CHAPTER

8 NON-BANKING FINANCE COMPANIES

INTRODUCTION

Apart from commercial banks and cooperative credit institutions (urban and rural), the financial system in India consists of a wide variety of NBFIS, such as Non-Bank financial Companies (NBFCs), financial institutions and primary dealers. NBFIs from a diverse group not only in terms of size and nature of incorporation, but also in terms of their functioning. In addition to enhancing competition in the financial system, these institutions play a crucial role in broadening the access of financial services to the population at large. With the growing importance assigned to the objectivies of financial penetration and financial inclusion. NBFIs are being regarded as important financial intermediaries particularly for the small scale retail sectors.

In recent times, the non-banking finance companies (NBFCs) have emerged as substantial contributors to the Indian economic growth by supplementing the efforts of banks and other development financial institutions. They play a key role in the direction of savings and investments. They offer a wide variety of financial services and play an important role in providing credit to the unorganised secor and small borrowers.

In the wake of rapid industrial development and liberalisation of the financial sector, the entrepreneurs, corporate sector as well as the key financial institutions have diversified their activities to cater to the specific needs of the economy. In this context, the key financial institutions and professionals have promoted financial institutions to create a diversified and competitive financial system.

The role of banks in non-bank financial services began to grow from the time of the amendment to the Banking Regulation Act in 1983. Many merchant banking divisions and mutual funds were set up by the public sector banks since then. Banks began to increase their non-bank and non-funded business which are called financial services. Some more development took place to expand the scope for such services: (1) Keeping open Indian capital market to foreign financial institutions and oversea corporate bodies to invest in India. (2) FERA dilution to encourage both the inflow and outflow of funds and foreign investment in India, some of which

might flow into the stock and capital markets. (3) opening up mutual fund business and even banking to the private sector. Already a number of private sector companies/firms are engaged in financial services, such as investment financing, hire-purchase, mortgage financing and housing finance etc. Private sector was permitted to set up mutual funds, banks and financial institutions. Financial deregulation, freeing of interest rates on debentures, banks' lending rates and their practices, etc., has helped the growth of the financial sector. Today the emerging trends in this sector are as follows:

1. Faster rate of growth made it a sunrise industry.
2. Deregulation and liberalisation of procedures, reduction in government redtape and discretionary controls and revolution in information technology and in communication led to globalisation of financial markets.
3. Interlinkages between all segments of financial sector began to grow faster and deeper.

NON-BANKING FINANCE COMPANIES

NBFCs, the largest component component of NBFIs, can be distinguished from banks with respect to the degree and nature of regulatory and supervisory controls. First, the regulations governing these institutions are relatively lighter as compared to banks. Secondly, they are not subeject to certain regulatory prescriptions applicable to banks. For instance, NBFCs are not subject to Cash Reserve Requirement (CRR) like banks. They are, however, mandated to maintain 15 per cent of their public deposit liabilities in Government and other approved securities as Statutory Liquidity Ratio (SLR). Thirdly, they do not have deposit insurance coverage and refinance facilities from the Reserve Bank. Fourthly, NBFCs do not have cheque issuing facilities and are not part of the payment and settlement system.

The Non-Banking Finance Companies (NBFCs) when compared to commercial and co-operative banks are a heterogeneous group of finance companies. These companies also intermediate between the savers and the investors. The NBFCs, in advanced countries have grown phenomenally and are now coming up in a massive way in the developing countries like Brazil, India, Jordan, Korea and Malaysia. The different categories, of the NBFCs include loan companies, investment companies, hire-purchase finance companies, equipment leasing companies, mutual benefit finance companies, miscellaneous finance companies, miscellaneous non-banking companies, residuary non-banking companies and housing finance companies. A wide variety of companies and markets are operating in an environment of macro-economic stability.

Types of Non-Bank Financial Services

1. Merchant Banking and New Issue Marketing.
2. Underwriting and Loan Syndication.
3. Bill Discounting and Money Market Operations.
4. Housing Finance.
5. Lease and Hire-Purchase Financing.
6. Venture Capital Funds.
7. Investment Financing.

8. Investment Consultancy and Advise.
9. Mergers, Acquisitions, Amalgamations.
10. Capital Restructuring, Revaluations and Designing Capital Structure.
11. Portfolio Management Services.
12. Corporate Asset Management Services.
13. Technical Consultancy and Project Preparation.
14. Mutual Funds.
15. New Issue House Services.
16. Depositories.

RECLASSFICATION OF NBFCs

Pursuant to the announcement in the Mid-term Review of Annual Policy statement for the year 2006-07, the NBFCs were reclassified into:

1. Asset Finance Companies (AFC)
2. Investment Companies, and
3. Loan Companies.

AFC is defined as any company which is a financial institution carrying on as its principal business of financing the physical assets supporting productive/economic activity such as automobiles, tractors, generator sets, earth-moving and material handling equipments and industrial machines.

There are two broad categories of NBFCs bases on whether they accept public deposits namely, NBFCs-Non Deposit taking (NBFC-ND) and NBFCs-Non Deposit taking (NBFC-ND). Since 2006, NBFCs were reclassified based on whether they were involved in the creation of productive assets. Under the new classification, the NBFCs creating productive assets were divided into there major categories, namely, assets finance companies, loan companies and investment companies. Considering the growing importance of infrastructural finance, a fourth category of NBFCs involved in infrastructural finance was introduced in February 2010 namely infrastructure finance companies (Box VI. 1).

Till recently, NCFCs-ND were subject to minimal regulation as they were non-deposit taking bodies and considered as posing little threat to financial stability. However, recognising the growth importance of this segment and its interlinkages with banks and other financial institutions, capital adequacy and exposure norms have been made applicable to NBFCs-ND that are large and systemically important from April 1,2007; such entities are referred to as NBFCs-ND-Systemically Important (SI).

ROLE OF NBFCs

Non-Banking Finance Companies (NBFCs) are an integral part of India's financial system. They play an important role in financial intermediation by acting as a link between savers and investors, and have been able to mobilise deposits on a substantial scale in recent years. NBFCs

also play a crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector. They also tend to offer enhanced equity and risk-based products. As estimated by the RBI, regulated deposits of NBFCs at the end of March 1997 formed 12.5 per cent of the aggregate deposits of scheduled commercial banks. Besides, during 1981-1996 non-banking deposits with households increased from 0.5% of GDP to 1.3%, while bank deposits held by households increased from 3.6% of GDP to 4.4% of GDP in the same period.

There are various categories of NBFCs including loan companies, investment companies, hire-purchase finance companies, equipment leasing companies, mutual benefit finance companies, chit funds and housing finance companies. Historically, NBFCs were no regulated till the mid-sixties, but after several unhealthy practices came to light, the RBI Act was amended and regulation extended to the non-banks.

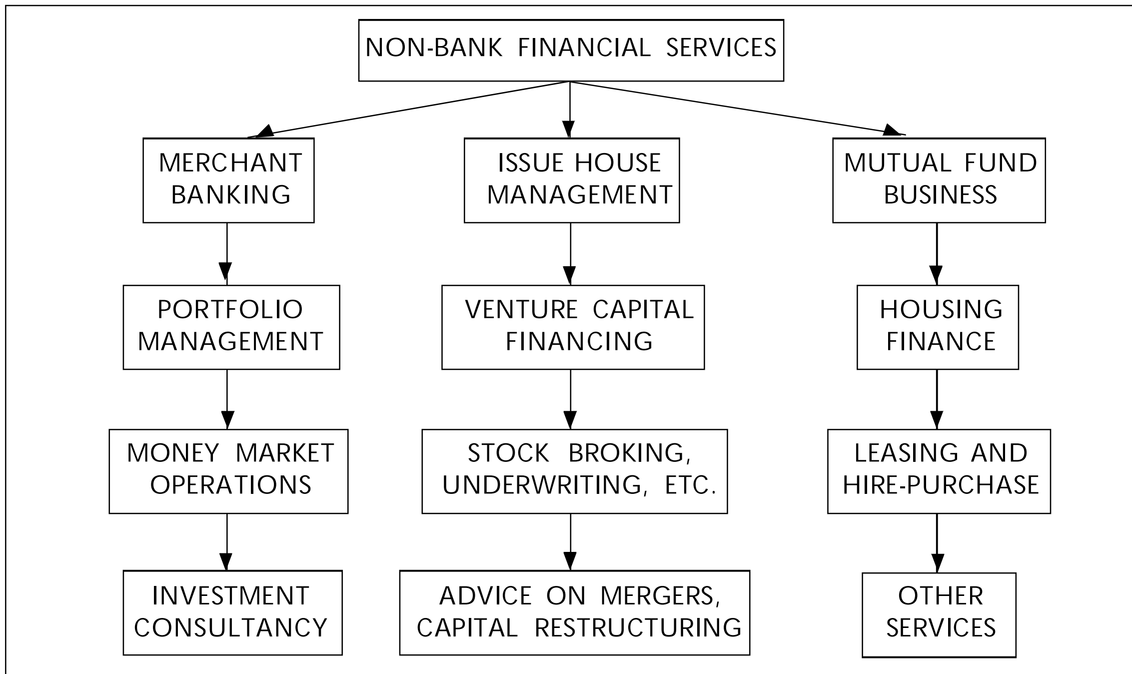
While housing finance companies are regulated by the National Housing Bank, other NBFCs are regulated by the Reserve Bank of India, under the provisions of Chapter III-B of the RBI Act and the respective directions issued to the different categories of NBFCs. Regulation covers their deposit-taking activity including period of acceptance of deposits, quantum, interest rate, etc. Ceilings stipulated on acceptance of deposits are Related to Net Owned Funds (NOF)[1+] and are different for different types of companies.

COMPETITIVE EDGE OF NBFCS

NBFCs supplement the activities of banks in deposit taking and lending and play a dynamic role in the economy. By providing more options to savers and investors; they have helped broaden the market. Because they accept a large volume of small deposits, they reach depositors in all segments, particularly the small savers. Another advantage enjoyed by NBFCs lies in their reach to cater to the specialised credit requirements of certain categories of borrowers not served by the organised banking system. The growth of NBFCs and their edge over banks in certain resects are explained by the fact that there was greater regulation over banks, while NBFCs were relatively free and would offer marginally higher rates of interest on deposits. Their simple procedures and greater customer orientation, and ability to offer higher returns on investment and extend credit to those who are not eligible to receive loans from commercial banks also helped the sector grow.

In particular, as the government pre-empted banks' resources in the form of high reserve requirements, banks had to ration credit. This gap in supply of credit was sought to be met by NBFCs who mobilised deposits from households not covered by banks and made credit available for investment in real assets, consumption and other purposes of which bank credit was not available. In comparison, NBFCs faced lower reserves than commercial banks and therefore had more loanable funds. Further, NBFCs were not constrained by government controls and could adopt modern technology and communications quickly to add value to their products and improve customer service and profits.

Chart 8.1



GROWTH OF NON-BANKING FINANCIAL SERVICES

As the demand for financial services grows, countries will need to encourage the development of non-banking financial intermediaries and securities markets in order to broaden the range of services and to stimulate competition and efficiency. India has made considerable progress towards more diversified financial systems.

The role of banks in non-banking financial services began to grow from the time of the amendment to the Banking Regulation Act in 1983. Many merchant banking divisions and mutual funds were set up by the public sector banks since then. Banks began to increase their non-banking and non-funded business which are called *financial* services. More recently, some more developments took place to expand the scope for such services: (1) Keeping open Indian capital market to foreign financial institutions and overseas corporate bodies to invest in India. (2) FERA dilution to encourage both the inflow and outflow of funds and foreign investment in India, some of which might flow into the stock and capital markets. (3) Opening up mutual fund business and even banking to the private sector. Already a number of private sector companies/ firms are engaged in financial services, such as investment financing, hire-purchase, mortgage financing and housing finance etc. Private sector was permitted to set up mutual funds, banks and financial institutions. Financial deregulation, freeing of interest rates on debentures, banks' lending rates and their practices, etc., have helped the growth of the financial sector. Today, the emerging trends in this sector are as follows:

1. Faster rate of growth made it a sunrise industry.
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In India, the number of such companies which stood at 7,063 in 1981 has increased to 12,409 at end June 2011. This constituted 48% in private limited category and 16% in the public limited category. The business of NBFCs have also shown tremendous growth over the years.

Table 8.1: Number of NBFCs Registered with the Reserve Bank

End-June	*NBFCs*	*NBFCs – D*	*NBFCs ND – S1*
2000	8,451	679	
2001	13,815	776	
2002	14,077	784	
2003	13,849	710	
2004	13,764	604	
2005	13,261	507	
2006	13,014	428	149
2007	12,968	401	173
2008	12,809	364	189
2009	12,740	336	234
2010	12,630	308	260
2011	12,409	297	282

The number of NBFCs taking deposits declined mainly due to the exit of many NBFCs from deposit taking activity. The number of RNBC remained unchanged at two as at end-March 2011. Various factors are responsible for such a marked growth which include more customer-oriented services by the NBFCs, comprehensive regulation of banking system on the one hand and absence of such regulation on the other for the NBFCs and the like.

The NBFCs basically comprise of firms undertaking a cross section of activities like loan companies, investment companies, hire-purchase finance companies, housing finance companies and other miscellaneous financial companies. In the last 10 years, deposits with NBFCs have grown ten fold. The same for scheduled commercial banks (SCBs) have comparatively increased 4.6 times only. The share of financial companies deposits to total SCBs deposits was just 3.88 per cent in 1981. In 1990, the same increased to 8.43 per cent. Except for 1986 and 1987 (due to the stockmarket slump), the growth of deposits with NBFCs was higher than that of SCBs.

However, deposits of NBFCs at end-March 2011 declined considerably to ` 11,964 crore. Public deposits held by RNBCs constituted 66.0 per cent of total deposits of all NBFCs at end-March, 2011. The ratio of deposits of reporting NBFCs to the aggregate deposits of SCBs dropped to 0.95 per cent.

Over time, the distinction between banks and NBFCs has also blurred, due to overlapping of functions. Further, due to regulations on banks and various stipulations, much demand for credit by the private sector could not be met by them. This gap was filled by these NBFCs which were successful in mobilising resources from saving surplus units and allocate them to saving deficit units for investment in areas and purposes for which bank credit was denied or restricted. Such growth of NBFCs greatly undermined the efficacy of monetary policy too as such the policy mainly works through influencing monetary and credit aggregates of the banking system only. Thus, the case for regulating this important and growing sector in the financial system is self evident.

In other developed and some developing countries too, such non-banking financial companies are subject to certain restrictions so as to provide a level playing field for all participants in the financial sector. In some countries, the regulations are same as for banking companies. In some others, separate regulations are there for NBFCs. Self regulating organisations are also a part of the regulatory system. Broadly, the prudential norms applicable to such organisations include capital adequacy, credit concentration ratio, liquidity ratio and creation of reserves. Punitive action in case of non-compliance is strict. Finance Corporation and State Finance Corporations are also guided by the general economic policy. The data for financial and investment companies relate to about 175 sample companies. The paid-up capital of these companies amount to about 85 per cent of the total paid-up capital of all non-government financial and investment companies, excluding banks and insurance companies. Their total assets form a very small proportion of the total assets of all banks and NBFCs and hence they are not likely to prove dangerous for the effectiveness of monetary controls. This only confirms the predominant position of commercial banks in our financial structure and since none of the other important financial intermediaries is free from controls, the threat from the growth of NBFCs for monetary policy in this country appears to be based on illusionary grounds.

NBFCs AND THE RESERVE BANK OF INDIA

The Reserve Bank of India has a separate Department to deal with the NBFCs. It was originally called the Department of non-banking companies. Now, it is referred to as Department of Financial Companies. The main objective of this Department is to exercise some control over the NBFIs by collecting data, issuing directions and inspecting them wherever necessary. Its central office is situated at Kolkata and it has four regional offices.

FUNCTIONS OF THE DEPARTMENT

The main functions of the Department of Financial Companies are the following:

(*i*) To identify financial companies and classify them.

(*ii*) To review the classification of such companies then and there.

(*iii*) To attend to legislative matters and issue directions to NBFCs on various matters.

(*iv*) To advise the Central Government and State Governments on matters pertaining to NBFCs.

(*v*) To receive and scrutinise the balance sheets, returns, accounts and statements of NBFCs.

(*vi*) To inspect them and take follow-up action.

(*vii*) To deal sternly with those companies which contravene any of the directions of the RBI.

(*viii*) To consider requests for grants of exemptions.

(*ix*) To carry out studies on the working of these companies.

(*x*) To deal with the complaints received from the public and to do any other work which are incidental to the above functions.

RBI's CONTROL OVER NBFCs

In the interest of the economy as a whole and in order to pursue an effective monetary policy, it is desirable that the NBFCs should be brought under the control of the Reserve Bank (RBI) in the same way as the commercial banks are controlled. It is so because, whenever the RBI increases its bank rate or changes the lending rates or deposit rates, they will have no impact on the rates charged by these non-banking financial intermediaries. Again, when the RBI follows a policy of 'credit squeeze', the industrial houses can escape from this policy by resorting to the system of financing through 'public deposits.' Besides, any person with any type of security can approach NBFCs at any time and obtain a loan. The RBI has no say over it. Yet another drawback of these companies has been the conspicuous lack of transparency of operations and proper financial disclosure. Again, several residuary non-banking companies are found to be operating with meagre capital and some of them even with negative capital. Moreover, some of the NBFCs have been found to be issuing misleading advertisements for attracting deposits. In these circumstances, the RBI cannot function effectively and implement its fiscal and monetary policies unless the NBFCs are brought under its control. Hence, the RBI has been taking several steps in this direction. Some of them are as follows:

ISSUE OF DIRECTIONS

The Reserve Bank has issued various directives from time to time to control the deposit acceptance activities of these companies. For instance, the non-banking financial companies are regulated by the RBI under the Non-banking Financial Companies (Reserve Bank) Directions, 1977. The Miscellaneous companies are governed by the Miscellaneous Non-banking Companies (Reserve Bank) Directions 1977. The residuary Non-banking Companies are regulated under the Residuary Non-Banking Companies (Reserve Bank) Directions, 1987. The Housing Finance Companies come under the Housing Finance Companies (National Housing Bank) Directions, 1989. The RBI regulates the activities of non-banking and non-financial companies under the Companies (Acceptance of Deposits) Rules 1975. The RBI exercises control over NBFCs by the issue of various directions as stated above.

RESTRICTION ON DEPOSITS

The Reserve Bank has also prescribed certain ceiling limits for the acceptance of deposits by these non-banking financial intermediaries. In the absence of these restrictions, they would go for hunting deposits enormously without any regard to their net equity. Ultimately, the innocent depositors would be affected. Generally, these companies can accept deposits to the tune of 10 times of their net owned funds. A mutual benefit company can accept deposits only from its shareholders. Hence, there is no ceiling limit. Housing finance companies with ` 20 crore of net owned funds can go up to 15 times of their net owned funds. Similarly, in the case of loan companies and investment companies, there is some relaxation in the ceiling limit.

The RBI has started regulating the period as well as the rates of interest of the deposits of these companies. For instance, recently the RBI issued a circular notifying that these companies should accept deposits for a minimum period of one year and the maximum being 10 years. Further, all these deposits are subject to a ceiling limit of 14 per cent per annum. It is necessary that the NBFCs are subject to the same administered interest rate regime as that of commercial banks.

REGULATION OF BROKERAGE

It has been the practice of the NBFCs to attract more and more deposits by paying attractive rates of brokerage or commission or incentives or by whatever name it may be called to the middlemen. Now, the RBI has prescribed certain limits on the payment of brokerage also. For instance, for deposits not exceeding one year, the rate of brokerage shall be 1 per cent of such deposit per annum, for a period 1 year to 2 years, it shall not exceed 1.5 per cent of such deposit and for a period of above 2 years, it shall not exceed 2 per cent of such deposits.

REGULATION OF LIQUIDITY

Realising the importance of maintaining liquidity, particularly for certain companies like equipment leasing companies and hire-purchase financing companies, the RBI has issued directions insisting these companies to maintain 10% of their deposits in liquid assets.

COMPULSORY REGISTRATION

Now, the RBI requires all non-banking financial intermediaries with net owned funds of ` 50 lakh and above to register compulsorily with the former by the end of July 1993. This registration would be a prerequisite for a company to expand its business further.

SUBMISSION OF RETURNS

All the NBFCs are required to submit periodical returns to the RBI on various matters pertaining to their operations. Though it is a statutory requirement, most of the companies do not file the returns in time. Some do not file at all. It is found that less than one-third of NBFCs are regular in the submission of periodical returns.

DESIGNATION OF BANKS

The RBI has stipulated that these companies must designate a commercial bank of their own. Yet, most of them have not designated their bank.

GROWTH OF TRADE CREDITS AND OTHER NON-BANK SOURCES

It is argued that in times of credit stringency, trade credits tend to take the place of bank credit and thus defeat the objectives of monetary policy. Since they are little affected by changes in interest rates, they introduce considerable elasticity into the response of business to efforts by the monetary authority to compress liquidity. It is, therefore, important to verify the significance of trade credits in the financing of Indian companies.

Box: 8.1

GUIDELINES TO NON-BANKING FINANCIAL COMPANIES ON PRUDENTIAL NORMS FOR INCOME RECOGNITION, ACCOUNTING STANDARDS, ASSET CLASSIFICATION, PROVISIONING FOR BAD AND DOUBTFUL DEBTS, CAPITAL ADEQUACY AND CONCENTRATION OF CREDIT/INVESTMENTS

A. Income Recognition

Income past due but not received within a period of six months is not to be booked till such time income it is actually received. Assets are to be classified as non-performing, based on recovery record. Interest on non-performing assets should not be booked as income if such interest has remained outstanding for more than six months on and from March 31, 1995.

B. Calculation of Provisioning Requirements against Non-Performing Assets* as at the end of March 31, 1995

	Status as		Provision required	
(i)	Sub-standard Asset (Classified as NPA for a period not exceeding two years)		A general provision of 10 per cent of total outstanding amount	
(ii)	Doubtful Asset (Classified as NPA for a period exceeding 2 years)	Period for which asset has been considered as doubtful	Provision required on secured portion (as % of secured portion)	Provision on unsecured portion (as % of unsecured portions)
		(a) Upto 1 year	20	100
		(b) 1 to 3 years	30	100
		(c) More than 3 years	50	100
(iii)	Loss Asset, i.e., an asset considered un-collectable (Identified so by the NBFC or external auditors or the RBI inspection)		Entire asset should be written off. If the asset is permitted to remain in the books, 100 per cent of the total outstanding amount should be provided for.	

C. Capital Adequacy

Ratio of capital to risk weighted assets and off balance sheet items should be a minimum of 6 per cent by March 31, 1995 and 8 per cent by March 31, 1996.

D. Credit Rating

NBFC and residuary non-banking companies are required to get themselves rated at least once every year for fixed deposits by one of the following three credit rating agencies and secure minimum rating as indicated below:

Name of the Credit Rating Agency	*Minimum Rating*
CRISIL	FA
ICRA	MA
CARE	CARE BBB (FD)

While companies with net owned funds of ` 2 crore and above had to the rating by March 31, 1995, those having net owned funds below ` 2 crore were given the option to get the rating by March 31, 1996.

*A "non-performing asset" is defined as a credit-facility in respect of which interest remained "past due" in the year ended March 31, 1995 for a period of more than 6 months.

Source: Currency and Finance, 1993-94.

A NEW APPROACH

The working group of financial companies under the chairmanship of Dr. A.C. Shah, was of the view that a thriving, healthy and growing non-banking financial sector is necessary for promoting the growth of an efficient and competitive financial system.

The approach of the committee towards NBFCs has been for ensuring their healthy growth, for improving the efficacy of the monetary and credit policy as also for inculcating financial discipline among the users and providers of funds.

RECOMMENDATIONS

The following recommendations have been made by the working group for the NBFCs:

(*i*) All the existing deposit-taking companies with net owned funds of ` 50 lakh and over should compulsorily register with the regulatory authority. This cut-off point may be reviewed subsequently. Companies with net owned funds below this cut-off point may, if they so prefer, opt for registration. 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 ` 50 lakhs will be allowed to accept public deposits at a lower level, *i.e.,* in accordance with provisions of Section 58A of the Companies Act, 1956.

(*ii*) Entry norms should be prescribed for all new NBFCs such as: (*a*) minimum net owned funds of ` 50 lakh at the time of commencement; (*b*) registration with the regulatory authority; (*c*) restriction on deposit-acceptance activity at the level permitted to unregistered companies in first two full financial years of operation; 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, methods of by operation, etc.

(*iii*) The function of registration and regulation should be undertaken by the proposed High Powered Supervisory Board.

(*iv*) The focus of NBFC — regulation should be shifted from liability side to asset side of NBFC balance sheet. Capital adequacy standard based on risk-weighted assets as recommended for commercial banks should be prescribed. The regulatory authority, in co-ordination with the representatives of NBFCs, Self Regulating Organisations and the Institute of Chartered Accountants of India.

(*v*) Until the time, capital adequacy framework is introduced, the existing limits on by deposit acceptance may be continued subject, however, to an overall debts equity by ratio in 15:1.

(*vi*) Restrictions should be placed on the portfolio management activities of these companies.

(*vii*) In addition, NBFCs should be required to: (*a*) maintain liquidity ratio of 10 per cent of their total deposit liabilities, (*b*) limit their risk exposure to single and group borrowers to 15 and 25 per cent of their net owned funds respectively, (*c*) transfer at least 20 per cent of their net profit to reserves 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.

(*viii*) Until the time commercial bank deposit interest rates are regulated, NBFC interest rates should also continue to be regulated and that the latter be pegged two to three percentage points above the former. NBFCs should be allowed to accept deposits for periods ranging between 12-84 months as against the existing range of 24-120 months.

(*ix*) The existing distinction between the terms 'exempted' and 'regulated' deposits for purposes of calculating the gearing ratio should be abolished and instead 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.

(*x*) Credit rating should be compulsory for all registered companies not in the immediate future but after a period of five years. Relaxation in the Advertisement Rules has also been recommended.

(*xi*) Norms regarding income recognition, disclosure or transparency of accounts, provision for bad and doubtful debts, etc., should be prescribed. 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.

(*xii*) Auditors, in the supervisory process, may be assigned a greater role. Periodical statements to be submitted by NBFCs to regulatory authorities will need certification by the auditors. Based on the rule of exception, NBFCs may be inspected by the regulatory authority.

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

(*xiv*) As regards unincorporated entities, apart from the existing restriction on the number of depositors, a ceiling on the quantum of deposits they can accept should be prescribed. A Standing Advisory Committee may be constituted for reviewing regulatory requirements for these bodies.

(*xv*) The regulatory authority should publish the list of all NBFCs periodically.

(*xvi*) 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 NBFCs.

Overall, it would appear that the recommendations of the working group have been pragmatic and keeping in line with the changes being contemplated in the financial sector at large. The positive approach of the recommendations is highlighted by the consideration that the role of NBFCs is complementary to the economic growth. The committee has shown not only great promptitude in addressing the problems of the NBFCs but also shown a great deal of selectivity in classifying the NBFCs and meeting their demands. Some of the suggestions, particularly the one relating to public awareness programme sound innovative. If the recommendations of the working group are accepted, they will launch the NBFCs in a healthy trajectory of growth path. If non-banking finance companies are to be efficient and robust, they must be set within a suitable legal and regulatory frame work. A vital test in deciding on the extent of regulation is the number and type of creditors. Last but not the least, the NBFCs will have to cooperate in various ways with the regulatory agencies to keep themselves and the economy healthy.

The RBI has accepted most of the above recommendations. If the above recommendations are implemented, it would go a long way in encouraging the healthy and orderly growth of non-banking financial companies and also in ensuring the solvency and safety of the financial system.

Thus, NBFCs are wrestling with a multitude of problems threatening their very survival. Their sources of funds are drying up, they have a poor public image, lending has become riskier, rising menace of non-performing assets and increased competition in retail finance from banks and financial institutions is reducing the spreads. The NBFCs need steady deposit renewals and inflow of fresh deposits to take care of their assets portfolio which are hard to come by on account of their tarnished image except by offer of high interest rates, resulting in inflating their cost of funds. It is like a vicious circle.

REGULATION FOR NBFCs

In view of the important role played by NBFCs, and the need to integrate their activities into the financial system, the scope of regulations to control the activities of NBFCs was expanded from time to time and several policy measures initiated to monitor their activities.

1. Entry Norms: Prior to the amendment of the RBI Act in 1997, there were practically no entry norms for NBFCs. Now, however, (a) it has been made mandatory for NBFCs to register with RBI and comply with minimum capital requirements; (b) a minimum NOF of ` 2.5 million has been stipulated for a company operating as NBFCs, and a minimum NOF of ` 20 million in respect of NBFCs which are incorporated on to after April 20, 1999.

2. Capital Adequacy Requirements: Overall borrowings of NBFCs had been regulated by linking their fund-raising ability to the NOF, but RBI has now shifted the focus of regulation from the liability side to the asset side by prescribing the capital adequacy requirements apart from stipulating other prudential norms. Accordingly, the capital to risk assets ratio has been by raised from 6% in March 1995, to 8% by March 1996, 10% by March 1998, and 12% from by March 31, 1999.

As at end - March 2007, 319 out of 332 NBFCs had CRAR of 12 per cent or more, and 13 had less than the minimum of 12 per cent.

3. Maintenance of Liquid Assets: As a measure of depositor protection, all NBFCs irrespective of their classification are required to maintain liquid assets at 12.5% and 15% of public deposits with effect from April 1, 1998 and April 1, 1999, respectively. Liquid assets are to be maintained in Government securities and Government-guaranteed securities only and kept free from all encumbrances, for making payment to depositors. It has been suggested that the liquid assets should be increased in a phased manner to 25% of the outstanding public deposits.

4. Prudential Norms: In order to regulate the assets of companies, in February 2007, RBI prescribed prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, credit/investment concentration norms, as in the case of banks. RBI has also prescribed half-yearly returns to be submitted by NBFCs or ensure compliance with the norms.

Norms relating to NPAs that are prescribed for NBFCs are similar to those applicable to commercial banks for loans. However, for the leasing and hire-purchase assets, the NPA norms are less stringent because the ownership of the underlying assets is vested in the NBFC itself and such assets being marketable, can be realised to refuse the loan losses.

5. Exposure Norm: Recently, NBFCs accessed substantial public deposits at high rates of interest, but the funds were not always invested prudently. To prevent deployment of public deposits in high risk and speculative ventures, the Vasudev Committee (1998) has recommended that in respect of NBFCs taking public deposits, RBI should prescribe ceilings for exposure to real estate, investment in capital markets, especially unquoted shares, and exposure to connected companies in which directors are interested.

6. Acceptance of Deposits: The prescriptions relating to ceiling for public deposits have been, at different times, related to different indicators of the underlying strength of the NBFC. The general approach has been to allow a higher ceiling for equipment leasing and hire-purchase companies whose assets are secure, while prescribing a lower ceiling for loan and investment companies.

(i) Credit Rating Requirement: In June 1994, RBI made it mandatory of NBFCs accepting deposits from the public to get themselves rated by any of the four credit rating agencies in India, and the extent of public deposits that can be accessed by them was corrected to the rating obtained by them, *i.e.,* higher the rating, the higher is the limit up to which the public deposits may be accepted. The objective was to raise the ceiling for acceptance of deposits by registered rated companies, while restricting unrated companies from accepting deposits from the public.

Recently, there have been some reactions with respect to credit rating. While NBFCs with NOF of less than ` 2.5 million are not allowed to accept public deposits at all, equipment leasing and hire-purchase companies can accept deposits without any credit rating up to 1.5 times NOF or ` 100 million whichever is lower, provided they have a CRAR of 15% or above.

Equipment leasing and hire-purchase companies with NOF above ` 2.5 million and minimum investment grade credit rating can accept deposits four times their NOF provided they

have a capital adequacy of 10% as on March 31, 1998 and 12% by March 31,1999. Loan and investment companies with investment grade credit rating can raise deposits up to 1.5 times their NOF provided they have a capital adequacy of 15%.

(ii) *Interest Rate Ceiling:* In 1996, companies having minimum investment grade credit rating, registered with the RBI and complying with prudential norms, were exempted from the ceiling on interest rate, permitted to access borrowings/deposits with any limit or up to a higher ceiling, and required to maintain reduced liquid assets. However, this at times led to intense competition and unethical practice including excessive deposits mobilised at unreasonable high interest rates, and creation of illiquid or non-performing assets. Consequently, the interest rate ceiling was reintroduced in January 2006, and RBI has stipulated interest rate ceiling of 10 per cent on deposits accepted by NBFCs. The share of deposits contracted by NBFCs in the interest rates up to 10 percent accounted for 89.5 per cent of the total, 10-12 per cent, 9.6 per cent and 12 per cent as above just 0.9 per cent.

PERSPECTIVE

For the development of a healthy, integrated financial system, there is a need to exploit the synergies between commercial banks and NBFCs and complement their efforts. In particular, NBFCs, which are smaller and more flexible intermediaries, can be more efficient in retailing banks' activities in consumer finance, hire-purchase and equipment leasing. Besides development of linkages, a sound regulatory framework for NBFCs will prevent widespread financial distress and facilitate the emergence of a strong and mature financial sector in the country.

CONCLUSION

Non-banking, financial companies are mostly private sector institutions, which have carved their niche in the Indian financial system. The NBFCs play a critical role as an instrument of credit delivery, particularly, in the micro, medium-small-scale sector and retail sectors.

The NBFCs are playing a unique role in mobilising funds, directing investments, providing a push to development, especially in the industrial sector, catering to the varied financial needs of the medium and the rural sector. All in all, a thriving, healthy and growing non-banking financial sector is necessary for promoting the growth of an efficient and competitive economy. Thus, NBFCs have emerged as a unique institution in the Indian financial system, bridging the credit gaps in several sectors. With the resource support from SIDBI and NABARD, the NBFCs can cater to the needs of SME, agriculture and retail sectors.

As NBFCs Provide important services in certain niche areas of the financial sector, improvement in the efficiency of these entities is of crucial importance. Protection of deposits, improvement in corporate governance practices and financial disclosures by NBFCs needs to be focused in future. At the same time NBFCs need to make concerted efforts to reduce their high operating expenses and simultaneously rise the level of the operating efficiency. They should inculcate professionalism in managing the NBFCs.

The focus of regulatory measures in respect of NBFCs has been on diversifying their areas of business by allowing them to issue co-branded cards and distribution of mutual fund products,

regulation of systemically important NBFCs, fair practices code and corporate governance. Equal emphasis has been on constantly improving the asset quality and CRAR of NBFCs.

REPORT OF THE TASK FORCE ON NBFCs (Chairman Mr. C.M. Vasudev): OCTOBER 1998: MAIN HIGHLIGHTS

ANNEXURE - 1

- Higher CRAR of say 15% for NBFCs accepting public deposits without credit rating; continue 12% CRAR of all rated NBFCs.
- Need for upward revisions of present minimum capital requirement of ` 2.5 million.
- RBI to review prudential norms applicable to NBFCs. To prevent deployment of public deposits in high-risk avenues, RBI to lay down ceilings for exposure to real estate and capital markets and tighten exposures to connected companies.
- Quantum of deposits may not be linked to the rating per se provided the rating is above the minimum investment grade. Proposed ceilings could be as under:

Type of Company	*Limit of Public Deposits*
NBFCs with NOF less than ` 2.5 million	No access to public deposits
EL/HP company without credit rating	1.5 times NOF or ` 100 million whichever is lower (higher CRAR of 15%)
EL/HP company with investment grade credit rating or above	4 times NOF
Loan/investment companies with investment grade credit rating or above	1.5 times NOF (higher CRAR of 15%)

- RBI to consider measures for easing the flow of credit from banks to NBFCs and also prescribe a suitable ratio between secured and unsecured deposits for NBFCs.
- Liquid asset ratio to be increased gradually to 25% of public deposits.
- RBI to be statutorily empowered to appoint depositors' grievance redress authorities with specified territorial jurisdiction. In the meantime, tighten procedures for dealing with complaints of depositors by putting in place a mechanism for speedy disposal of complaints.
- Intensive publicity campaigns through print and electronic media for increasing depositors' awareness. No deposit insurance for depositors in NBFCs.
- Setting up of a separate mechanism for regulation and supervision of NBFCs under RBI, with representation of experts and other professionals. Strengthening offsite surveillance of NBFCs and ensuring sensitive market intelligence.

SELF ASSESSMENT QUESTIONS

(1) Examine the note of the banking finance companies in India.

(2) Analyse the growth of NBFCS and it implications.

(3) Examine the regulation of NPRFCS.