations incur the following costs: Payment of interest, mobilisation cost and advertisement cost. The partners are eligible to receive 16%, interest on their capital if there is no contrary agreement in partnership deed. On deposits interest payable is ranges from 18% to 24%. The total cost involved in raising the funds comes to an average of 30% of the funds raised.

3.3 USES OF FUNDS

Advances:

Advances given by Private Finance Corporations are of two types.
Cheque Discount:

Under this scheme the amount is advanced to a customer against his cheque. The maximum time allowed is three months. At the time of advance, the total interest is deducted from the advance.

Time Bill Discount:

Under this scheme the amount is advanced to a customer for 100 days. The customer starts making payment from the next day. Daily he has to pay $1/100$ of the advanced amount, with in 100 days the total amount is recovered.

In TBD advances the interest is deducted and the remaining amount is paid to the customer.

Chit Payment:

In the process of organisation of chits, every month the Private Finance Corporations pay the chit amount to the highest bidders.

Lottery Scheme Payments:

Even though lottery schemes are illegal, Private Finance Corporations run so many lottery schemes. For the payment of prizes they have to allot some funds.
3.4 RATE OF RETURN ON USES OF FUNDS:

In lending the funds the rate of interest charged by the Private Finance Corporation on CDs is more than 36%, whereas in their books they record it as only 18%.

Most of the Private Finance Corporations are doing their business depending mainly on TBDs. They charge more than 40% and record in 18% per annum.

For running the chits the minimum commission they charge is 60%.

On lottery schemes they charge highest interest rate being no limit. One out of 100 customers is benefited by these schemes, while 99 of the customers are put to loss. Running these schemes has been found to be counter productive in many instances. In quite a few schemes the Private Finance Corporations have been observed to have incurred substantial losses.

3.5 PROFITABILITY

The costs involved in the mobilization of the funds comes to less than 24% of the funds mobilised at the
maximum. The returns to the Private Finance Corporations from utilisation of Funds come to nearly more than 40%. The profitability works out to more than 16% of the funds involved.

Most of the Private Finance Corporations record their income as only 24% of the funds utilised with the result they are paying less tax. Thus these Private Finance Corporations are becoming as a source for the generation of black money.

The role of the Chartered Accountants is also worth mentioning here. They are the persons who file not only tax returns, they also prepare the final accounts of these organisations.

Table 3.2
Sources & Uses of Funds

<table>
<thead>
<tr>
<th>SOURCES</th>
<th>USES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>CDs</td>
</tr>
<tr>
<td>Deposits</td>
<td>TBDs</td>
</tr>
<tr>
<td>Chits</td>
<td>Chits</td>
</tr>
<tr>
<td>Lottery Schemes</td>
<td>Lottery Schemes</td>
</tr>
</tbody>
</table>
Table 3.3

RATES OF INTEREST

<table>
<thead>
<tr>
<th>Paid on Mobilisation of Funds</th>
<th>Received on Circulation of Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 24%</td>
<td>More than 40%</td>
</tr>
</tbody>
</table>

3.6 NBFCs PRUDENTIAL NORMS CONTAINED IN THE RBI DIRECTIONS, 1998

The rapid growth of Non-Banking Financial Companies and institutions, the abnormal increase in the deposits mobilised, the cheating practices against the investors and frequent insolvency position of these organisations attracted the attention of the Monetary Authorities. The Reserve Bank of India took notice of the above mentioned aberrations and came to the conclusion that, in order to prevent the collapse of the financial system as a whole the activities of these organisations must be regulated.

To cite an instance or two the cases of CRB Capital and Devi Jewellery may be mentioned.
The activities of CRB Capital, Devi Jewellers and other false promoters, threw lakhs of investors into streets and they lost their hard earned money which they had deposited in these companies. The result is the confidence of the small investors is killed. It became a challenging task to the Monetary Authorities to restore the confidence of small investors.

In this direction as a first step the RBI sought compulsory registration of NBFCs. At that juncture there were 90,000 NBFCs operating in the market. The word regulation inhibited most of them and only 40,000 of them got registered.

The directions to NBFCs are contained in the Reserve Bank's notification No. 118/DG(APT)-98, dated January 31, 1998, which came into effect from the 31st January, 1998.

**SALIENT FEATURES OF NEW RBI GUIDELINES**

**Categorisation of Companies:**

For the purpose of the new regulations, NBFCs have been divided into three broad categories as indicated below:
i. NBFCs accepting public deposits:

ii. NBFCs not accepting public deposits and are engaged in loans, investment, hirepurchase finance and equipment leasing activities; and

iii. NBFCs not accepting public deposits and have acquired shares/securities in their own group/holding/subsidiary companies of not less than 90 per cent of their total assets and are not trading in these shares/securities.

While NBFC's accepting public deposits will be subjected to all the provisions of the directions, those which do not accept public deposits will be supervised in a limited manner.

Definition of Public Deposits:

The term "Public Deposit" has been defined on the lines of the definition provided in the Companies (Acceptance of Deposits) Rules, 1975, framed under the Companies Act, 1956, and the Reserve Bank of India Act. Public deposits will include fixed, recurring etc., deposits received from public, deposits received from relatives and friends, deposits from shareholders by a public limited company and the money raised by issue of unsecured debentures/bonds.
Public deposits would, however, exclude money raised by NBFCs by way of issue of secured debentures/bonds, borrowings from banks/financial institutions, deposits from directors, inter-corporate deposits (ICD), deposits received from foreign citizens and those received by the private limited companies from their shareholders.

Prohibition from accepting public deposits for NBFCs having net owned fund (NOF) of less than Rs. 25 lakhs

The NBFCs having net owned fund of less than Rs. 25 lakhs will not be entitled to accept deposits from public. However, they can raise borrowings from other sources.

Credit rating requirement and quantum of public deposits

The ceiling on quantum of public deposits for an NBFCs has been linked to its level of credit rating as given by approved credit rating agencies. Higher credit rating will entitle NBFCs to raise larger quantum of public deposits as per details given in the table.
### Table 3.5
Credit Rating Requirement and Quantum of Public Deposits

<table>
<thead>
<tr>
<th>Level of Credit rating</th>
<th>Equipment/hire purchase</th>
<th>Loan and leasing</th>
<th>Investment companies (as a multiple of net owned funds)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>3 times</td>
<td>2 times</td>
<td></td>
</tr>
<tr>
<td>AA</td>
<td>2 times</td>
<td>1 time</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>1 time</td>
<td>0.5 time</td>
<td></td>
</tr>
</tbody>
</table>

NBFCs having a credit rating lower than 'A' cannot accept public deposits. Those NBFCs which have accepted public deposits in excess of the prescribed limits have been allowed time up to December 31, 1998, to regularise their position.

**Interest rate ceiling:**

All the NBFCs have now been subjected to the interest rate ceiling of 16 per cent. NBFCs which are currently offering interest rates in excess of the prescribed ceiling are required to roll back their interest rate to bring it within the ceiling with immediate effect.
Brokerage:

Brokerage payable by NBFCs on deposits of one year to five years has now been uniformly fixed at 2 per cent as against the varying rates earlier. In addition, NBFCs may also pay to the brokers by way of reimbursement on the basis of vouchers/bills produced an amount not exceeding 0.5 per cent of the deposits collected.

Submission of Returns:

NBFCs accepting public deposits only will be required to submit to RBI annual statutory returns and financial statements. NBFCs not accepting public deposits are exempted from this requirement.

Compliance of Prudential Norms:

(i) The NBFCs, including residuary non-banking companies accepting public deposits will be required to comply with all the prudential norms encompassing income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, capital adequacy and credit/investment concentration. Prudential norms have been revised to make them more transparent and have been reissued in the form of directions to make them mandatory. Some of the important changes made in the norms are mentioned below.
Income recognition norms for lease and hire purchase assets.

a. The income recognition, asset classification and provisioning norms as applicable to lease and hire purchase assets have been relaxed having regard to their distinctive nature. Hitherto, such assets were to be treated as NPAs in case the lease rental and hire purchase instalments remained past due for six months. In terms of new norms, such assets will be classified as NPAs if the said instalments are overdue for 12 months and above.

Capital adequacy ratio

b. Capital adequacy requirement of NBFCs with net owned fund of Rs. 25 lakhs and above and accepting public deposits has been raised from the present level of 8 per cent to 10 per cent to be achieved by March 31, 1998, and to 12 per cent by March 31, 1999.

Credit/investment concentration norms

c. While the existing credit concentration norms to a single borrower and a group of borrowers at 15 and 25 per cent of the owned fund remain unchanged, the investment concentration norms have been modified. It has been prescribed that investment in a single company or in a
single group of companies should not exceed 15 and 25 per cent respectively of the NBFC's owned fund. Further, composite limits of credit and investment by an NBFCs in a single entity and a single group of entities have been prescribed at 25 per cent and 40 per cent respectively of its owned fund.

Prohibition from grant of loan by an NBFC against the security of its own shares.

d. NBFCs have been advised not to grant any loan against the security of its own shares. Any such loan granted so far should be repaid in due course. However, no fresh loan should be granted against such security.

Details of the norms have been separately issued to the companies.

e. The NBFCs which are accepting and holding public deposits only are required to submit half-yearly prudential returns. These returns will be duly certified by their auditors. The NBFCs engaged in leasing, hire purchase finance, loan and investment activities and not accepting public deposits are required to comply with prudential norms other than norms on capital adequacy and credit/investment concentration. They will, however, not be required to submit the prudential norm return to RBI.
The investment companies holding not less than 90 per cent of their assets being the securities of their group/holding/subsidiary companies and not accepting public deposits are exempted from the prudential norms.

Maintenance of liquid assets:

The liquid asset requirement will now be applicable to public deposits only. The ratio of liquid assets shall also be uniform for all NBFCs accepting public deposits at 12.5 and 15.0 per cent effective from April 1, 1998, and April 1, 1999, respectively.

Application forms for deposits acceptance:

The contents of the deposits application forms have been further modified to make the depositors aware of the facilities available for redressal of their grievances and also to give them a proper perspective regarding the role and responsibility of the regulatory authority. The deposits taking companies have been directed to certify the correctness of their financial position and confirm that their operations comply with Reserve Bank's directions. The depositors have also been enjoined to satisfy themselves about the financial details of the
company before placing their deposits, and to declare on the deposits application form that they have gone through the declarations made by the company regarding its conformity with the RBI regulations.

Regulations for NBFCs accepting public deposits:

The NBFCs not accepting/holding public deposits shall be regulated in a limited manner. These companies are exempt from all the provisions of directions relating to acceptance of public deposits and the requirements of capital adequacy as also credit/concentration norms. However, in order to avail of the exemptions from the regulations, these NBFCs are required to get a resolution passed by their board of directors to the effect that they will not accept any "public deposits". The board resolution in the case of investment companies not accepting public deposits and which have acquired shares of not less than 90 per cent of their assets in their group/holding/subsidiary companies will also specifically include the names of their holding/group/subsidiary companies whose shares/securities they hold or propose to invest during the ensuing year. It will be the duty of the statutory auditors to comment in their report that
these companies have not accepted public deposits and have complied with the specified norms. Any violation/non-compliances is required to be reported by the statutory auditors to Reserve Bank of India by exemption.

Auditor's Certificate:

i. Reserve Bank has also made certain refinements in the norms for classification of NBFCs into various sub-groups based on their principal activity as evidenced from the asset/income pattern. Having regard to the special regulatory dispensation accorded to equipment leasing and hire purchase finance companies, the criteria for classification of the NBFCs into these categories has been tightened. Thus, an NBFC to be eligible for being classified as equipment leasing company or a hire purchase finance company shall have not less than 60 per cent of its assets and shall derive not less than 60 per cent of its income from equipment leasing and hire purchase activities taken together.

ii. All new NBFCs incorporated after January 9, 1997, will be provisionally classified as loan or investment companies for a period of one year and the classification will be reviewed thereafter on the basis of their
asset/income pattern as disclosed in their balance sheet/profit and loss account and other related aspects. Existing NBFCs as also those which remain unclassified will be classified on the basis of their principal activity as evidenced from their financial statements into various categories such as Equipment Leasing Companies, Hire Purchase Finance Companies, Loan Companies, Investment Companies, Miscellaneous Non-Banking Companies or Residuary Non-Banking Companies as the case may be. Only such of the NBFCs as have been specifically notified under Section 620A of the Companies Act, 1956, by the Government of India, will be classified as Nidhi Companies. NBFCs which function as Nidhis will be classified as Loan Companies and the directions as applicable to "Loan Companies" will be made applicable to them till such notification.

Depositors cautioned:

Reserve Bank has cautioned the depositors that whatever be the rigours of regulation, the regulations by themselves cannot provide a fail-safe system for ensuring repayment of deposits. Depositors should, therefore, be circumspect and satisfy themselves about the financial
soundness and health of the companies before placing their deposits keeping in mind that they are investing their money at their own risk and responsibility.

The industry reacted 'sharply' to the RBI guidelines, and it is stated that with these guidelines the business will end. It is impracticable to carry the business under these guidelines. The Association of Leasing and Financial Services Companies (ALFS) made a representation to RBI to review the guidelines. After carefully examining the reaction of the industry, RBI relaxed the same regulations governing the NBFCs.

NBFCs have been given three years time till December 31, 2000 -- to repay their excess deposits, subject to certain conditions.

As per the modifications in the NBFC regulations announced today, the ceiling on quantum of public deposits as a multiple of net owned funds (NOF) and linked to credit rating in respect of equipment leasing and hire purchase companies has been enhanced.

Such companies having a rating of minimum investment grade have also been allowed to access public deposits. Earlier, companies having rating lower than "A" were not allowed to accept public deposits.
Equipment leasing and hire purchase companies with "AAA*" rating can now accept deposits four times their net owned funds as against three times earlier. Those with "AA*" rating can accept deposits 2.5 times their NOF (earlier two times) and those with "A*" rating 1.5 times as against one time earlier.

Companies having minimum investment grade rating i.e. "A-" (A minus) by Crisil and ICRA, "BBB*" by CARE and "BBB-" by DCR India are now allowed to raise public deposits 0.5 time their NOF.

In the case of loan and investment companies, the existing regulations on public deposits remain unchanged.

The time limit for adjusting excess public deposits as on January 1, 1998, have been allowed time till December 31, 2000 to repay subject to that one third of the excess deposits is repaid by December end every year so that the entire excess deposits is repaid by December 31, 2000.

During these three years, the equipment leasing and hire purchase companies which are rated investment grade or above and loan and investment companies which
have rating of "A" or above have been allowed to accept or renew public deposits subject to reducing the excess deposits by one third every year.

The equipment leasing and hire purchase companies which are unrated or rated below the minimum investment grade and loan and investment companies which are unrated or rated below the specified grade "A" are allowed only to renew the maturing deposits and not allowed to accept fresh deposits.

If the ceiling on public deposits gets reduced following a downgrading of the rating, the resultant excess deposits should be repaid/regularised in 12 months.

The RBI has also modified the prudential norms for NBFCs. While the loans and other credit facilities shall continue to be classified as NPAs for each borrower as per existing norms, the lease and hire purchase transactions may be classified independently on the basis of record of recovery in each account.

In other words, in respect of borrowers having multiple lease/hire purchase facilities, NPAs will be calculated by taking into account the default in respect of relative account. NPAs will be calculated by taking into account the default in respect of relative accounts only.
The definition of NOF has been modified to include preference shares which are compulsarily convertible into equity. This is applicable for acceptance of deposits and for following prudential norms.

As per the new norms, NBFCs are required to disclose the level of their rating and the name of the rating agency in their application forms for public deposits.

The other existing regulations including those regrading ceiling on the interest rates on deposits at 16 per cent per annum, payment of brokerage at two per cent of deposits and submission of auditor's report and capital adequacy remain unchanged, the RBI said in release.

The industry unhappy with above relaxations and it is stated that RBI deviated from the policy of deregulation of industry.

The investors are at low confidence stage, the RBI regulations relaxed in a short span of time, the industry is in dismood all these factors culminated in to a storm atmosphere in the financial market. It is the testing time to the RBI as how to regulate the activities of NBFCs to make meaningful agencies to complement the
financial system for the purpose of increasing the confidence of investors. We have to wait some time to reap the results.

It has been after a long time of observation of the activities of NBFCs and after considerable distress to the small investors that the RBI came to regulate the activities of NBFCs. Now the Private Finance Corporations are also running on the same line as did the NBFC and it is high time the RBI come out in the separate legislation to regulate their activities and avert distress to the public. The Government of Andhra Pradesh has been seriously contemplating legislative measures to regulate the activities of Private Finance Corporations, but the contemplating period is proving to be too long.