A MANUAL ON NON BANKING FINANCIAL INSTITUTIONS

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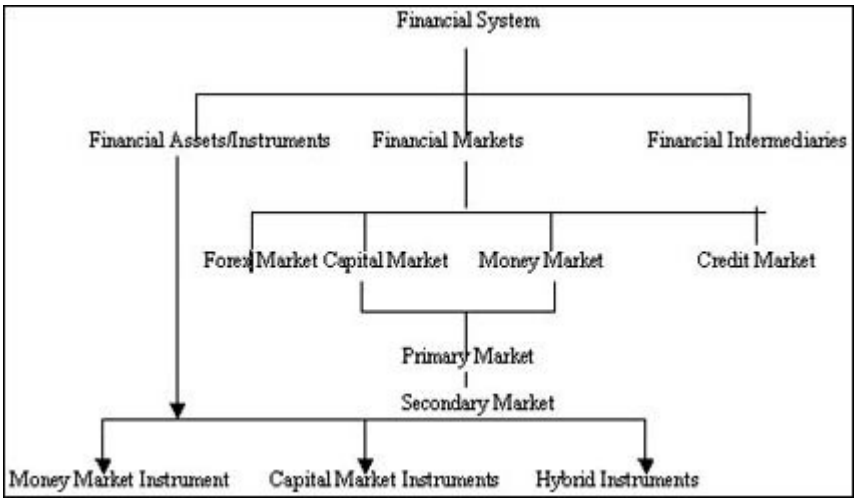
1.0 INTRODUCTION

Non Banking Finance Institutions is a constituent of the institutional structure of the organized financial system in India

The term “Finance” is often understood as being equivalent to “money”. However, finance exactly is not money; it is the source of providing funds for a particular activity. Providing

or securing finance by itself is a distinct activity or function, which results in Financial Management, Financial Services and Financial Institutions. Finance therefore represents the resources by way funds are needed for a particular activity. We thus speak of 'finance' only in relation to a proposed activity. Finance goes with commerce, business, banking etc. Finance is also referred to as "Funds" or "Capital", when referring to the financial needs of a corporate body.

The Financial System of any country consists of financial markets, financial intermediation and financial instruments or financial products. All these items facilitate transfer of funds and are not always mutually exclusive. Inter-relationships between these are a part of the system e.g. Financial Institutions operate in financial markets and are, therefore, a part of such markets.
The word system, in the term financial system, implies a set of complex and closely connected or inter-linked Institutions, agents, practices, markets, transactions, claims, and liabilities in the economy.



The Financial Intermediaries in the Financial System can broadly be said to comprise of:

- Banks; and
- NBFCs

And NBFCs can be further classified into different types depending on their nature of business.

Further, total Finance sector in India may be classified into Formal and Informal Finance.

The informal sector of finance may be said to refer to all economic activities that fall outside the formal sector that is regulated by economic and legal institutions e.g money lenders, some channels of micro finance and the other not necessarily regulated sectors. Landlords, local shopkeepers, traders, suppliers and professional money lenders, and relatives are the informal sources of micro-finance for the poor, both in rural and urban areas.

The Formal sector can be said to comprise of the Formal and necessarily regulated channels of financing like, finance provided by Banks, Financial Institutions, Non-Banking Financial Institutions, and Micro finance institutions.

2.0 NON BANKING FINANCIAL INSTITUTIONS AND INTERNATIONAL REGULATORY SYSTEM

In most countries, the financial system extends beyond traditional banking institutions to include Non Banking Financial Intermediaries like insurance companies, mutual funds, market makers and other financial service providers.

There has been tremendous growth worldwide in the mobilization of financial resources outside traditional banking systems. Channeled mainly through capital markets, such rapid financial diversification is posing new challenges for regulators in many emerging markets.

These non-banks financial institutions provide services that are not necessarily suited to banks, serve as competition to banks, and specialize in sectors or groups. Having a multi-faceted financial system, which includes non-bank financial institutions, can protect economies from financial shocks. However, in developing countries that lack a coherent policy framework and effective regulations, non-bank financial institutions can exacerbate the fragility of the financial system.

To summarize:

- NBFIs have much to contribute, but they also bring some risks;
- Those risks are best contained by sound regulation that seeks to create a generally level playing field, without stifling either the growth or individuality of NBFIs;
- These objectives notwithstanding, NBFI regulation is generally underdeveloped throughout most of the world;
- The three areas in which improvements are most needed are:

1. In the legal powers granted to NBFI regulators
2. In the prudential standards, regulations and rules which, in general, need to become more risk-based to catch up with banking standards;
3. In the internal practices and processes of regulators where there is a general need for stronger governance standards and for a greater commitment to enforcement among prudential regulators and conduct regulators alike.

What is a Non Banking Financial Institution (NBFI)?

A Non Banking Financial Institution/ Non Banking Financial Intermediary has different definitions in different countries:

- Any institution which is not a bank but is involved in finance ....
- Financial institutions not taking demand deposits
- Financial institutions not taking any deposit

NBFIs are different types of financial institutions that provide the following types of services:

- Payments
- Liquidity / credit
- Divisibility: break up large denomination and aggregate small denomination
- Store of value
- Information: processing and assessing risks
- Risk pooling: lower the risks of investors

Many NBFI provide services that are also provided by banks, hence the distinction between banks and NBFI has become blurred. Many NBFI belong to supervised conglomerates (or conglomerates that should be supervised).

Types of NBFIs

NBFIs can be classified by the main services they provide:

• Deposit taking institutions (e.g Thrifts, credit unions, savings& loans.)
• Risk-pooling institutions (e.g insurance co.)

• Contractual savings institutions (e.g Mutual funds, pension funds, other investment institutions)
• Market makers (e.g Investment banks, stockbrokers.)
• Specialized sectoral financiers (e.g leasing companies, real state finance co., micro-finance institutions.)
• Financial service providers (e.g Brokers, investment advisers.)

Contributions by NBFIs and Banks

Financial institutions, including banks and non-banks, provide some or all of the following core financial services. These services are often provided in combinations:

1. Some financial institutions provide payments services – by issuing claims that have the capacity to be used in settling transactions. To serve as an effective means of payments, a claim must have a highly stable and reliable value, be widely accepted in exchange and must be linked to the arrangements for ultimate settlement of value.

2. Liquidity is the ease with which an asset's full market value can be realized once a decision to sell has been made. Financial institutions enhance liquidity through specialization and scale.

3. Divisibility - Divisibility is the extent to which an asset can be traded in small denominations. Financial institutions break up large denomination (lumpy) claims and aggregate small denomination claims to meet divisibility preferences of the community.

4. Store of value is the extent to which an asset provides a reliable store of purchasing power over time – this is fundamental to satisfying savings preferences.

5. Information is costly to access and process. Providing economies of scale in processing and assessing risks is an important role of financial institutions.

6. Risk pooling is the extent to which an asset spreads the default risk of the underlying promises by pooling. By pooling assets, financial institutions have much more scope to risk pool than do individuals.

Banks provide an attractive bundle of most of the core financial services in their deposit product:

- Ability to write cheques on deposits means that banks offer payments services and liquidity equal to that of currency.
- Deposits also offer exceptionally high divisibility (at least to the same level as currency).
- The store of value service is that of a debt promise in that deposits promise repayment at (nominal) face value plus interest.
- Banks resolve the information conflict faced by borrowers and generally enjoy substantial economies of scale in processing and analyzing information.
- Finally, banks risk pool borrowers' promises into a single promise by the intermediary itself.

Rationale for NBFIs

Banks offer all of the services that NBFIs offer, then why do we Need NBFIs? The Answer to this question emerges if we analyse the differences between Banks and NBFIs.

Difference between Banks and NBFIs in India:

NBFCs are doing functions akin to that of banks, however there are a few differences:

(i) a NBFC cannot accept demand deposits;
(ii) it is not a part of the payment and settlement system and as such cannot issue cheques to its customers; and
(iii) deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation (DICGC) is not available for NBFC depositors unlike in case of banks.

1. Inefficiency of Banks

In principle, there is no reason why banks can't provide all services – indeed to an extent they do. However they are extremely inefficient in providing some services and even face conflicting incentives in providing all services.

In short, the way in which banks provide their core services means that they cannot provide all services equally efficiently.
In order to provide certainty of value for payments, bank deposits must be low risk. This limits the range and nature of assets that banks can hold on the asset

side of their balance sheets and thereby the extent to which they can offer risk pooling. It also limits their ability to offer a wide range of store of value services, especially equity type stores of value services.

More generally, NBFIs play a range of roles that are not suitable to banks:

- through the enhancement of equity promises (adding liquidity, divisibility, informational efficiencies and risk pooling services), NBFIs broaden the spectrum of risks available to investors;
- in this way they encourage investment and savings and improve the efficiency of investment and savings;
- through the provision of contingent promises they foster a risk management culture by encouraging those who are least able to bear risk to sell those risks to those better able to manage them; and
- they can enhance the resilience of the financial system to economic shocks

NBFIs complement banks by providing services that are not well suited to banks; they fill the gaps in financial services that otherwise occur in bank-based financial systems.

2. Serve as Competition for Banks

Equally important, NBFIs provide competition for banks in the provision of financial services. NBFIs unbundle bank services and compete with them as providers. They specialize in particular sectors and target particular groups.

3. Economic Development

There is a growing body of hard evidence to suggest that:

- The development of financial intermediaries contributes strongly to economic growth;
- That contribution is increased where intermediation is provided through a balanced combination of NBFIs and banks – in particular, there is a strong correlation between the depth and activeness of non-banks and stock markets on the one hand, and economic development on the other.

In the first place, banks offer assets (deposits) that claim to be capital certain. If this promise is to be honored, then there must be limits to the range and nature of assets that a bank can reasonably take on to its balance sheets. Notwithstanding the existence of universal banking in many parts of the world (i.e., banks also engaged in securities market

activities), this consideration implies that bank-based financial system will tend to have a smaller range of equity-type assets than those with a more broadly based structure including a wide range of NBFIs. More generally, NBFIs play range of roles that are not suitable for banks and through their provision of liquidity, divisibility, informational efficiencies, and risk pooling services, they broaden the spectrum of risks available to investors. In this way, they encourage and improve the efficiency of investment and savings. Through the provision of a broader range of financial instruments, they are able to foster a risk management culture by attracting customers who are least able to bear risks and fill the gaps in financial services that otherwise occur in bank-based financial systems.

4. Financial Stability

In a financial sector in which NBFIs are comparatively undeveloped, banks will inevitably be required to assume risks that otherwise might be borne by the stock market, collective investment schemes or insurance companies. However, there is basic incompatibility between the kinds of financial contracts offered by the banks and those offered by the financial institutions. Thus, banks are more likely to fail as a result. One way of minimizing financial fragility in the developing economies may be to encourage a diversity of financial markets and institutions, where investors are able to assume a variety of risks outside the banking system itself. Without this diversity, there is a tendency for all risks to be bundled within the balance sheet of the banking system, which may lead to severe financial crises more likely. This point was widely noted by policymakers in their analysis of the lessons of the Asian currency crisis, for instance.

As Alan Greenspan (1999) pointed out, the impact of the currency crisis in Thailand might have been significantly less severe if some of the risks borne by the Thai banks had instead been borne by the capital markets.

Risks Associated with NBFIs And Why we Need to Regulate the NBFIs :

While NBFIs can contribute to the economy, they also bring risks and the only way to contol these risks is through proper regulation. Risk will vary depending upon the economic functions performed by NBFIs.

The challenge for regulation is striking the right balance between the risks and benefits.

On the one hand, too little or no regulation can lead to crisis and severely impact the vulnerable and the economy. This has been a major attribute to the Asian crisis in the late 90s – finance companies in Thailand and merchant banks in Korea. On the other hand, too strict or inappropriate regulation can hinder innovation and development. The call for 'deregulation' in developed economies reflects this.

Getting the right balance is a perpetual challenge for financial regulators and supervisors, not only in the developing countries, but also in developed and advanced economies.

1. To Prevent Systemic Risk

' Systemic' means, - affecting the entire body or organization (the complex whole.) Systemic Risk means the market risk or the risk that cannot be diversified away, as opposed to "idiosyncratic risk", which is specific to individual stocks. It refers to the movements of the whole economy.

A systemic problem can be said to arise when a failure of one institution creates large social costs (contagion, generalized panic, interruption of the payments system, etc):

The essence of systemic risk is therefore the correlation of losses. For example, if one bank goes bankrupt and sells all its assets, the drop in asset prices may induce liquidity problems of other banks, leading to a general banking panic.

Regulation of NBFIs to prevent systemic risk is necessary because NBFIs tend not to adequately internalize systemic risks.

2. Guard against 'regulatory arbitrage' – when different institutions subject to different regulatory constraints can offer the same type of products.

NBFIs can be used as a means of outwitting or evading the intent of regulations imposed on banks.

Competition between NBFIs and banks in providing financial services is healthy. But competition based on lax regulation is unhealthy - and can have disastrous consequences that may affect economic growth and financial stability for years.

This effect has been clearest where NBFIs have been either totally or largely unregulated and have thereby gained a competitive advantage in competing with regulated banks on their own territory.

The fallout from this type of behaviour was widely experienced in the Asian region in the late 1990s.

- In Thailand, finance companies issued high-yielding promissory notes and borrowed offshore, then loaned the funds in local currency to high-risk borrowers who could not meet banking standards – when the crisis hit in mid 1997, the Government was forced to close 69 insolvent finance companies;
- Malaysia experienced similar problems with finance companies that had extended hire -purchase loans;
- In Korea, NBFIs grew very strongly in the pre-97 period precisely because they competed directly with banks, but with a regulatory advantage. The problem re -emerged in a different guise between '97 and '99 when poorly regulated Investment Trust Companies took over as the primary source of corporate finance.
- China has also had problems associated with Investment Trust Companies.

The business in which NBFIs are permitted to engage is ultimately a matter of choice. To illustrate the point, following the crisis in 1997, the Korean Authorities accepted that Merchant Banks in Korea effectively are in the same business as banks and have changed their regulatory requirements so that their merchant banks now face essentially the same capital, provisioning, liquidity, large exposure and foreign exchange requirements as banks.
In contrast, in Australia the decision was taken that Merchant Banks should not be allowed to do the business of banks (defined as taking deposits from the public) and so they are regulated much more lightly than banks.

To prevent regulatory arbitrage between banks and NBFIs there is a need to have a coherent regulatory framework that covers the whole of the financial system and which regulates similar risks in similar ways – regardless of which institutions offer the particular services.

3. Conglomerate Contamination

A major risk with NBFIs arises from their association with banks through

conglomerates.

While many countries have quite sound regulatory frameworks for supervising banks, very few have either the legal power or the policy framework for adequately supervising conglomerate groups in which banks own and operate large non-bank subsidiaries.

This problem was also a contributor to the crisis in the late 1990s, most particularly in Korea and Indonesia. But the problem is by no means confined to emerging markets. Australia has lost only two banks through outright failure in the past century. Both failed because of high-risk activities carried out through their unregulated and very large subsidiaries.

4. To Protect consumers against market misconduct

This is one of the primary reasons for NBFI supervision and regulation – that depositors are protected against the NBFIs failure to repay.
In a perfect market, we would expect individual depositors, policy holders and investors to have information based on which they can assess the institutions before they enter into any deals. The reality is information is not always reliable and customers lack expertise to analyse the information to determine the value of promises made to them by financial institutions. The regulator's role is to ensure that those promises are reasonable, understandable and adequately backed by capital reserves.

To protect the consumers, the regulators need to lay down certain Rules of Conduct for the NBFIs which will help to prevent insider trading, conflict of interest, false advertisement etc. For this purpose the Regulators generally have certain norms like:

- Certain Entry restrictions like licensing etc.
- Disclosure of information
- Financial strength (minimum capital etc.)
- Governance of the NBFIs (responsibilities etc.)
- Rules for conduct of business

5. To enhance efficiency of NBFIs:

To enhance the efficiency of NBFIs and to prevent anti-competitive behavior, the Regulators need to lay down Rules that deal with structure of industries

(merger or anti-trust laws), Rules that prevent anti-competitive behavior (collusion; free entry and exit).

6. To Prevent Asymmetric information

Asymmetric Information arises where products and services are sufficiently complex that disclosure itself is not enough to allow consumers to make informed choices (buyers and sellers not equally informed)

In economics and contract theory, information asymmetry deals with the study of decisions in transactions where one party has more or better information than the other. This creates an imbalance of power in transactions which can sometimes cause the transactions to go awry. Information asymmetry models assume that at least one party to a transaction has relevant information whereas the other(s) do not.

To prevent from creating a situation of asymmetric information, Regulators need to specify norms with respect to the following:

- Entry and exit rules
- Minimum capital or liquidity requirements
- Restrictions to operations and limits
- Risk management requirements and accountability

7. Social objectives

NBFIs have an important role to play in financial and economic development of a country. International experience with government sponsored entities or rules goes to show that it is not clear that the solution is always better than the problem. The Government has to consider various issues like- Not enough financing for a sector? Housing? Agriculture? Others? Are interest rates too high? Etc.
However, under negative (or positive) externalities, private decisions of an organization provide less (or more) than the socially desirable outcome of a service. Therefore regulation by the Government is most essential so that the NBFI does not overlook its importance and the necessity of fulfilling its social objectives

8. NBFIs can be popular vehicles for money laundering and financing of terrorism and hence the need for regulation on that front is also in place.

Regulatory Authorities for NBFIs in some Countries

The structure of the regulator can and does take different forms in different jurisdictions. A recent trend has been a shift towards more integrated supervision with banking, insurance and capital market regulation being brought within one organisation.

The United Kingdom's Financial Services Authority is an example of integrated supervision while Australia's twin regulators (ASIC and APRA) focus on prudential and market conduct functions, respectively.

1. United Kingdom :

Financial Services Authority (FSA)
FSA is the Regulator of all providers of financial services in the UK
However, Bank of England retains responsibility for systemic risk.

2. Australia:

Twin regulators

1. Australian Securities and Investments Commission (ASIC):
ASIC is the corporates, markets conduct and financial services regulator. ASIC regulates Australian companies, financial markets, financial services organisations and professionals who deal and advise in investments, superannuation, insurance, deposit taking and credit.

2. Australian Prudential Regulation Authority (APRA):
APRA is the prudential regulator of the Australian financial services industry.
APRA oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry.

3. Singapore:

Monetary Authority of Singapore (MAS)
MAS covers both prudential supervision of the banking and insurance sectors, capital market regulation and business conduct regulation across the financial system.

4. United States:

Principal Regulatory Agencies of the US Financial System

Regulatory Agency:	Regulatory Areas:
Securities and Exchange Commission **SEC**	Organized exchanges and financial markets, market participants, mutual funds and investment companies, Section 20 affiliates
Commodities, Futures Trading Commission **CFTC**	Derivatives markets and participants
Office of Comptroller of the Currency **OCC**	Federally chartered commercial banks
Federal Reserve System	All member banks, bank holding companies, Section 20 affiliates
Federal Deposit Insurance Corporation **FDIC**	State chartered commercial and cooperative banks, insured industrial banks
National Credit Union Administration **NCUA**	Federally chartered credit unions
Office of Thrift Supervision **OTS**	Savings and loan associations, savings banks
State Banking and Insurance Commissions	State chartered banks (deposit institutions) and insurance companies

Source: Background paper prepared by Terry M. Chuppe, *Non-Bank Financial Institutions Regulation*, 1996. Mimeo, Washington, D.C.

5. India:

Reserve Bank of India (RBI)

6. Mauritius:

Financial Services Commission (FSC).

7. Malaysia:

Bank Negara Malaysia (BNM), the Central Bank

8. Bangladesh:

Bangladesh Bank (the Central Bank)

9. Phillipines:
The Bangko Sentral ng Pilipinas (Central Bank of the Philippines)

3.0 EMERGENCE OF NBFCs – INDIAN HISTORICAL PERSPECTIVE

The non-banking financial companies (NBFCs) flourished in India in the decade of the 1980s against the backdrop of a highly regulated banking sector. The simplified sanction procedures and low entry barriers encouraged the entry of a host of NBFCs. However, in many cases mismanagement / lack of efficient management resulted in problems arising out of adverse portfolio selection, un-prudent operations, inability to manage risk both on asset and liability side. In many cases due to non availability of adequate credit from the banking sector NBFCs had to rely excessively on unsecured public deposits for their existence / survival by paying higher rate of interest. To service such high cost deposits, some NBFCs were forced to deploy their funds which carried high return coupled with high risk . This ultimately resulted in higher risks for their depositors, which in some cases had culminated in the crisis of confidence and credibility.

The Reserve Bank of India Act, 1934 was amended on 1st December, 1964 by the Reserve Bank Amendment Act, 1963 to include provisions relating to non-banking institutions receiving deposits and financial institutions. It was observed that the existing legislative and regulatory framework required further refinement and improvement because of the rising number of defaulting NBFCs and the need for an efficient and quick system for redressal of grievances of individual depositors.

Also, it was felt necessary to initiate immediate action for the protection of depositors' interest. RBI issued the Non Banking Companies (Reserve Bank) Directions, 1977, guidelines on prudential norms and various other Directions and clarifications, from time to time for governing the activities of NBFCs. Central Government, during 1974, introduced 58A in the Companies Act, 1956 which empowered Central Government to regulate acceptance and renewal of deposits and to frame rules in consultation with Reserve Bank of India (RBI) prescribing (a) the limit up to, (b) the manner and (c) the conditions subject to which deposits may be invited or accepted / renewed by companies.The Central Government in consultation with RBI framed Companies (Acceptance of Deposits) Rules, 1975.

Given the need for continued existence and growth of NBFCs, the need to develop a framework of prudential legislations and a supervisory system was felt especially to encourage the growth of healthy NBFCs and weed out the inefficient ones. Continuing this process, RBI Act, 1934 was amended in 1997 which authorised the Reserve Bank to determine policies, and issue directions to NBFCs regarding income recognition, accounting standards, NPAs, capital adequacy, etc. The amended Act, inter alia, provided for compulsory registration of all NBFCs into three broad categories, viz., (i) NBFCs accepting public deposit; (ii) NBFCs not accepting/holding public deposit; and (iii) core investment companies (i.e., those acquiring shares/securities of their group/holding/ subsidiary companies to the extent of not less than 90 per cent of total assets and which do not accept public deposit).

Until some years back, the prudential norms applicable to banking and non-banking financial companies were not uniform. Moreover, within the NBFC group, the prudential norms applicable to deposit taking NBFCs (NBFCs-D) were more stringent than those for non-deposit taking NBFCs (NBFCs-ND). Since the NBFCs-ND were not subjected to any exposure norms, they could take large exposures. The absence of capital adequacy requirements resulted in high leverage by the NBFCs. Since 2000 however, the Reserve Bank has initiated measures to reduce the scope of 'regulatory arbitrage' between banks, NBFCs-D and NBFCs-ND.

NBFCs - Committees formed

Various committees were formed in India to review the existing framework and address the shortcomings. Some of the committees and its recommendations are given hereunder:

1. James Raj Committee (1974)

The James Raj Committee was constituted by the Reserve Bank of India in 1974. After studying the various money circulation schemes which were floated in the country during that time and taking into consideration the impact of such schemes on the economy, the Committee after extensive research and analysis had suggested for a ban on Prize chit and other schemes which were causing a great loss to the economy. Based on these suggestions, the Prize Chits and Money Circulation Schemes (Banning) Act, 1978 was enacted.

2. Chakravarthy Committee (1984)

This Committee headed by Shri Sukhamoy Chakravarty was formed to review the Working of the Monetary System. It made several recommendations for the development of money market.

3. Vaghul Committee (1987)

As a follow-up to the Chakravarty committee, the RBI set up a Working Group on Money Market under the Chairmanship of Shri N. Vaghul, which submitted its Report in 1987 containing number of measures to widen and deepen the money market.

4. Narasimhan Committee (1991)

This committee was formed to examine all aspects relating to the structure, organization & functioning of the financial system.

5. Dr.A.C.Shah Committee (1992)

The Working Group on Financial Companies constituted in April 1992 i.e the Shah Committee set out the agenda for reforms in the NBFC sector. This committee made wide ranging recommendations covering, inter-alia entry point norms, compulsory registration of large sized NBFCs, prescription of prudential norms for NBFCs on the lines of banks, stipulation of credit rating for acceptance of public deposits and more statutory powers to Reserve Bank for better regulation of NBFCs.

6. Khanna Committee (1995)

This Group was set up with the objective of designing a comprehensive and effective supervisory framework for the non-banking companies segment of the financial system. The important recommendations of this committee are as follows:

i. Introduction of a supervisory rating system for the registered NBFCs. The ratings assigned to NBFCs would primarily be the tool for triggering on-site inspections at various intervals.
ii. Supervisory attention and focus of the Reserve Bank to be directed in a comprehensive manner only to those NBFCs having net owned funds of Rs.100 lakhs and above.
iii. Supervision over unregistered NBFCs to be exercised through the off-site surveillance mechanism and their on-site inspection to be conducted selectively as deemed necessary depending on circumstances.
iv. Need to devise a suitable system for co-ordinating the on-site inspection of the NBFCs by the Reserve Bank in tandem with other regulatory authorities so that they were subjected to one-shot examination by different regulatory authorities.

v. Some of the non-banking non-financial companies like industrial/manufacturing units were also undertaking financial activities including acceptance of deposits, investment operations, leasing etc to a great extent. The committee stressed the need for identifying an appropriate authority to regulate the activities of these companies, including plantation and animal husbandry companies not falling under the regulatory control of either Department of Company Affairs or the Reserve Bank, as far as their mobilisation of public deposit was concerned.

vi. Introduction of a system whereby the names of the NBFCs which had not complied with the regulatory framework / directions of the Bank or had failed to submit the prescribed returns consecutively for two years could be published in regional newspapers.

Most of the recommendations of the Committee were accepted by the Reserve Bank after an in depth analysis and the revised framework for effective supervision of the NBFCs including off-site monitoring of NBFCs is being put in place.

7. Vasudev Committee (1998)

This committee emphasised the need for strengthening of the NBFC sector including entry norms and prudential norms, and dealt with framework for acceptance of public deposits, issues concerning unincorporated financial intermediaries and addresses issues of supervision of NBFCs.

The important recommendations of this committee are as follows:

i. Present minimum captial requirement of Rs.25 lakhs to be reviewed upwards keeping in view the need to impart greater financial soundness and achieve economies of scale in terms of efficiency of operations and managerial skills.

ii. As operations of NBFCs are concentrated in remote areas, the RBI may apprise the State Governments of the companies which have been granted registration as well as the companies whose applications have been rejected.

iii. The present capital adequacy ratio requirement may be maintained at 12% for all rated NBFCs, higher rate of about 15% need to be prescribed by RBI for those NBFCs which seek public deposit without credit rating.

iv. RBI may stipulate that the NBFCs should invest at least 25% of their reserves in marketable securities apart from the SLR securities already held by the NBFCs.

v. Linking of quantum of public deposits with credit rating because apart from having the effect of conferring regulatory functions on the rating agencies, it also exposes the NBFCs to frequent asset liability mismatches arising out of changes in credit rating.

vi. RBI should consider measures for easing the flow of credit from banks to NBFCs and then consider prescribing a suitable ratio as between secured and unsecured deposits for NBFCs.

vii. Appointment of depositors' grievance Redressal authorities with specified territorial jurisdiction.

viii. The procedure for liquidation of NBFCs to be substantially in line with those available for banks.

ix. A separate instrumentality for regulation and supervision of NBFCs under the aegis of the RBI should be set up, so that there is a great focus in regulation and supervision of the NBFC sector.

x. The Committee felt it was not judicious to introduce a deposit insurance scheme for the depositors in NBFCs because of the moral hazard issues, likelihood of assets stripping and likely negative impact on the growth of a healthy NBFC sector.

xi. Reserve Bank could use the services of chartered accountants with suitable experience and capabilities to carry out inspection of the smaller NBFCs.

NBFC – some recent measures

1. Advising NBFC on Advertisement in Electronic Media -

In order to ensure transparency in the interest of depositors in the context of such advertisements, a provision was incorporated in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998, in terms of which companies are required to state that they have a valid Certificate of Registration issued by the Reserve Bank. However, the Reserve Bank does not accept any responsibility or guarantee about the present position as to the financial soundness of the company or for the correctness of any of the statements or representations made or opinions expressed by the company and for repayment of deposits/discharge of the liabilities by the company.

2. Corporate Governance

Listed NBFCs which are required to adhere to listing agreement and rules framed by SEBI on Corporate Governance are already required to comply with SEBI prescriptions on Corporate Governance.

As per the RBI Circular RBI/2009-10/17 DNBS (PD) CC No. 156 / 03.10.001 / 2009-10 dated July 1, 2009; guidelines for corporate governance have been proposed for
1. All Deposit taking NBFCs with deposit size of Rs 20 crore and above
2. All non-deposit taking NBFCs with asset size of Rs 100 crore and above (NBFC-ND-SI).

Some of the guidelines include -
a) Constitution of Audit Committee in case of NBFC-D with deposit size of Rs 20 crore
b) Constitution of Nomination committee: The guidelines state that it would be desirable that NBFC-D with deposit size of Rs 20 crore and above and NBFC-ND-SI may form a Nomination Committee to ensure 'fit and proper' status of proposed/existing Directors
c) Constitution of Risk Management Committee-To manage the integrated risk, a risk management committee may be formed, in addition to the ALCO (Asset Liability Management Committee) in case of the above category of NBFCs.
d) Disclosure & Transparency - Certain information should be put up by the NBFC to the Board of Directors at regular intervals as may be prescribed by the Board in this regard.
e) Compliance with instructions on connected lending relationships

3. Revising Rate of Interest - The maximum interest rate payable on public deposits by NBFCs was revised to 12.5 per cent per annum on and from April 24, 2007.

4. Advising NBFCs for (a) not engaging telemarketers who do not have any valid registration Certificate from Department of Telecommunications (DoT), Government of India as Telemarketers, (b) furnishing list of telemarketers engaged by them alongwith the registered Tel.Nos. being used by them for making telemarketing calls to TRAI and (c) ensuring that all the agents presently engaged by them register themselves with DoT telemarketers in pursuance to the Telecom Regulatory Authority of India (TRAI) having framed Telecom Unsolicited Commercial Communications (UCC) Regulations for curbing UCC to the subscribers who do not want to receive UCC.

5. Reporting of Secondary Market Transactions
All NBFCs were advised to report their secondary market transactions in corporate bonds done in OTC market, on The Fixed Income Money Market and Derivatives Association of India's (FIMMDA's) reporting platform with effect from September 1, 2007
FIMMDA is an Association of Commercial Banks, Financial Institutions and Primary Dealers. FIMMDA is a voluntary market body for the bond, Money And Derivatives

Markets

6. Monitoring of Frauds in NBFCs

In March 2008 all deposit taking NBFCs (including RNBCs) were advised that the extant instructions with regard to monitoring of frauds were revised and as such cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' were to be reported as fraud if the intention to cheat/defraud was suspected/proved. However, in cases where fraudulent intention was not suspected/ proved at the time of detection but involve cash shortages of more than ten thousand rupees and cases where cash shortages more than five thousand rupees were detected by management/auditor/inspecting officer and not reported on the occurrence by the persons handling cash, then such cases may also be treated as fraud and reported accordingly.

7. Issuing Guidelines on Registration, Operations, Prudential Norms and Investment Directions for Mortgage Guarantee Companies

8. Issuing guidelines on Treatment of Deferred Tax Assets (DTA) and Deferred Tax Liabilities (DTL) for Computation of Capital

As creation of deferred tax assets (DTA) or DTL gives rise to certain issues impacting the balance sheet of the company, NBFCs were advised on July 31, 2008 regarding the regulatory treatment to be given to these issues. As per these guidelines, the balance in DTL account will not be eligible for inclusion in Tier I or Tier II capital for capital adequacy purpose as it is not an eligible item of capital. DTA will be treated as an intangible asset and should be deducted from Tier I capital. NBFCs were advised to ensure compliance with these guidelines from the accounting year ending March 31, 2009

9. Instructing on the obligations of NBFC under PMLA Act,2002

Cash transaction reporting by branches/offices of NBFCs to their Principal Officer should be submitted on a monthly basis and the Principal Officer, in turn, should ensure to submit cash transaction report (CTR) for every month to the Financial Intelligence Unit – India (FIU-IND) within the prescribed time schedule.

10. Undertaking various Policy Initiatives for NBFCs-ND-SI in 2007-08 such as Guidelines on Capital Adequacy, Liquidity and Disclosure Norms; Issuance of Perpetual Debt Instruments and Access to Short-Term Foreign Currency Borrowings

11. Instructions on Capital adequecy norms for non- deposit taking NBFC - The Reserve Bank of India (RBI) on 2nd June 2008 asked non-deposit taking NBFCs to raise the

minimum Capital to Risk-weighted Assets Ratio (CRAR) from 10% now to 12% with immediate effect and further to 15% with effect from April 1, 2009.

4.0 NON BANKING FINANCIAL COMPANY – MEANING

Non-banking financial companies (NBFCs) engaged in varied financial activities are part of the Indian financial system providing a range of financial services.

Although the terms Non Banking Financial Institution (NBFI) and Non Banking Financial Company (NBFC) is generally used interchangeably in India and when referring to each the meaning implied is the same, however technically there lies a difference in the as the terms have been defined in specific terms in the Reserve Bank of India Act (RBI Act) 1934 and hence the necessity for a separate chapter on the subject.

A Non Banking Financial Institution/ Non Banking Financial Intermediary (NBFI) is prevalent in most countries and may have different forms and different definitions in different countries. NBFI will thus serve the purpose of description of a more universal class while we will use the term NBFC as more suited to India as the definition of NBFC inherently incorporates the fact that it is a company incorporated under the Companies Act, 1956.

NBFC is a company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934 which should have a minimum net owned fund of Rs 25 lakh (raised to Rs 200 lakh w.e.f April 21, 1999).

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/ stock/ bonds/ debentures/ securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.

‘NBFC’, is defined under sec. 45-I(f) of the Act, as under
"non-banking financial company" means-
(i) a financial institution which is a company;

(ii) a non banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
(iii) such other non-banking institution or class of such institutions, as the bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.

For this purpose, the definition of 'Principal Business' given, vide Press Release 1998-99/1269 dated April 8, 1999 may be followed:
"The company will be treated as a non-banking financial company (NBFC) if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets) and income from financial assets is more than 50 per cent of the gross income. Both these tests are required to be satisfied as the determinant factor for principal business of a company."

Definitions of NBFC

Whereas the 'Reserve bank of India Act 1934' itself defines the term NBFC, there is a different definition of the same term viz. NBFC in the 'Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1988' that the RBI itself has issued under the aforesaid Act of 1934.

A. NBFC under the RBI Act

Under section 45-I(a) of the RBI Act,1934 'business of non banking financial institution ', is defined in terms of the business of a financial institution and NBFC.

NBFI

Sec: 45-I(a) : "business of a non-banking financial institution" means carrying on of the business of a financial institution referred to in clause (c) and includes business of a non-banking financial company referred to in clause (f);]

FI

The Act defines 'Financial Institution' (FI) u/s 45-I(c) as

"financial institution" means any non-banking institution which carries on as its business or part of its business any of the following activities, namely :-
(i) the financing, whether by way of making loans or advances or otherwise, of any activity other than its own;
(ii) the acquisition of shares, stock, bonds, debentures or securities issued by a government or local authority or other marketable securities of a like nature;
(iii) letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of section 2 of the Hire-Purchase Act, 1972 (26 of 1972);
(iv) the carrying on of any class of insurance business;
(v) managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any State, or any business, which is similar thereto;
(vi) collecting, for any purpose or under any scheme or arrangement by whatever name called monies in lump sum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes or gifts, whether in cash or kind, or disbursing monies in any other way, to persons from whom monies are collected or to any other person,
but does not include----------.”

The definition of FI uses the definition of a Non Banking Institution. (NBI)

NBI has been defined under the RBI Act 1934 as follows:

NBI

Sec.45-I(e) : "non-banking institution" means a company, corporation or co-operative society.

NBFC

‘NBFC’, itself is defined under sec. 45-I(f) of the Act, as under

Sec. 45-I(f):) "non-banking financial company" means-
(i) a financial institution which is a company;
(ii) a non banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) such other non-banking institution or class of such institutions, as the bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.
For this purpose, the definition of 'Principal Business' given, vide Press Release 1998-99/1269 dated April 8, 1999 may be followed: "The company will be treated as a non-banking financial company (NBFC) if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets) and income from financial assets is more than 50 per cent of the gross income. Both these tests are required to be satisfied as the determinant factor for principal business of a company."

An analysis of forgoing provisions reveals that except for specifically notified categories, a company that is a FI, or a NBI receiving deposits, alone would qualify as an NBFC.

On reading jointly both of the definitions of FI and NBI reveals that for a company to be an NBFC it should either carry on any of the businesses as enumerated in (i) to (vi) of FI Sec. 45-I(c) or it should otherwise receive public deposits in any manner.

B. NBFC under the Non Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1988

Here the RBI has adopted another definition of NBFC.

NBFC
Para 2(1)(xi) of the Directions defines NBFC as -
Non-banking financial company means only the non-banking institution which is a loan company or an investment company or an asset finance company (w.e.f 6.12.2006) or a mutual benefit financial company.

The terms used in the above definition are also defined in the Directions, as under:

Loan company para 2(1)(viii) of the directions
Loan company means any company which is a financial institution carrying on as it's principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

Investment company para 2(1)(vi) of the directions
Investment Company is a company which is a financial institution carrying on as it's principal business the acquisition of securities.

Asset Finance Company para2(1)(ia) of the directions
Asset Finance Company means any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive / economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines.

Mutual Benefit Financial Company para 2(1)(ix) of the directions
means a company which is a financial institution notified by The Central Government under section 620A of The Companies Act 1956

Each category of above notified companies is an NBFC for the Directions. As per the definition given in the directions, these companies are a 'financial institution'.
However, the directions do not define financial institution.
Therefore 'financial institution' mentioned under imports its meaning from the definition in section 45-I(c) of the RBI Act. This is consequent to Para 2(2) of the directions.

As a consequence, each of these four categories of NBFC's under the Directions are also within the statutory meaning under the Act of the term NBFC.

Thus, NBFC's under the Reserve Bank of India Directions are a subset of the NBFC's under the Reserve Bank of India Act.

Classification of NBFCs

There is a lacuna in the form of a classification problem of Non Banking Finance Institutions. The RBI has identified as many as 12 categories of NBFIs. Five of them are regulated by the RBI; one — chit funds — jointly by the RBI and the Registrar of Chits and two — mutual benefit funds including nidhis and micro finance companies — by the Department of Company Affairs, Government of India. The National Housing Bank (NHB) regulates housing finance companies. The RBI has also included insurance companies,

stock broking companies and merchant banking companies among NBFCs. The last two are regulated by the Securities and Exchange Board of India while insurance companies come under the Insurance Regulatory and Development Authority. Other than the fact that all these come under the category of "non-banks," there are not many common features.

1. With effect from December 6, 2006 the NBFCs registered with RBI have been reclassified as

(i) Asset Finance Company (AFC)
(ii) Investment Company (IC)
(iii) Loan Company (LC)

The above type of companies may be further classified into:

- NBFCs accepting public deposits (NBFCs – D), and
- NBFCs not accepting / holding public deposits (NBFCs – ND)

Systemically important NBFCs

International Monetary Fund has framed principles for regulation of the financial sector, where it suggests that institutions performing similar functions should be subject to similar regulations. Accordingly, All NBFCs–ND with an asset size of Rs.100 crore and more as per the last audited balance sheet are now considered as systemically important NBFCs–ND (NBFC-ND-SI). NBFCs–ND– SI are required to maintain a minimum CRAR of 10 per cent. No NBFC–ND–SI is allowed to (i) lend to any single borrower/group of borrowers exceeding 15 per cent / 25 per cent of its owned fund; (ii) invest in the shares of another company/ single group of companies exceeding 15 per cent / 25 per cent of its owned fund; and (iii) lend and invest (loans/investments taken together)
exceeding 25 per cent of its owned fund to a single party and 40 per cent of its owned fund to a single group of parties.
This classification is in addition to the present classification of NBFCs into deposit-taking, and non-deposit-taking NBFCs. [RBI on Financial Regulation of Systemically Important NBFCs and Banks' Relationship with them- dated 12.12.2006]

2. Residuary non-banking companies (RNBCs)

A separate category of NBFCs called the Residuary non-banking companies (RNBCs) also exists as they could not be categorised into any one of the above three categories.

RNBCs are a category of NBFCs whose principal business is acceptance of deposits and investing in approved securities. These companies are required to maintain investments as

per directions of RBI, in addition to liquid assets. The functioning of these companies is different from those of NBFCs in terms of method of mobilisation of deposits and requirement of deployment of depositors' funds. However, Prudential Norms Directions are applicable to these companies also.

There is no ceiling on raising of deposits by RNBCs but every RNBC has to ensure that the amounts deposited and investments made by the company are not less that the aggregate amount of liabilities to the depositors.

To secure the interest of depositor, such companies are required to invest in a portfolio comprising of highly liquid and secured instruments viz. Central/State Government securities, fixed deposit of scheduled commercial banks (SCB), Certificate of deposits of SCB/FIs, units of Mutual Funds, etc.

3. Miscellaneous non-banking companies MNBCs (Chit Fund),

The Chit Companies, although governed by the Miscellaneous Non-banking Companies (MNBCs) (Reserve Bank) Directions, 1977, issued by the Reserve Bank with regard to acceptance of deposits, are regulated by the Registrar of Chits of the respective State Governments.

Furthermore, MNBCs, not accepting public deposits have been exempted from submitting returns to the Reserve Bank since December 27, 2005.

4. Mutual benefit financial companies (Nidhis and unnotified Nidhis)

Mutual benefit funds including Nidhi companies are not regulated by the Reserve Bank (except as pertaining to deposit taking activities) as they come under the regulatory purview of the Ministry of Corporate Affairs

5. Housing finance companies.

The National Housing Bank (NHB) regulates housing finance companies

6. Insurance companies

Insurance Companies are regulated by the Insurance Regulatory and Development Authority.

7. Stock broking companies and Merchant banking companies

These companies are regulated by the Securities and Exchange Board of India.

8. Mortgage Guarantee Companies

Mortgage Guarantee Companies have been notified as Non-Banking Financial Companies under Section 45 I(f)(iii) of the RBI Act, 1934.

Supervision of NBFCs by Reserve Bank

The supervisory framework for NBFCs is based on three criteria, viz.,
(a) the size of NBFC,
(b) the type of activity performed, and
(c) the acceptance or otherwise of public deposits.

Towards this end, a four-pronged supervisory strategy comprising –

(a) on-site inspection based on CAMELS (capital, assets, management, earnings, liquidity, systems and procedures) methodology,
(b) computerised off-site surveillance through periodic control returns,
(c) an effective market intelligence network, and
(d) a system of submission of exception reports by auditors of NBFCs, has been put in place.

The regulation and supervision is comprehensive for companies accepting or holding public deposits to ensure protection of interests of depositors.

Companies holding or accepting public deposits are required to comply with all the directions on acceptance of public deposits, prudential norms and liquid assets, and should submit periodic returns to the Reserve Bank. They are supervised using all the supervisory tools indicated above.

Companies not holding or accepting public deposits are regulated and supervised in a limited manner. They are required to comply only with prudential norms relating to income recognition, accounting standards, asset classification and provisioning against bad and doubtful debts. They are less frequently inspected. Such companies are now required to submit a monthly return to the Reserve Bank.

5.0 PRE-REQUISITES FOR CARRYING ON BUSINESS OF NBFC

The company desiring to be registered as a NBFC is required to submit its application for registration in the prescribed format along with necessary documents for RBI's consideration. RBI issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

The following pre-requisites mentioned below are cumulative and not alternative.

1. Registration Requirement

In terms of Section 45-IA of the RBI Act, 1934, it is mandatory that every NBFC should be registered with RBI to commence or carry on any business of non-banking financial institution as defined in clause (a) of Section 45 I of the RBI Act, 1934.

The registration is compulsory for all NBFCs, irrespective of their holding of public deposits. The RBI (Amendment) Act, 1997, which introduced comprehensive changes in Chapter III-B, III-C and V, provides for an entry point norm of Rs.25 lakh as the minimum net owned fund (NOF). Subsequently, fornew NBFCs seeking registration with the Reserve Bank to commence business on or after April 21, 1999, the requirement of minimum level of NOF was revised upwards to Rs.2 crore. No NBFC can commence or carry on business of a financial institution including acceptance of public deposit without obtaining a Certificate of Registration (CoR) from the Reserve Bank.

The company is required to submit its application for registration in the prescribed format alongwith necessary documents for RBI's consideration. The Bank issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied

Requirements to be complied with and documents to be submitted to RBI by NBFCs for obtaining certificate and Registration from RBI

An indicative list of documents/information to be furnished along with the application. All documents/information is to be submitted in duplicate.

1.	Minimum NOF requirement Rs. 200 lakh.
2.	Application to be submitted in two separate sets tied up properly in two separate files.
3.	Annex II to the Application Form to be submitted duly signed by the director/Authorized signatory and certified by the statutory auditors.

4.	Annex III (directors' profile) to the Application Form to be separately filled up for each director. Care should be taken to give details of bankers in respect of firms/companies/entities in which directors have substantial interest.
5.	In case the directors are associated or have substantial interest in other companies, indicate clearly the activity of the companies (whether NBFC or not).
6.	Board Resolution specifically approving the submission of the application and its contents and authorising signatory.
7.	Board Resolution to the effect that the company has not accepted any public deposit, in the past (specify period)/does not hold any public deposit as on the date and will not accept the same in future without the prior approval of Reserve Bank of India in writing.
8.	Board resolution stating that the company is not carrying on any NBFC activity/stopped NBFC activity and will not carry on/commence the same before getting registration from RBI.
9.	Auditors Certificate certifying that the company is/does not accept/is not holding Public Deposit.
10.	Auditors Certificate certifying that the company is not carrying on any NBFC activity.
11.	Net owned fund as on date.
12.	Certifying compliance with section 45S of Chapter IIIC of the RBI Act, 1934 in which director/s of the company has substantial interest.
13.	Details of changes in the Memorandum and Articles of Association duly certified.
14.	Last three years Audited balance sheet along with directors & auditors report.
15.	Details of clauses in the memorandum relating to financial business.
16.	Details of change in the management of the company during last financial year till date if any and reasons thereof.
17.	Details of acquisitions, mergers of other companies if any together with supporting documents.
18.	Details of group companies/associate concerns/subsidiaries/holding companies.
19.	Details of infusion of capital if any during last financial year together with the copy of return of allotment filed with Registrar of Companies.
20.	Details of the bank balances/bank accounts/complete postal address of the branch/bank, loan/credit facilities etc. availed.
21.	Business plan for next three years indicating market segment to be covered

	without any element of public deposits.
22.	Cash flow statement, asset/income pattern statement for next three years.
23.	Brief background note on the activities of the company during the last three years and the reasons for applying for NBFC registration.
24.	II(*b*) is the company engaged in any capital market activity? If so, whether there has been any non-compliance with SEBI Regulations? (Statement to be certified by Auditors).
25.	Whether any prohibitory order was issued in the past to the company or any other NBFC/RNBC with which the directors/promoters etc. were associated? If yes, details there of.
26.	Whether the company or any of its directors was/is involved in any criminal case, including under section 138(1) of the Negotiable Instruments Act? If yes, details thereof.
27.	Whether the company was granted any permission by ECD to function as Full-fledged Money Changers?
28.	Whether the company was/is authorised by ECD to accept deposits from NRIs.
29.	Whether "Fit and Proper" Norms for Directors have been fulfilled.

NBFCs exempted from Registration with RBI

However, to obviate dual regulation, certain category of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock broking companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi companies as notified under Section 620A of the Companies Act, 1956, Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982 or Housing Finance Companies regulated by National Housing Bank.

As laid down in RBI Master Circular RBI/2009-10/6 DNBS.PD. CC.No. 148 /03. 02.004 / 2009-10 dated July 1, 2009 the following are some exemptions from the provisions of RBI Act, 1934 but subject to certain conditions:

(i) A Housing Finance Institutions has been exempted from provisions of Chapter III B of the RBI Act, 1934

(ii) A merchant banking company has been exempted from the provisions of Section 45-IA [Requirement of registration and net owned fund], Section 45-IB [Maintenance of liquid assets] and 45-IC [Creation of Reserve Fund] of the RBI Act, 1934 , Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 and Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998

(iii) In the case of Micro Finance Companies and Mutual Benefit Companies- Sections 45-IA, 45-IB and 45-IC of the Reserve Bank of India Act, 1934 shall not apply

(iv) In the case of Government Companies- Sections 45-IB and 45-IC of the Reserve Bank of India Act, 1934 paragraphs 4 to 7 of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 and Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 except paragraph 13 A of the said directions relating to submission of information to Reserve Bank in regard to change of address, directors, auditors, etc shall not apply

(v) In the case of Venture Capital Fund Companies Section 45-IA and Section 45-IC of the Reserve Bank of India Act, 1934 shall not apply

(vi) In the case of Insurance/Stock Exchange/Stock Broker/Sub-Broker-The provisions of Section 45-IA, 45-IB, 45-IC, 45MB and 45MC of the Reserve Bank of India Act, 1934 and provisions of Non-Banking Financial Companies Acceptance of Public Deposit (Reserve Bank) Directions contained in Notification No. DFC.118 / DG(SPT)-98 dated January 31. 1998, the Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 dated January 31, 1998 shall not apply

(vii) In the case of Nidhi Companies, the provisions of Sections 45-IA, 45-IB and 45-IC of the Reserve Bank of India Act, 1934 shall not apply

(viii) Chit Companies doing the business of chits exclusively are exempted

The list of registered NBFCs is available on the web site of Reserve Bank of India and can be viewed at www.rbi.org.in

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2. Incorporation under The Companies Act 1956

It should be a company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934

3. Minimum Net Owned Fund

A company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934 should have a minimum net owned fund of Rs 25 lakh raised to Rs 200 lakh w.e.f April 21, 1999 Vide Notification no DNBS 132/CGM (VSNM)-99, dated 20-4-1999, by the RBI for an NBFC which commences the business of an NBFC after 21st April 1999. Thus, this specification of higher "net owned fund" is not applicable to NBFCs that commenced business before 21 April 1999.

Net Owned Fund is defined in the Explanation to Section 45-IA of the RBI Act 1934 as follows

(a) The aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance sheet of the company after deducting therefrom-

(i) accumulated balance of loss;

(ii) Deferred revenue expenditure; and

(iii) Other intangible assets; and

(b) Further reduced by the amounts representing-

(1) Investments of such company in shares of-

(i) Its subsidiaries;

(ii) Companies in the same group;

(iii) All other non-banking financial companies; and

(2) The book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with-

(i) Subsidiaries of such company; and

(ii) Companies in the same group,

to the extent such amount exceeds ten per cent, of (a) above

General Compliance Requirements

All NBFCs, being companies registered under the Companies Act, have to fulfill compliance relating to the Board of Directors, Share Capital, Management Structure, Audits, Meetings, maintenance as well as publication of books of accounts and general conduct as per the requirements of the Companies Act 1956.

In addition, they have to fulfill the specific requirements of the Reserve Bank of India (RBI) as set out in the Directions and various notifications and amendments by the RBI. The RBI also prescribes a set of compliance norms for all NBFCs. The Prudential Norms for NBFCs accepting public deposits are more rigorous.

6.0 REGULATORY FRAMEWORK FOR NBFCs IN INDIA

The NBFC sector is characterised by its heterogeneity. It is heterogeneous in term of size, business, spread and ownership. It is more than three decades since RBI has started regulating and supervising the functioning of the NBFC sector in India. RBI presently regulates the NBFCs whether undertaking, exclusively or in combination, the activities of asset financing, loaning and investment as their principal business, irrespective of whether they accept public deposits or not.

The scheme of regulation of the deposit acceptance activities of the Non-Banking Companies was conceived in the sixties as an adjunct to monetary and credit policy of the country and also to provide an indirect protection to the depositors by insertion in the year 1963, of a new Chapter III B in the Reserve Bank of India Act, 1934. The regulations till 1997 empowered the Reserve Bank of India, only to regulate or prohibit issue of prospectus or advertisement soliciting deposit, collect information as to deposits and to give directions on matters relating to deposits.

During the nineties a spurt was observed in the number of non-banking companies and the volume of deposits accepted. Proliferation of institutions both financial and non-financial depending mainly or wholly on deposits from public was viewed with concern by the authorities. Further in the absence of any prudential ceiling, the

NBFCs deployed their funds where they had little experience and expertise as also lent to those sectors with high risks. The resultant high level of Non Performing Assets aggravated the liquidity crunch faced by many companies and led to significant failures

Amendments to RBI Act and New Regulatory Framework

Various committees, which went into these aspects, strongly recommended that there should be an appropriate regulatory framework over NBFCs and that more powers should be vested with RBI to regulate NBFCs in a better manner. Chapters III-B, III-C and V of the RBI Act were comprehensively amended in January 1997 for vesting more powers with the RBI and providing, *inter alia*, for minimum entry point norm, compulsory registration with the Reserve Bank of all existing and newly incorporated NBFCs for carrying on and commencement of financial business. RBI put in place in January 1998 a new regulatory framework involving prescription of prudential norms for NBFCs, regulation of deposit taking activity to ensure that the NBFCs function on sound and healthy lines and strengthen the financial system of the country. Regulatory and supervisory attention was focused on NBFCs -D which accept public deposits so as to enable RBI to efficiently discharge its responsibilities to protect the interests of the depositors. The process has helped in ensuring consolidation of NBFC sector as a whole.

With the amendment, any company seeking to commence/carry on business of NBFI was required to obtain Certificate of Registration from the Bank under Section 45-IA of the RBI Act, 1934 and also have a minimum Net Owned Fund (NOF) of Rs 25 lakhs. The NOF requirement was increased to Rs 200 lakhs w.e.f. April 21, 1999. While giving registration, an evaluation of the quality of management is undertaken by applying 'fit and proper' norm based on the information furnished by the company in respect of the promoters/directors, bankers' report, report from other regulators like SEBI/IRDA etc. (in case the promoters/directors are involved in activities regulated by these institutions). New Companies are not allowed to raise public deposits for period of two years from the date of registration. For allowing these companies to raise public deposits after a period of two years, detailed appraisal/review is undertaken by the Bank.

Further two sets of detailed directions on Prudential were issued by RBI in 2007. The directions interalia, prescribe guidelines on income recognition, asset classification and provisioning requirements applicable to NBFCs, exposure norms, constitution of audit committee, disclosures in the balance sheet, requirement of capital adequacy, restrictions on investments in land and building and unquoted shares.

An Overview of Regulation of NBFCs

(1) Mission	(3) Basic Structure of Regulatory and Supervisory Framework
To ensure that	Prescription of prudential norms
i. the financial companies function on healthy lines,	akin to those applicable to banks,
* these companies function in consonance	Submission of periodical Returns for the purpose of off-site surveillance,

An Overview of Regulation of NBFCs *(Concld.)*

with the monetary policy framework, so that their functioning does not lead to systemic aberrations,	Supervisory framework comprising (a) on-site inspection (CAMELS pattern) (b) off-site Monitoring through returns(c) market intelligence And (d) Exception reports by statutory auditors,,
* the quality of surveillance and supervision exercised by the RBI over the NBFCs keeps pace with the developments in this sector.	Punitive action like cancellation of Certificate of Registration (CoR), prohibition from acceptance of deposits and alienation of assets, filing criminal complaints and winding up petitions in extreme cases, appointment of the RBI observers in certain cases, etc.
* comprehensive regulation and supervision of Asset liability and risk management system for NBFCs,	Co-ordination with State Governments to curb unauthorised and fraudulent activities, training programmes for personnel of NBFCs, State Governments and Police officials.
(2) Amendments to the Reserve Bank of India (RBI) Act, 1934	(4) Other steps for protection of depositors' interest
RBI Act was amended in January 1997 providing for, *inter alia.*	Publicity for depositors' education And awareness, workshops / seminars for trade and industry organisations, depositors' associations, chartered accountants, etc.
* Entry norms for NBFCs and prohibition of deposit acceptance (save to the extent permitted under the Act) by unincorporated bodies engaged in financial business,	
* Compulsory registration, maintenance of liquid assets and creation of reserve fund,	

* Power of the RBI to issue directions to an NBFC or to the NBFCs in general or to a class of NBFCs.
* Comprehensive regulation and Supervision of deposit taking NBFCs and limited supervision over those not accepting public deposits.

(source- www.rbi.org.in)

Regulatory Framework of NBFC

1. Reserve Bank of India

Governing Body: Department of Non-Banking Supervision of the Reserve Bank of India (DNBS-RBI)

Governing Laws:

a. CHAPTER IIIB, III-C and V of Reserve Bank of India (RBI) Act 1934;

b. RBI Directions

c. RBI Circulars ; Notifications and Guidelines issued from time to time

a. CHAPTER IIIB OF RBI ACT 1934

Provisions relating to Non banking Institutions receiving deposits and Financial Institutions

45H : Chapter IIIB not to apply in certain cases

45 I : Definitions

45-IA : Requirement of Registration and Net owned Fund

45-IB: Maintenance of percentage of assets

45-IC: Reserve Fund

45J: Regulation by Bank on Prospectus

45JA: Power of RBI to determine Policy and issue Directions

45K: Power of RBI to collect information from NBI as to deposits and give Directions

45L: Power of RBI to call information from FI and give Directions

45M: Duty of NBI to furnish statements etc. required by Bank
45MA: Powers & Duties of Auditors
45MB: Power of RBI to prohibit acceptance of deposit and alienation of assets
45MC: Power of RBI to file winding up petition
45N: Inspection
45NA: Deposits not to be solicited by unauthorized person
45NB: Disclosure of Information
45NC: Power of Bank to exempt
45Q: Chapter IIIB to override other laws
45QA: Power of CLB to offer repayment of deposit
45QB: Nomination by Depositors

b. RBI Directions

i. Non Banking Financial Companies Acceptance of Public Deposits(Reserve Bank) Directions 1998
ii. Non Banking Financial (Deposit Accepting or holding) Companies Prudential Norms (Reserve Bank) Directions 2007
iii. Non Banking Financial (Non Deposit Accepting or holding) Companies Prudential Norms (Reserve Bank) Directions 2007
iv. Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008

[RBI DNBS Circular No. DNBS (PD) CC No. 129/03. 02.82/ 2008-09 Dated 23.09.2008-"Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008"

Reserve bank of India has issued Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008 in supersession of the Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1998 for the purpose of proper assessment of books of accounts of NBFCs. These Directions apply to every auditor of a non-banking financial company in the Reserve Bank of India Act and Direction deals with the provisions relating to additional Report to be submitted to the Board of Directors by Auditors and its content. At the same time it imposes Obligation on auditor to submit an exception report to the Bank. These directions will come into force with immediate effect.]

v. Reserve Bank of India (Non Banking Financial Companies) Returns Specifications 1997

vi. Residuary Non Banking Companies (Reserve Bank) Directions 1987

vii. Miscellaneous Non Banking Companies (Reserve Bank) Directions 1977

viii. Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003

c. RBI Circulars issued on July 01,2009

"Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007"

"Non-Banking Financial (Non - Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007"

"Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008"

"Reserve Bank of India (Non-Banking Financial Companies) Returns Specifications 1997"

Exemptions from the provisions of RBI Act, 1934

Frauds – Future approach towards monitoring of frauds in NBFCs

"Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977"

'Know Your Customer' (KYC) Guidelines – Anti Money Laundering Standards

'Prevention of Money Laundering Act, 2002 - Obligations of NBFCs in terms of Rules notified thereunder'

Residuary Non-Banking Companies

The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003

directions/instructions issued to the Securitisation Companies/ Reconstruction Companies

Mortgage Guarantee Companies

Fair Practices Code

allied activities- entry into insurance business, issue of credit card and marketing and distribution of certain products

Corporate Governance

Miscellaneous instructions to NBFC- ND-SI

Miscellaneous instructions to Non-Banking Financial Companies

"Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998

2. State Laws on protection of interests of depositors in financial establishments

Some State Laws -

a. Tamil Nadu Protection of Interest of Depositor's (Financial Establishments) Act 1997 [Tamil Nadu is the first state to enact such an act in the country]

b. Maharshtra Protection of Interests of Depositors (In Financial Establishments) Act 1999

c. The Delhi Protection Of Interests Of Depositors (In Financial Establishments) Act, 2001

d. Bihar Protection of Interests of Depositors (In Financial Establishments) Act 2002

e. Gujarat Protection of Interests of Depositors (In Financial Establishments) Act 2003

f. The Madhya Pradesh protection of Depositor's Interest Act 2000

3. The Companies Act 1956

Some applicable sections include:

Section 3 : Definitions of "Company"; "existing company"; "private company"; and "public company"
Section 4: Meaning of "holding company" and "subsidiary"
Section 4A: Public Financial Institutions
Section 43A: Private Company to become public company in certain cases
Section 58A: Deposits not to be invited without issuing an advertisement
Section 58AA: Small Depositors
Section 58AAA: Default in acceptance or refund of deposits to be cognizable
Section 209(1): Books of Accounts to be kept by company
Section 217(1) : Director's Report
Section 227: Powers and Duties of Auditors
Section 252: Minimum Number of Directors
Section 292A: Audit Committee
Section 370(1B): Loans etc. to companies under the same management
Section 372 (11) : Purchase by company of shares etc. of other companies
Section 620A: Power to modify Act in its application to Nidhis etc.

Section 637A: Power of Central Government or Tribunal to accord approval etc. subject to conditions and to prescribe fees on applications

4.Company's Rules

i. Companies (Acceptance of Deposit) Rules, 1975
ii. Companies (Acceptance of Deposits Amendment) Rules, 1997
iii. Companies (Application for Extension of time or Exemption under sub-section (8) of section 58A) Rules, 1979

5.Foreign Exchange Regulations

i. Foreign Exchange Management (Deposit) Regulations 2000
ii. Foreign Exchange Management (Transfer or issue of Security by a Person Resident outside India) Regulations, 2000

6.Securities Contracts (Regulation) Act 1956

Some applicable sections include:
Section 2(h): Definition of "Securities"
Section 2(j): Definition of "Stock Exchange"
Section 4: Grant of Recognition to Stock Exchanges

7. Housing Finance Companies

The Housing Finance Companies (NHB) Directions 2001

8. Mortgage Guarantee Companies

Mortgage Guarantee Companies Investment (Reserve Bank) Directions, 2008
Mortgage Guarantee Company (Reserve Bank) Guidelines, 2008
Notification No. DNBS (MGC)1/CGM(PK) -2008 dated January 15, 2008
Notification No. DNBS (MGC) 2 /CGM(PK) -2008 dated January 15, 2008

9. Securitisation Companies and Reconstruction Companies

i. The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003
ii. Exemption to Securitisation or Reconstruction Companies from RBI Act- August 28, 2003
iii. Quarterly Statement to be submitted by Securitisation Companies/ Reconstruction

Companies registered with the Reserve Bank of India under Section 3(4) of the SARFAESI Act – September 26,2008
iv. Guidelines on declaration of Net Asset Value of Security Receipts issued by Securitisation Company/ Reconstruction Company- May 28, 2007
v. Master Circular on directions/instructions issued to the Securitisation Companies and Reconstruction Companies – July 01,2008
vi. Regulation of SCs/RCs-submission of returns and audited balance sheet by SCs/RCs - March 5, 2008

10. Miscellaneous Non-Banking Companies
i. Non-banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977.
ii. Miscellaneous Non Banking Companies (Reserve Bank) Directions, 1977
iii. Chit Funds Act,1982

11. Residuary Non Banking Companies
Residuary Non Banking Companies (Reserve Bank) Directions, 1987

12. Micro Financial Sector (Development and Regulation) Bill, 2007
13. Reports on Money Lending and Nidhis

Salient features of the RBI regulatory framework

The Reserve Bank regulates and supervises NBFCs as defined in Chapter III B of the RBI Act,1934. Accordingly, the Reserve Bank has issued a set of directions to regulate the activities of NBFCs under its jurisdiction. Some features of the RBI regulatory framework are as follows:

- An NBFC must have specific authorization to accept deposits from the public.
- NBFC must display the Certificate of Registration or a certified copy thereof at the Registered office and other offices/branches.
- Registration of an NBFC with the RBI merely authorizes it to conduct the business of NBFC. RBI does **not** guarantee the repayment of deposits accepted by NBFCs. NBFCs cannot use the name of the RBI in any manner while conducting their business.

- The NBFC whose application for grant of Certificate of Registration (CoR) has been rejected or cancelled by the RBI is neither authorized to accept fresh deposits nor renew existing deposit. Such rejection or cancellation is also published in newspapers from time to time . Besides, a list of NBFCs permitted to accept public deposits, NBFCs whose applications for CoR has been rejected or whose CoR has been cancelled by the RBI is available on the RBI's web site www.rbi.org.in(go to site map and then NBFC list)

- NBFCs which accept deposits should have minimum investment grade credit rating granted by an approved credit rating agency for deposit collection, except certain Asset Finance (equipment leasing and hire purchase finance) companies and Residuary Non-Banking Companies (RNBCs),

- NBFCs excluding RNBCs cannot

-Offer a rate of interest on deposits more than that approved by RBI from time to time (at present 12.5%).
-Accept deposit for a period less than 12 months and more than 60 months
-Offer any gifts/incentives to solicit deposits from public.

- RNBCs should

  -offer a rate of interest of not less than 5% per annum on term deposits and 3.5% on daily deposits, both compounded annually, under extant directions.
  -RNBCs cannot accept deposits for a period less than 12 months and more than 84 months.
  -RNBCs cannot offer any gifts/incentives to solicit deposits from public

- NBFCs including RNBCs can

-accept deposit only against issue of proper receipt.
-The receipt should bear the name of the company and should be signed by an authorized official of the company.
-The receipt should mention the name of the depositor, the amount in words as well as figures, the rate of interest payable on the deposit amount and the date of repayment of matured deposit along with the maturity amount.

- In the case of brokers/agents etc collecting public deposits on behalf of NBFCs, the depositors should satisfy themselves that the brokers/agents are duly authorized by the NBFC.

- If a deposit taking NBFC fails to repay the deposit or the interest accrued thereon in accordance with the terms and conditions of acceptance of such deposit, redressal of grievance can be through,
  - the Regional Bench of the Company Law Board at Chennai/Delhi/Kolkata/Mumbai

- Acceptance of deposits by companies engaged in activities including plantation activities, commodities trading, multilevel marketing, manufacturing activities, housing finance, nidhis (mutual benefit financial companies), and potential nidhis (mutual benefit company) and companies engaged in collective investment schemes do not come under the purview/regulations of the RBI.

- Individuals, firms and other unincorporated association of individuals or bodies shall not accept deposits from the public–
  (i) if his or its business wholly or partly includes any of the financial activities such as loans and advances, acquisition of shares or marketable securities, leasing or hire purchase activities , or
  (ii) if his or its principal business is that of receiving deposits or lending in any manner.

7.0 ACCEPTANCE OF PUBLIC DEPOSITS

All NBFCs are not entitled to accept public deposits. Only those NBFCs holding a valid Certificate of Registration with authorisation to accept Public Deposits can accept/hold public deposits. NBFCs authorised to accept/hold public deposits besides having minimum stipulated Net Owned Fund (NOF) should also comply with the Directions such as investing part of the funds in liquid assets, maintain reserves, rating etc. issued by the Bank.

Public Deposit

The term 'deposit' is defined under Section 45 I(bb) of the RBI Act, 1934. 'Deposit' includes and shall be deemed always to have included any receipt of money by way of deposit or loan or in any other form but does not include:

- amount raised by way of share capital, or contributed as capital by partners of a firm;
- amount received from scheduled bank, co-operative bank, a banking company, State Financial Corporation, IDBI or any other institution specified by RBI;
- amount received in ordinary course of business by way of security deposit, dealership deposit, earnest money, advance against orders for goods, properties or services;
- amount received by a registered money lender other than a body corporate;
- amount received by way of subscriptions in respect of a 'Chit'.

Paragraph 2(1)(xii) of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 defines a ' public deposit' as a 'deposit' as defined under Section 45 I(bb) of the RBI Act, 1934 and further excludes the following:

- amount received from the Central/State Government or any other source where repayment is guaranteed by Central/State Government or any amount received from local authority or foreign government or any foreign citizen/authority/person;
- any amount received from financial institutions;
- any amount received from other company as inter-corporate deposit;
- amount received by way of subscriptions to shares, stock, bonds or debentures pending allotment or by way of calls in advance if such amount is not repayable to the members under the articles of association of the company;
- amount received from shareholders by private company;
- amount received from directors or relative of the director of a NBFC;
- amount raised by issue of bonds or debentures secured by mortgage of any immovable property or other asset of the company subject to conditions;
- the amount brought in by the promoters by way of unsecured loan;
- amount received from a mutual fund;
- any amount received as hybrid debt or subordinated debt;
- any amount received by issuance of Commercial Paper.

Minimum Net Owned Fund – Deposit Taking NBFCs

To ensure a measured movement towards strengthening the financials of all deposit taking NBFCs by increasing their NOF to a minimum of Rs.200 lakh in a gradual, non-disruptive and non-discriminatory manner, the RBI vide RBI/2007-08/369 -DNBS (PD) C.C. No. 114 /03. 02.059/2007-08 dated June 17, 2008 prescribed that:

In order to strengthen the financial system in general and deposit taking entities in particular NBFCs accepting deposits should be adequately capitalized and at the same time also have a uniform minimum NOF.

To ensure a measured movement towards strengthening the financials of all deposit taking NBFCs by increasing their NOF to a minimum of Rs.200 lakh in a gradual, non-disruptive and non-discriminatory manner, it has been decided to prescribe that:

(a) As a first step, NBFCs having minimum NOF of less than Rs. 200 lakh may freeze their deposits at the level currently held by them.

(b) Further, Asset Finance Companies (AFC) having minimum investment grade credit rating and CRAR of 12% may bring down public deposits to a level that is 1.5 times their NOF while all other companies may bring down their public deposits to a level equal to their NOF by March 31, 2009.

Category of NBFC	**Present Ceiling on public deposits**	**Revised Ceiling on public deposits**
AFCs maintaining CRAR of 15% without credit rating and having NOF more than Rs 25 lakh but less than Rs 200 lakh	1.5 times of NOF or Rs 10 crore whichever is less	Equal to NOF
AFCs with CRAR of 12% and having minimum investment grade credit rating and having NOF more than Rs 25 lakh but less than Rs 200 lakh	4 times of NOF	1.5 times of NOF
LCs/ICs with CRAR of 15% and having minimum investment grade credit rating and having NOF more than Rs 25 lakh but less than Rs 200 lakh	1.5 times of NOF	Equal to NOF

AFCs – Asset Finance Companies
LCs – Loan Companies
ICs – Investment Companies

(c) Those companies which are presently eligible to accept public deposits up to a certain level, but have, for any reason, not accepted deposits up to that level will be permitted to accept public deposits up to the revised ceiling prescribed

(d) Companies on attaining the NOF of Rs.200 lakh may submit statutory auditor's certificate certifying its NOF.

(e) The NBFCs failing to achieve the prescribed ceiling within the stipulated time period, may apply to the Reserve Bank for appropriate dispensation in this regard which may be considered on case to case basis.

Credit Rating

No non-banking financial company having Net Owned Fund Two Hundred lakh of rupees and above shall accept public deposit unless it has obtained minimum investment grade or other specified credit rating for fixed deposits from any one of the approved credit rating agencies at least once a year and a copy of the rating is sent to the Reserve Bank of India along with return on prudential norms.

An unrated NBFC, except certain Asset Finance companies (AFC), cannot accept public deposits. An exception is made in case of unrated AFC companies with CRAR of 15% which can accept public deposit up to 1.5 times of the NOF or Rs 10 crore whichever is lower without having a credit rating. A NBFC may get itself rated by any of the four rating agencies namely, CRISIL, CARE, ICRA and FITCH Ratings India Pvt. Ltd.

Approved Credit Rating Agencies and Minimum Investment Grade Credit Rating

The names of approved credit rating agencies and the minimum credit rating shall be as follows:-

Name of the agency	Minimum investment Grade Rating
(a) The Credit Rating Information Services of India Ltd. (CRISIL)	FA-(FA Minus)
(b) ICRA Ltd.	MA-(MA Minus)
(c) Credit Analysis & Research Ltd. (CARE)	CARE BBB(FD)
(d) Fitch Ratings India Private Ltd.	tA-(ind)(FD)]

Upgrading/ Downgrading of credit rating

In the event of upgrading or downgrading of credit rating of any non-banking financial company to any level from the level previously held by the non banking financial company, it shall within fifteen working days of its being so rated inform, in writing, of such upgrading/downgrading to the Reserve Bank of India.
If rating of a NBFC is downgraded to below minimum investment grade rating, it has to stop accepting public deposit, report the position within fifteen working days to the RBI and reduce within three years from the date of such downgrading of credit rating, the amount of excess public deposit to nil or to the appropriate extent permissible under paragraph 4(4) of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998; however such NBFC can renew the matured public deposits subject to repayment stipulations specified above and compliance with other conditions for acceptance of deposits.

NBFCs also issue financial products like Commercial Paper, Debentures etc. to which rating is assigned by rating agencies. The ratings assigned to such products may undergo changes for various reasons ascribed to by the rating agencies.

Therefore RBI vide Notification RBI /2008-09 /372 DNBS (PD) CC. No.134/03.10.001 / 2008-2009 dated 4.02.2009, has clarified that all NBFCs (both deposit taking and non-deposit taking) with asset size of Rs 100 crore and above excluding RNBCs, shall furnish the information about downgrading / upgrading of assigned rating of any financial product issued by them, within fifteen days of such a change in rating, to the Regional Office of the Bank under whose jurisdiction their registered office is functioning.

Period of Deposit

The NBFCs are allowed to accept/renew public deposits for a minimum period of 12 months and maximum period of 60 months. The RNBCs have different norms for acceptance of deposits.

Prohibition from accepting demand deposit

No NBFC can accept/renew any public deposit which is payable on demand.

Interest on Public Deposit

NBFCs cannot offer interest rates higher than the ceiling rate prescribed by RBI from time to time. The present ceiling is 12.5 per cent per annum (on and from April 24, 2007. The interest may be paid or compounded at rests not shorter than monthly rests. This is the maximum permissible rate an NBFC can pay on its public deposits and they may offer lower rates.

Regulation of excessive interest charged by NBFCs

RBI advised all NBFCs, inter alia, that the rates of interest beyond a certain level may be seen to be excessive and can neither be sustainable nor be conforming to normal financial practice. Boards of NBFCs were, therefore, advised to lay out appropriate internal principles and procedures in determining interest rates and processing and other charges.

RBI in exercise of powers under Section 45 L of the RBI Act, 1934 issued Directions regarding excessive rates of interest charged by NBFCs on January 2, 2009. The said directions laid down in Notification No. DNBS. 204 / CGM(ASR)-2009 dated January 2, 2009 specified:

a) The Board of each NBFC shall adopt an interest rate model taking into account relevant factors such as, cost of funds, margin and risk premium, etc and determine the rate of interest to be charged for loans and advances. The rate of interest and the approach for gradations of risk and rationale for charging different rate of interest to different categories of borrowers shall be disclosed to the borrower or customer in the application form and communicated explicitly in the sanction letter.

b) The rates of interest and the approach for gradation of risks shall also be made available on the web-site of the companies or published in the relevant newspapers. The information published in the website or otherwise published should be updated whenever there is a change in the rates of interest.

c) The rate of interest should be annualised rates so that the borrower is aware of the exact rates that would be charged to the account.

Payment of brokerage

On and from January 31, 1998 no non-banking financial company shall pay to any broker on public deposit collected by or through him, -
(i) brokerage, commission, incentive or any other benefit by whatever name called, in excess of two per cent of the deposit so collected;and
(ii) expenses by way of reimbursement on the basis of relative vouchers/bills produced by him, in excess of 0.5 percent of the deposit so collected.

Particulars to be specified in application form soliciting public deposits

No non-banking financial company shall accept or renew any public deposit except on a written application from the depositor in the form to be supplied by the company, which form shall contain all the particulars specified in the Non-Banking Financial Companies and Miscellaneous Non-Banking Companies
(Advertisement) Rules, 1977, made under section 58A of the Companies Act, 1956 and also contain the specific category of the depositor, i.e. whether the depositor is a shareholder or a director or a promoter of the company or a member of public.

The application form should also contain the following :-
(a) the credit rating assigned for its fixed deposit and the name of the credit rating agency which rated the company;
(b) in case of non-repayment of the deposit or part thereof as per the, the depositor may approach Company Law Board;
(c) in case of any deficiency of the company in servicing its deposit, the depositor may approach the National Consumers Disputes Redressal Forum, the State Level Consumers Disputes Redressal Forum or the District Level Consumers Disputes Redressal Forum for relief;
(d) a statement that the financial position of the company as disclosed and the representations made in the application form are true and correct and that the company and its Board of Directors are responsible for the correctness and veracity thereof;
(e) the financial activities of the company are regulated by the Reserve Bank of India;
(f) at the end of application form but before the signature of the depositor, the following verification clause by the depositor should be appended:

"I have gone through the financials and other statements / particulars / representations furnished / made by the company and after careful consideration I am making the deposit with the company at my own risk and volition".

Furnishing of receipts to depositors

Every non-banking company shall furnish to every depositor or his agent, a receipt for every amount which has been or which may be received by the company by way of deposit

The said receipt shall be duly signed by an officer entitled to act for the company in this behalf and shall state the date of deposit, the name of the depositor, the amount in words and figures received by the company by way of deposit, the rate of interest payable thereon and the date on which the deposit is repayable.

Liquid Asset Requirement

In terms of Section 45-IB of the RBI Act, 1934, the minimum level of liquid asset to be maintained by NBFCs is 15 per cent of public deposits outstanding as on the last working day of the second preceding quarter. Of the 15%, NBFCs are required to invest not less than ten percent in approved securities and the remaining 5% can be in unencumbered term deposits with any scheduled commercial bank. Thus, the liquid assets may consist of Government securities, Government guaranteed bonds and term deposits with any scheduled commercial bank.

The investment in Government securities should be in dematerialised form which can be maintained in Constituents' Subsidiary General Ledger (CSGL) Account with a scheduled commercial bank (SCB) / Stock Holding Corporation of India Limited (SHICL). In case of Government guaranteed bonds the same may be kept in dematerialised form with SCB/SHCIL or in a dematerialised account with depositories [National Securities Depository Ltd. (NSDL)/Central Depository Services (India) Ltd. (CDSL)] through a depository participant registered with Securities & Exchange Board of India (SEBI). However in case there are Government bonds which are in physical form the same may be kept in safe custody of SCB/SHCIL.

NBFCs have been directed to maintain the mandated liquid asset securities in a dematerialised form with the entities stated above at a place where the registered office of the company is situated. However, if an NBFC intends to entrust the securities at a place

other than the place at which its registered office is located, it may do so after obtaining the permission of RBI in writing. It may be noted that liquid assets in approved securities will have to be maintained in dematerialised form only.

The liquid assets maintained as above are to be utilised for payment of claims of depositors. However, deposit being unsecured in nature, depositors do not have direct claim on liquid assets.

Register of deposits

Every miscellaneous non-banking company shall keep one or more registers in which shall be entered separately in the case of each depositor the following particulars, namely-

(a) name and address of the depositor,
(b) date and amount of each deposit,
(c) duration and the due date of each deposit,
(d) date and amount of accrued interest or premium
on each deposit,
(e) date and amount of each repayment, whether
of principal, interest or premium,
(f) any other particulars relating to the deposit.

The register or registers aforesaid shall be kept at the registered office of the company and shall be preserved in good order for a period of not less than eight calendar years following the financial year in which the latest entry is made of the repayment or renewal of any deposit of which particulars are contained in the register:

Information to be included in the Board's report

In every report of the Board of Directors laid before the company in general meeting under sub-section (1) of section 217 of the Companies Act, 1956 there shall be included in the case of non-banking company, the following particulars or information, namely:
(a) the total number of depositors of the company whose deposits have not been claimed by the depositors or paid by the company after the date on which the deposit became due for repayment or renewal; and

(b) the total amount due to the depositors and remaining unclaimed or unpaid beyond the dates referred to as aforesaid.
(2) The said particulars or information shall be furnished with reference to the position as on the last date of the financial year to which the report relates and if the amounts remaining unclaimed or undisbursed as referred to above exceed in the aggregate the sum of rupees five lakhs, there shall also be included in the report a statement on the steps taken or proposed to be taken by the Board of Directors for the repayment of the amounts due to the depositors and remaining unclaimed or undisbursed.

Nomination facility for Depositors

Nomination facility is available to the depositors of NBFCs. The Rules for nomination facility are provided for in section 45QB of the Reserve Bank of India Act, 1934. Non-Banking Financial Companies have been advised to adopt the Banking Companies (Nomination) Rules, 1985 made under Section 45ZA of the Banking Regulation Act, 1949. Accordingly, depositor/s of NBFCs are permitted to nominate, one person to whom, the NBFC can return the deposit in the event of the death of the depositor/s. NBFCs are advised to accept nominations made by the depositors in the form similar to one specified under the said rules, viz Form DA 1 for the purpose of nomination, and Form DA2 and DA3 for cancellation of nomination and variation of nomination respectively.

Interest on overdue matured deposits

As per Reserve Bank's Directions, overdue interest is payable to the depositors in case the company has delayed the repayment of matured deposits, and such interest is payable from the date of receipt of such claim by the company or the date of maturity of the deposit whichever is later, till the date of actual payment. If the depositor has lodged his claim after the date of maturity, the company would be liable to pay interest for the period from the date of claim till the date of repayment. For the period between the date of maturity and the date of claim it is the discretion of the company to pay interest.

Prepayment of deposits

A NBFC accepts deposits under a mutual contract with its depositors. In case a depositor requests for pre-mature payment, Reserve Bank of India has prescribed Regulations for such an eventuality in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 wherein it is specified that NBFCs cannot grant any loan against a public deposit or make premature repayment of a public deposit within a

period of three months (lock-in period) from the date of its acceptance, however in the event of death of a depositor, the company may, even within the lock - in period, repay the deposit at the request of the joint holders with survivor clause / nominee / legal heir only against submission of relevant proof, to the satisfaction of the company.

An NBFC subject to above provisions, if it is not a problem company, may permit after the lock–in period premature repayment of a public deposit at its sole discretion, at the rate of interest prescribed by the Bank.

A problem NBFC is prohibited from making premature repayment of any deposits or granting any loan against public deposits/deposits, as the case may be. The prohibition shall not, however, apply in the case of death of depositor or repayment of tiny deposits i.e. up to Rs. 10000/- subject to lock in period of 3 months in the latter case.

Default in repayment of Deposit

If a NBFC defaults in repayment of deposit, the depositor can approach

a) Company Law Board (CLB) or / and

b) Consumer Forum or file a civil suit to recover the deposits.

A depositor can approach any or all of these redressal authorities' i.e consumer forum, court or CLB.

a) Depositor approaches the CLB

Where a non-banking financial company fails to repay any deposit or part thereof in accordance with the terms and conditions of such deposit, the Company Law Board (CLB) either on its own motion or on an application from the depositor directs, by order, the non-banking financial company to make repayment of such deposit or part thereof forthwith or within such time and subject to such conditions as may be specified in the order.

The depositor can approach CLB by mailing an application in prescribed form to the appropriate bench of the Company Law Board according to its territorial jurisdiction with the prescribed fee.

Relevant Forms as laid down in Company law Board Regulations, 1991 are:
Form 1 – Form of petition to company law board

Form 2- Interlocutory application
Form 3- Reference to Company Law Board
Form 4- Application By Depositor / Debenture Holder Under Section 58A(9) or Section 117C(4) of the Act Or Section 45QA of The Reserve Bank Of India Act, 1934

The details of addresses and territorial jurisdiction of the bench officers of CLB are as under:

Sr. No.	**Addresses**	**Territorial Jurisdiction**
1.	Bench Officer, Company Law Board, Northern Region Bench, Shastri Bhavan, 'A' Wing, 5th Floor, Dr. Rajendra Prasad Road, New Delhi 110 001.	Uttar Pradesh, Jammu & Kashmir, Punjab, Himachal Pradesh, Rajasthan, Haryana and Union Territories of Chandigarh and Delhi
2.	Bench Officer, Company Law Board, Southern Region Bench, Shastri Bhavan, 'A' Wing, 5th Floor, Block 8, No 26, Haddows Road, Chennai 600 006.	Tamil Nadu, Andhra Pradesh, Kerala, Karnataka, Union Territories of Amindivi, Minicoy and Lakshadweep Islands and Pondicherry
3.	Bench Officer, Company Law Board, Western Region Bench, 2nd Floor, N.T.C. House, 15, Narottam Morarjee Marg, Ballard Estate, Mumbai-400 038.	Maharashtra, Gujarat, Madhya Pradesh, Goa and Union Territories of Dadra & Nagar Haveli, Daman and Diu.
4.	Bench Officer, Company Law Board, Eastern Region Bench, 9, Old Post Office Street, 6th Floor, Kolkata 700 001.	West Bengal, Orissa, Bihar, Assam, Tripura, Manipur, Nagaland, Meghalaya, Arunachal Pradesh, Mizoram, Union Territories of Andaman and Nicobar Islands.
5.	Bench Officer, Company Law Board, Principal Bench at New Delhi, Shastri Bhavan, 'A' Wing, 5th Floor, Dr. Rajendra Prasad Road, New Delhi 110 001.	All Principal Bench matters all over India.

b) Depositor approaches the Court and an official liquidator is appointed :

In a number of cases official liquidators have been appointed on the defaulting NBFCs. Official Liquidator is appointed by the court after giving the company reasonable opportunity of being heard in a winding up petition. The liquidator performs duties of winding up and such duties in reference thereto as the court may impose.

Where the court has appointed an official liquidator or provisional liquidator, he becomes custodian of the property of the company and runs the day-to-day affairs of the company. He has to draw up a statement of affairs of the company in prescribed form containing particulars of assets of the company, its debts and liabilities, names/residences/occupations of its creditors, the debts due to the company and such other information as may be prescribed. The scheme is drawn up by the liquidator and same is put up to the court for approval. The liquidator realizes the assets of the company and arranges to repay the creditors according to the scheme approved by the court. The liquidator generally inserts advertisement in the newspaper inviting claims from depositors/investors in compliance with court orders. Therefore, the investors/depositors should file the claims within due time as per such notices of the liquidator. The Reserve Bank also provides assistance to the depositors in furnishing addresses of the official liquidator.

c) No Ombudsmen

There is no Ombudsman for hearing complaints against NBFCs. However, in respect of credit card operations of an NBFC, if a complainant does not get satisfactory response from the NBFC within a maximum period of 30 days from the date of lodging the complaint, the customer will have the option to approach the Office of the concerned Banking Ombudsman for redressal of his grievance/s.

Key Prudential Norms for NBFCs accepting public deposits

The Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 [Contained in Notification No. DNBS (PD) CC No. 144/ 03.02.001/ 2009-10 dated July 1, 2009) prescribe guidelines on income recognition, asset classification and provisioning requirements applicable to NBFCs, exposure norms, constitution of audit committee, disclosures in the balance sheet, requirement of capital adequacy, restrictions on investments in land and building and unquoted shares.

Key Prudential norms

	NBFCs taking Public Deposits
Net Owned Funds	Rs 2 crore
Capital Adequacy Ratio	Minimum of 12%
Non Performing Assets	Need to make provisions against non performing assets
Credit Rating	Minimum investment grade or other specified credit rating
Period of Public Deposit	Between 1 year and 5 years
Interest Rate on Deposits	Interest rate ceiling specified (now 12.5% per annum)
Transfer to Reserve Fund	20% of profits
Investment in Approved Securities	Minimum 10% of liquid asset in approved securities and 5% in unencumbered term deposits with any scheduled commercial bank
Limit of	4 times net owned funds for

Deposits	asset finance companies and 1.5 times net owned fund for loan and investment companies

1. Framing & Implementing Policies: The Board of Directors shall frame investment policy for the company and implement the same. Also The BOD of every NBFC granting/intending to grant demand/call loans shall frame a policy for the company and implement the same.

2. Accounting Standards and Guidance Notes issued by Institute of Chartered Accountants of India (ICAI) shall be followed in so far as they are not inconsistent with any the Directions.

3. Every NBFC shall separately disclose in its balance sheet the provisions made as per paragraph 9 of the Directions without netting them from the income or against the value of assets. [According to Para 9 - Every NBFC shall, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make provision against sub-standard assets, doubtful assets and loss assets as provided in the Paragraph]

4. A NBFC having assets of Rs. 50 crore and above as per its last audited balance sheet shall constitute an Audit Committee, consisting of not less than 3 members of its Board of Directors.

5. Every NBFC shall prepare its balance sheet and profit and loss account as on March 31 every year. Where a NBFC intends to extend the date of its balance sheet as per provisions of the Companies Act, it should take prior approval of the RBI before approaching the Registrar of Companies for this purpose.
Further, even in cases where the Bank and the ROC grant extension of time, the NBFC shall furnish to the Bank a proforma balance sheet (unaudited) as on March 31 of the year and the statutory returns due on the said date.

6. Every NBFC shall append to its balance sheet, the particulars in the schedule as set out in Annex to the Directions.

7. No NBFC shall undertake any transaction in government security in physical form through any broker. (It can undertake only through its CSGL Account or its Demat Account)

8. Submission of Statutory Auditor Certificate:

Every NBFC shall submit a Certificate from its Statutory Auditor that it is engaged in the business of NBFI requiring it to hold a Certificate of Registration under Section 45-IA of the RBI Act.
A certificate from the Statutory Auditor in this regard with reference to the position of the company as at end of the financial year ended March 31 may be submitted to the Regional Office of the Department of Non-Banking Supervision under whose jurisdiction the non-banking financial company is registered, latest by June 30, every year.
Such certificate shall also indicate the asset / income pattern of the NBFC for making it eligible for classification as Asset Finance Company, Investment Company or Loan Company.

9. Capital Adequacy Requirement:
Every non-banking financial company shall maintain a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than twelve per cent of its aggregate risk weighted assets on balance sheet and of risk adjusted value of off-balance sheet items. The total of Tier II capital, at any point of time, shall not exceed one hundred per cent of Tier I capital.

“Tier I Capital” means owned fund as reduced by investment in shares of other non-banking financial companies and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group
exceeding, in aggregate, ten per cent of the owned fund;

“Tier II capital” includes the following:
(a) preference shares other than those which are compulsorily convertible into equity;
(b) revaluation reserves at discounted rate of fifty five percent;
(c) general provisions and loss reserves to the extent these are not attributable to actual diminution in
value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to
the extent of one and one fourth percent of risk weighted assets;
(d) hybrid debt capital instruments; and

(e) subordinated debt

to the extent the aggregate does not exceed Tier I capital.

10. Loans against NBFCs own shares is prohibited

11. Submission of half yearly return

NBFCs including RNBCs shall submit a half-yearly return within 3 months of the expiry of the relative half-year as on September and March every year, in the format NBS 2 provided in Annex 2 to the Regional Office of the Department of Non-Banking Supervision of the RBI under whose jurisdiction the registered office of the company is located as per Second Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 and Schedule B to Residuary Non-Banking Companies (Reserve Bank) Directions, 1987.

12. Exposure to Capital Market

Every NBFC (incldg. RNBC) with total assets of Rs. 100 crore and above according to the previous audited balance sheet, shall submit a monthly return within a period of 7 days of the expiry of the month to which it pertains in the format NBS 6 provided in Annex 3 to the Regional Office of the Department of Non-Banking Supervision of the RBI as indicated in the Second Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 and Schedule B to the Residuary Non-Banking Companies (Reserve Bank) Directions, 1987.

Relevant Provisions of the Companies Act 1956

The following Sections in the Companies Act, 1956 relate to Public deposits

a) Sec 58A- Deposits not to be invited without issuing an advertisement
b) Sec 58AA- Small depositors
c) Sec 58AAA-Default in acceptance or refund of deposits to be cognizable
d) Sec 58B- Provisions relating to prospectus to apply to advertisement

The relevant rules framed there under include:

a) Companies (Acceptance of Deposit) Rules, 1975
b) Companies (Application for Extension of time or Exemption under sub-section (8) of section 58A) Rules, 1979

The important provisions of the Act and the Rules are summarised as under:

1. The rules do not apply to banking companies and financial companies for which RBI have separately prescribed rules.
2. Deposit means deposit of money and include any amount borrowed by a company, but does not include certain types of borrowings; viz. amount received:
i. From Government, Local Authority, Foreign Government or any other foreign person, citizen or authority or any amount guaranteed by Government.
ii. From Banks.
iii. From various Government or semi-Government financial Cos. Or Corporation/insurance Cos. Or a Public financial institution as may be notified by the CG.
iv. From any other company.
v. By way of security deposit from an employee./td>
vi. By way of security or advance from any purchasing, selling or other agents in the course of business or any advance received against orders for supply of goods, properties or services.
vii. By way of subscription to any share, stock, bonds or debentures pending allotment. Any amount received by way of calls in advance so long as this is not repayable under the Articles.
viii. In trust or in transit.
ix. From a director in case of any company or from a shareholder in case of a private company out of his own funds (that is not borrowed or accepted from others) including a Company which has become public u/s.43A so long as it retains S. 3(1)(iii) conditions in its Articles. The director/shareholder concerned however has to furnish a declaration in writing to the effect that the amount is not being given out of funds acquired by him by borrowing or accepting from others.
x. By issue of bonds or debentures secured by the mortgage of any immovable property or with an option to convert them into shares. Provided the amount does not exceed the market value of property.
xi. From promoters by way of unsecured loans pursuant to agreement with financial institutions for loans so long as such loans are outstanding.

3. Acceptance of deposits
a) No company shall accept or renew any deposit which is repayable on demand or on notice or after a period of less than six months or more than thirty six months from the date of acceptance or renewal of such deposit
b) No company shall invite or accept or renew any deposits in any form, on a rate of interest exceeding 12.5 per cent per annum at rests which shall not be shorter than monthly rests
c) No company shall pay brokerage to any broker at a rate, exceeding one per cent of the deposits for a period up to one year, one and half per cent of the deposits for a period of

more than one year but up to two years, and two percent of the deposits for a period exceeding two years collected by or through such broker, and such payment shall be on one time basis.
d) No company with a net owned fund of less than rupees one crore shall invite public deposits
e) Any person who is authorised by a company, in writing, to solicit deposits on its behalf and through whom deposits are procured will only be entitled to brokerage

4. Invitations of deposits by a company can be made only by means of an advertisement specifying the financial position, management structure and other particulars relating to a company. A company which has defaulted in repayment of deposit or interest thereon is prohibited from inviting deposits.
5. The depositors shall fill the application form supplied by the company. The company in return issues a deposit receipt which is an acknowledgement of debt by the company. The terms and conditions of the deposit are printed on the back of the receipt.
6. The company shall maintain a register of deposits containing the prescribed particulars. Such registers shall be preserved in good order for a period of not less than eight calendar years from the financial year in which the latest entry is made in the register
7. Every company shall file returns of deposits duly certified by their auditor with a Registrar on or before 30th June of every year.
8. The expression 'small depositor' means "a depositor who has deposited (in a financial year) a sum not exceeding twenty thousand rupees in a company and includes his successors, nominees and legal representatives". In case of any default by the company in paying back to them, it shall inform the Tribunal within sixty days from the date of default. The Tribunal will then direct the company to repay to small depositors within a period of thirty days from the date of receipt of intimation of default. On failure to comply with the orders of the Board, the company and its directors shall be punishable with imprisonment and payment of daily fine during the period in which such non-compliance continues. However, if such a defaulting company wants to invite deposits from small depositors, it shall state the complete nature of default in all its future advertisements and application form.
9. Section 58AAA, any default / contravention under sections 58A and 58AA, relating to deposits, will be treated as a cognizable offence. In other words, under this provision, the directors of the defaulting company can be arrested and put behind bars. Incidentally, the courts will take cognizance only of the complaint
of the central government or any of its authorised officers.

8.0 SUBMISSION OF RETURNS

The NBFCs accepting public deposits should furnish to RBI:

i. Audited balance sheet of each financial year and an audited profit and loss account in respect of that year as passed in the general meeting together with a copy of the report of the Board of Directors and a copy of the report and the notes on accounts furnished by its Auditors;
ii. Statutory Annual Return on deposits - NBS 1;
iii. Certificate from the Auditors that the company is in a position to repay the deposits as and when the claims arise;
iv. Quarterly Return on liquid assets;
v. Half-yearly Return on prudential norms;
vii. Half-yearly ALM Returns by companies having public deposits of Rs. 20 crore and above or with assets of Rs. 100 crore and above irrespective of the size of deposits ;
vii. Monthly return on exposure to capital market by companies having public deposits of Rs. 50 crore and above; and
viii. A copy of the Credit Rating obtained once a year along with one of the Half-yearly Returns on prudential norms as at (v) above.

The NBFCs having assets of Rs. 100 crore and above but not accepting public deposits are required to submit a Monthly Return on important financial parameters of the company. All companies not accepting public deposits have to pass a board resolution to the effect that they have neither accepted public deposit nor would accept any public deposit during the year.

However, all the NBFCs (other than those exempted) are required to be registered with RBI and also make sure that they continue to be eligible to retain the Registration. Further, all NBFCs (including non-deposit taking) should submit a certificate from their Statutory Auditors every year to the effect that they continue to undertake the business of NBFI requiring holding of CoR under Section 45-IA of the RBI Act, 1934.

RBI has powers to cause Inspection of the books of any company and call for any other information about its business activities. For this purpose, the NBFC is required to furnish the information in respect of any change in the composition of its Board of Directors, address of the company and its Directors and the name/s and official designations of its principal officers and the name and office address of its Auditors. With effect from April 1,

2007, non-deposit taking NBFCs with assets of Rs 100 crore and above were advised to maintain minimum CRAR of 10% and also comply with single/group exposure norms. The companies have to achieve CRAR of 12% by March 31, 2009 and 15% by March 31, 2010.

Returns and Forms to be filed by NBFCs

a. ANNUAL

1. FORM NBS-1

` (Annual Return on deposits as on 31st March 20-----)

- To be submitted by all NBFCs accepting/holding public deposits and MNBCs – Except RNBCs
- To be submitted to the Regional Office of Deptt. Of Non Banking Supervision, RBI, where the NBFCs/MNBCs registered office is situated.
- To be submitted Once a year after 31st March and latest by September 30th, with reference to its position as on 31st March, irrespective of the date of closing of the financial year of the Company concerned
- A Certificate from the Auditors of the Company should be appended to the Return in the prescribed format

- In respect of Part 3 of the Return (pertaining to Net Owned Fund)- the information should be furnished as per the latest balance sheet but preceding the date of the return.

  In terms of Notification No.DNBS.135/CGM(VSNM)-2000, dated 13-1-2000, NBFCs shall prepare their balance sheets and profit and loss accounts as on March 31, every year with effect from its accounting year ending with 31st March 2001. Therefore with effect from accounting year ending 31st March 2001, the information in Part 3 of the return shall be as on the date of current balance sheet thus coinciding with the date of return.

- Submission of the Return should not be delayed for any reason such as the finalisation/ completion of the audit of the annual accounts. The compilation of the Return should be on the basis of the figures available in the books of accounts of the company and should be certified by its Statutory Auditors.

- The number of accounts should be given in actual figures while the amounts of deposits should be shown in lakhs of rupees**.** The amount should be rounded off to the nearest lakh. Illustratively, an amount of Rs.4,56,100 should be shown as 5 and not as 4.6 or 5,00,000. Similarly, an amount of Rs.61,49,500 is to be shown as 61 and not as 61.5 or 61,00,000.

- The Return should be signed by a Manager (as defined in Section 2 of the Companies Act, 1956) and if there is no such Manager, by Managing Director or any official of the Company who has been duly authorised by the Board of Directors and whose Specimen Signature has been furnished to the Reserve Bank of India for the purpose. In case the Specimen Signature has not been furnished in the prescribed card, the Return must be signed by the authorised official and his Specimen Signature furnished separately.

- In case there is nothing to report in any part / item of the Return, the relevant part/ item may be marked ***'Nil'*** in the column meant for *"No. of accounts"* and ***00s*** may be indicated in the column meant for *"Amount"*.

- 'Subsidiaries' and 'Companies in the same group' mentioned in this Return have the same meanings assigned to them in Section 4 and Section 372 (11) respectively, of the Companies Act, 1956 as appearing prior to amendment to the Companies Act dated 31st October 1998.

- In case this return is being filed through electronic media(internet), to the specified Web Server, a hard -copy of the same may be submitted to the concerned Regional Office duly signed .

2. FORM NBS-7

(Annual Statement of Capital Funds, Risk assets/exposures and Risk Asset Ratio etc., as at end of March 20---)

Introduced vide Circular No. DNBS.PD/CC.No.93/03.05.002/2006-2007, dated 27.04.2007.

b. HALF YEARLY

FORM NBS- 2
(Half Yearly Statement of Capital Funds, Risk Assets / Exposures and Risk Asset Ratio etc. as at the end of March/ September 20----)

Form NBS-2 introduced vide Notification No. DNBS.192/DG (VL)-2007, dated 22-2-2007.

This Return is divided into 10 parts- A,B,C,D,E,F,G,H,I,J.

It has to be accompanied by a certification from the MD/CEO of the Company.

It has to be accompanied by a Auditor's Report from the Statutory auditors of the Company

c. QUARTERLY RETURN

FORM NBS-3
Quarterly Return on Statutory Liquid Assets for the 4 quarters (ended March/June/September/December 20---)

Its divide into 3 parts- A,B and C and is accompanied by 4 Annexures.

Annexure 1: List of Approved Securities Held Towards Liquid Asset Requirement
Annexure 2: List of Deposits Held with Scheduled Commercial Banks

Annexure 3: Name and Address of the Designated Bank/ Depository through a Depository Participant /the Bank where the Constituents' Subsidiary General Ledger Account is maintained.

d. MONTHLY RETURNS

1. Monthly Return by NBFCs not accepting deposits and having asset size of Rs.100cr and above.

It is the monthly return on important parameters of NBFCs not accepting/holding public deposits and having asset size of Rs.100cr and above.

It gives information on:

- Co. profile
- Sources of Funds
- Application of Funds
- Requirements as to profit and loss account
- Asset classification
- Percentage of NPAs
- Banks/Fis exposure on the Co.
- Co.'s exposure to group/ associate/related parties
- Details of Capital Market Exposure
- Foreign Sources of Funds

It has Certification by the Managing Director and is also Certified by the Aiditors of the Co.

Enclosures to this return include:

1. Specimen Signature cards
2. List of Principal Officers and names & addresses of Directors
3. A copy of the Audited Balance Sheet(with schedules) for the quarter ended March.

2. FORM NBS-6 Monthly Return on Exposure to Capital Market

- Introduced vide vide Notification No. DNBS.192/DG (VL)-2007, dated 22-2-2007.
- This return is to be filled by all deposit taking NBFCs having total assets of Rs 100 crore and above as on March 31 of the previous year

(e.g. for the return for the month of April 2007 or October 2007 the base date total assets would be March 2007, similarly for the return for the month of March 2008 base date total assets would be March 2007). In the absence of audited figures, provisional figures may be taken for the purpose.

- The return should be submitted to the Regional Office of the Department of Non-Banking Supervision, Reserve Bank of India under whose jurisdiction its Registered Office is situated.

- Definition of capital market exposure (CME)

The CME, for the purpose of this return, would be the aggregate of exposures of the company in the form of:
(i) investment in quoted equity shares, quoted compulsorily convertible preference shares (CCPS), quoted convertible bonds and debentures and quoted units of primarily equity oriented mutual funds;
(ii) loans and advances against securities at (i) above, including those for financing of IPOs, etc.
(iii) secured and unsecured loans and advances to and guarantees issued on behalf of stock brokers; and
(iv) underwriting commitments in respect of equity related primary issues including through book building route; and
(v) any other equity related exposure to capital market.

The CME does not cover acceptance of shares, debentures, units of mutual funds, etc. assigned to the NBFCs and RNBCs as collateral or additional security, if they are accepted as per normal business practice and appraisal procedure, as also the investments by RNBCs in compliance with the provisions of paragraph 6 of the Residuary Non-Banking Companies (Reserve Bank) Directions, 1987.

- 'Subsidiaries' and 'Companies in the same group' mentioned in this Return have the same meanings assigned to them in Section 4 and Section 372 (11) respectively, of the Companies Act, 1956.

- Turnover means total of sales and purchases in the same category of investments.

- In case there is nothing to report in any part / item of the Return, ***00s*** may be indicated in the column(s) meant for *"Amount"*.

- The Return should be signed by any of the Principal Officers as given in the Annual return on deposits (NBS-1/NBS-1A).

- The term Gross Purchases indicates exposures which result in increase in capital market exposure and Gross Sales means exposure which result in decline in capital market exposure of the NBFC/RNBC.

The Return is divided into 3 parts:
Part 1= Quoted Investments
Part2= Unquoted Investments
Part3= Position as per last audited Balance Sheet

3. Form – NBS – 4 Monthly return on repayment of deposits

The Reserve Bank has put in place comprehensive regulatory and supervisory mechanism for Non-Banking Financial Companies (NBFCs) to ensure that these companies work on sound and healthy lines and the interests of the depositors are adequately protected. RBI Amendment Act, 1997 has made it mandatory for NBFCs to obtain Certificate of Registration from the Bank as a pre-requisite for commencing or continuing the business of a NBFC. On application, the Bank grants CoR to the companies under Section 45-1A of RBI Act, 1934 on fulfillment of criteria laid down therein. Further companies can hold CoR only as long as they continue to fulfil these requirements. In case a company does not fulfil the conditions for grant of CoR or continuance of CoR, the Bank rejects the application of the company or cancels the CoR granted to it, as the case may be.

The regulatory and supervisory attention of the Bank is being focussed on companies which are holding public deposits.

In order to protect the interests of depositors and to monitor the repayment of public deposits of companies holding public deposits and whose applications have been rejected or Certificates of Registration have been cancelled, the Bank has devised a new return,

NBS-4, to be submitted by such companies on a monthly basis to the Regional Office under whose jurisdiction the registered office of the company is located.

The return has been introduced from June 30, 2000 and the rejected companies have been advised accordingly.

4. FORM NBS-5 Monetary and Supervisory Return

To be submitted by all Non-Banking Financial Companies, and Residuary Non-Banking Companies covered by Para 8 (3) of Notification No.DFC.118/DG(SPT)-98 dated January 31, 1998 and para 2 of the RNBC (Reserve Bank) Directions 1987 respectively , holding public deposits of Rs 20 Crore and above as per the last audited balance sheet

NBFC's not accepting public deposits but having asset size of Rs.100crore and above

In order to monitor the activities of nonbanking financial companies not accepting/ holding public deposits (NBFCs-ND), a system of quarterly reporting was introduced in respect of companies having asset size of Rs.500 crore and above. The reporting system in the prescribed format for such NBFCs-ND was put in place beginning September 2004. The arrangement was reviewed and it was felt that the intervening period of one quarter was too long to take informed and timely decisions. The periodicity for the submission of the return was, therefore, changed from quarterly to monthly from September 2005.

Similarly, with a view to increasing the coverage of NBFCs, the threshold level was raised by making the reporting system applicable to NBFCs with asset size of Rs.100 crore and above, beginning September 2005, instead of Rs.500 crore and above earlier.

Documents / Compliance required to be submitted to the Reserve Bank of India by the NBFCs not accepting/holding public deposits

a. RBI DNBS Circular No. DNBS.PD/ CC.No.130 / 03.05.002 /2008-09- Dated 24.09.2008 -Monitoring Framework for non-deposit taking NBFCs

Reserve bank of India has decided to call for the basic information from non-deposit taking NBFCs with asset size of Rs 50 crore and above but less than Rs 100 crore at quarterly intervals and returns for the quarter ended September 2008 may be submitted by first week of December 2008. At the end of each quarter , these quarterly return could be filed online with the Regional Office of the Department of Non-Banking Supervision in whose jurisdiction company is registered.

b. The NBFCs having assets size of Rs. 100 crore and above but not accepting public deposits are required to submit a Monthly Return on important financial parameters of the company. All companies not accepting public deposits have to pass a board resolution to the effect that they have neither accepted public deposit nor would accept any public deposit during the year.

c. All NBFCs including non-deposit taking should submit a certificate from their Statutory Auditors every year to the effect that they continue to undertake the business of NBFI requiring holding of CoR under Section 45-IA of the RBI Act,
1934.

Applicability of NBFCs-ND-SI regulations (vide Notification RBI/2008-09/491 DNBS (PD) CC.No. 141/03.10.001/2008-09 dated 4.6.2009

1. In terms of circular DNBS (RID) C.C. No. 57/02.05.15/2005-06 dated September 6, 2005, all NBFCs with assets size of Rs 100 crore and above, and not accepting / holding public deposits were required to submit a Monthly Return on Important Financial Parameters to the Regional Office under whose jurisdiction the company is located.

Further, in terms of "Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007" as amended from time to time, systemically important non-deposit taking non-banking financial companies are required to comply with, inter alia, capital adequacy, credit concentration and disclosure norms along with reporting requirements. ‘Systemically important non-deposit taking non-banking financial company'(NBFC-ND-SI) as defined in Para 2(xix) of the said Directions means a non banking financial company not accepting/holding public deposits and having total assets of Rs 100 crore and above as shown in the last audited balance sheet.

2. A non-deposit taking NBFC with an asset size of less than Rs. 100 crore as on balance sheet date might subsequently add on assets before the next balance sheet date due to several reasons including business expansion plan. It is clarified that once an NBFC reaches an asset size of Rs. 100 crore or above, it shall come under the regulatory requirement for NBFCs-ND-SI as stated above, despite not having such assets as on the date of last balance sheet.

3. Therefore, it is advised that all such non-deposit taking NBFCs may comply with RBI regulations issued to NBFC-ND-SI from time to time, as and when they attain an asset size of Rs. 100 crore, irrespective of the date on which such size is attained.

4. It is further observed that in a dynamic environment, the asset size of a company can fall below Rs 100 crore in a given month, which may be due to temporary fluctuations and not due to actual downsizing. It is clarified that in such a case the company may continue to submit the Monthly return on Important Financial Parameters to Reserve Bank of India and to comply with the extant directions as applicable to NBFC-ND-SI, till the submission of their next audited balance sheet to Reserve Bank of India and a specific dispensation is received from the Bank in this regard.

The Master Circular RBI/2009-10/18 DNBS (PD) CC No. 157 / 03.10.001 / 2009-10 dated July 1, 2009 consolidates all instructions issued exclusively to NBFC-ND-SI i.e. other than those which have been consolidated in Master Notification on Prudential Norms and Master Circular - compendium of instructions issued to NBFCs.

9.0 ANTI MONEY LAUNDERING STANDARDS

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The Prevention of Money Laundering Act, 2002 (PMLA) is in force since 1st July 2005. Under PMLA certain exclusive and concurrent powers are conferred on the Director, Financial Intelligence Unit, India (FIU-IND).

Financial Intelligence Unit – India (FIU-IND) was set by the Government of India vide order dated 18th November 2004 as the central national agency responsible for receiving, processing, analyzing and disseminating information relating to suspect financial transactions. FIU-IND is an independent body reporting directly to the Economic Intelligence Council (EIC) headed by the Finance Minister.

Section 13(2) of the Prevention of Money Laundering Act, 2002, empowers the Director, FIU-IND to impose fine on any banking company, financial institution or intermediary for failure to comply with the obligations of maintenance of records, furnishing information and verifying the identity of clients. The amount of fine may vary from ten thousand rupees to one lakh rupees for each failure.

Obligation of NBFCs in terms of The Prevention of Money Laundering Act, 2002 and Rules notified there under:

Section 12 of the Prevention of Money Laundering Act, 2002 lays down following obligations on banking companies, financial institutions and intermediaries.

"12. (1) Every banking company, financial institution and intermediary shall -

(a) maintain a record of all transactions, the nature and value of which may be prescribed, whether such transactions comprise of a single transaction or a series of transactions integrally connected to each other, and where such series of transactions take place within a month;

(b) furnish information of transactions referred to in clause (a) to the Director within such time as may be prescribed;

(c) verify and maintain the records of the identity of all its clients, in such a manner as may be prescribed.

Provided that where the principal officer of a banking company or financial institution or intermediary, as the case may be, has reason to believe that a single transaction or series of transactions integrally connected to each other have been valued below the prescribed value so as to defeat the provisions of this section, such officer shall furnish information in respect of such transactions to the Director within the prescribed time. (2) The records referred to in sub- section (1) shall be maintained for a period of ten years from the date of cessation of the transactions between the clients and the banking company or financial institution or intermediary, as the case may be."

Notifications issued by RBI

- 01.07.2009- Master Circular- 'Prevention of Money Laundering Act, 2002 - Obligations of NBFCs in terms of Rules notified thereunder'
- 05.08.2008 - Obligations of NBFCs under PMLA and Counterfeit Currency Report
- 05.04.2006 - Prevention of Money Laundering Act, 2002 – Obligation of NBFCs
- 21.03.2006 - Prevention of Money Laundering Act, 2002 – Obligation of Primary (Urban) Co-operative Banks
- 07.03.2006 - KYC guidelines – AML Standards – NBFCs, Miscellaneous NBCs, and Residuary NBCs
- 21.11.2005 - Credit Card Operations of banks - Commercial Banks/NBFCs (Excluding RRBs)
- 11.10.2005 - KYC for persons authorized by NBFCs to collect public deposit on behalf of NBFCs
- 21.02.2005 - KYC guidelines – AML Standards – NBFCs, Miscellaneous NBCs, and Residuary NBCs

Obligations as per the RBI Notifications

- NBFCs were advised to go through the provisions of PMLA, 2002 and the Rules notified there under and take all steps considered necessary to ensure compliance with the requirements of section 12 of the Act
- NBFCs should also report information in respect of all transactions referred to in Rule 3 of the Prevention of Money Laundering Rules to the Director, Financial Intelligence Unit-India (FIU-IND).
- NBFCs are required to prepare a profile for each customer based on risk categorization. The need for periodical review of risk categorization has been emphasized.
- As a part of transaction monitoring mechanism, NBFCs are required to put in place an appropriate software application to throw alerts when the transactions are inconsistent with risk categorization and updated profile of customers.
- NBFCs to ensure electronic filing of cash transaction report (CTR) and Suspicious Transaction Reports (STR) to FIU-IND. In case of NBFCs, where all the branches are not yet fully computerized, the Principal Officer of the NBFC should cull out the transaction details from branches which are not computerized and suitably arrange to feed the data into an electronic file with the help of the editable electronic utilities of CTR/STR as have been made available by FIU-IND on their website http://fiuindia.gov.in.

- Make Cash Transaction Reports (CTR) to FIU-India for every month latest by 15th of the succeeding month. It is further clarified that cash transaction reporting by branches/offices of NBFCs to their Principal Officer should invariably be submitted on monthly basis (not on fortnightly basis) and the Principal Officer, in turn, should ensure to submit CTR for every month to FIU-IND within the prescribed time schedule.
- In regard to CTR, it is reiterated that the cut-off limit of Rupees ten lakh is applicable to integrally connected cash transactions also.
- Pay special attention to all complex, unusual large transactions and all unusual patterns of transactions, which have no apparent economic or visible lawful purpose. The background including all documents/office records/memorandums pertaining to such transactions and purpose thereof should, as far as possible, be examined and the findings at branch as well as Principal Officer level should be properly recorded. These records are required to be preserved for ten years as is required under PMLA, 2002. Such records and related documents should be made available to help auditors in their work relating to scrutiny of transactions and also to Reserve Bank/other relevant authorities.
- The customer should not be tipped off on the STRs made by them to FIU-IND. It is likely that in some cases transactions are abandoned/aborted by customers on being asked to give some details or to provide documents. NBFCs should report all such attempted transactions in STRs, even if not completed by customers, irrespective of the amount of the transaction.
- NBFCs should make STRs if they have reasonable ground to believe that the transaction involve proceeds of crime generally irrespective of the amount of transaction and/or the threshold limit envisaged for predicate offences in part B of Schedule of PMLA, 2002 .

Know Your Customer (KYC) Guidelines

The RBI vide its Circular DNBS(PD).CC No. 34/10.01/2003-04 dated January 6, 2004 had issued guidelines on 'Know Your Customer' norms. NBFCs were advised to follow certain customer identification procedure for opening of accounts and monitoring transactions of a suspicious nature for the purpose of reporting it to appropriate authority.

The Master Circular RBI/2009-10/9 DNBS (PD) CC No. 151/03.10.42/ 2009-10

dated July 1, 2009 consolidates all earlier circulars on this subject.

These 'Know Your Customer' guidelines had been revisited in the context of the Recommendations made by the Financial Action Task Force (FATF) on Anti Money Laundering (AML) standards and on Combating Financing of Terrorism (CFT). These standards have become the international benchmark for framing Anti Money Laundering and combating financing of terrorism policies by the regulatory authorities.

Compliance with these standards by the banks/financial institutions/NBFCs in the country had become necessary for international financial relationships. The Department of Banking Operations and Development of Reserve Bank had issued detailed guidelines to the banks based on the Recommendations of the Financial Action Task Force and the paper issued on Customer Due Diligence (CDD) for banks by the Basel Committee on Banking Supervision.

These KYC guidelines are equally applicable to NBFCs. All NBFCs were advised to adopt the same with suitable modifications depending on the activity undertaken by them and ensure that a proper policy framework on 'Know Your Customer' and Anti-Money Laundering measures is formulated and put in place with the approval of the Board. It may also be ensured that NBFCs are fully compliant with the provisions of this circular before December 31, 2005.

Guidelines on 'Know Your Customer' Norms, contain the following –

- 'Know Your Customer' Standards

- Customer Acceptance Policy (CAP)

- Customer Identification Procedure (CIP)

- Monitoring of Transactions

- Risk Management

- Customer Education

10. FAIR PRACTICES CODE

The Fair Practices Code of the NBFCs should be put up on their website, if any, for the information of various stakeholders.

NBFCs were advised on September 28, 2006 (Guidelines on Fair Practices Code- [DNBS (PD) CC No. 80 / 03.10.042 / 2005-06 dated September 28, 2006), to prescribe the broad guidelines on fair practices that are to be framed and approved by the boards of directors of all non-banking financial companies (including RNBCs). The fair practices code so framed and approved by the board of directors is to be published and disseminated on the website of the company, if any, for the information of the public

Vide Master Circular RBI/2009-10/15 DNBS (PD) CC No. 153 / 03.10.042 / 2009-10 dated July 1, 2009 consolidated all earlier circulars on the topic

Guidelines on Fair Practices Code for NBFCs

(i) Applications for loans and their processing

(a) Loan application forms should include necessary information which affects the interest of the borrower, so that a meaningful comparison with the terms and conditions offered by other NBFCs can be made and informed decision can be taken by the borrower.

(b) The NBFCs should devise a system of giving acknowledgement for receipt of all loan applications. Preferably, the time frame within which loan applications will be disposed of should also be indicated in the acknowledgement.

(ii) Loan appraisal and terms/conditions

The NBFCs should convey in writing to the borrower, the amount of loan sanctioned along with the terms and conditions including annualised rate of interest and method of application thereof and keep the acceptance of these terms and conditions by the borrower on its record.

(iii) Disbursement of loans including changes in terms and conditions

The NBFCs should give notice to the borrower of any change in the terms and conditions including disbursement schedule, interest rates, service charges, prepayment charges etc. NBFCs should also ensure that changes in interest rates and charges are effected only prospectively. A suitable condition in this regard should be incorporated in the loan agreement.

(iv) Post disbursement supervision

(a). Post disbursement supervision by NBFCs should be constructive and the genuine difficulties which the borrower may face, may be given due consideration.

(b) Before taking a decision to recall / accelerate payment or performance under the agreement or seeking additional securities, NBFCs should give notice to borrowers in consonance with the loan agreement.

(c) NBFCs should release all securities on repayment of all dues or on realisation of the outstanding amount of loan subject to any legitimate right or lien for any other claim NBFCs may have against borrower. If such right of set off is to be exercised, the borrower shall be given notice about the same with full particulars about the remaining claims and the conditions under which NBFCs are entitled to retain the securities till the relevant claim is settled /paid.

(v) General

(a) NBFCs should refrain from interference in the affairs of the borrower except for the purposes provided in the terms and conditions of sanction of the loan (unless new information, not earlier disclosed by the borrower, has come to the notice of the lender).

(b) In case of receipt of request for transfer of borrowal account, either from the borrower or from a lender which proposes to take over the account, the consent or otherwise i.e. objection of the NBFC, if any, should be conveyed within 21 days from the date of receipt of request. Such transfer shall be as per transparent contractual terms in consonance with law.

(c) In the matter of recovery of loans, the NBFCs should not resort to harassment.

(vi) Grievance Redressal Mechanism

The Board of Directors of NBFCs should also lay down the appropriate grievance redressal mechanism within the organization to resolve disputes arising in this regard. Such a mechanism should ensure that all disputes arising out of the decisions of lending institutions' functionaries are heard and disposed of at least at the next higher level. The Board of Directors should also provide for periodical review of the compliance of the Fair Practices Code and the functioning of the grievances redressal mechanism at various levels

of management. A consolidated report of such reviews may be submitted to the Board at regular intervals, as may be prescribed by it.

(vii) Fair Practices Code based on the guidelines outlined hereinabove should be put in place by all NBFCs with the approval of their Boards at the earliest possible, but not later than June 30, 2006. NBFCs will have the freedom of drafting the Fair Practices Code, enhancing the scope of the guidelines but in no way sacrificing the spirit underlying the above guidelines. The same should be put up on their web-site, if any, for the information of various stakeholders.

Sample Fair Practice Code

XYZ Ltd. – Fair Practices Code

With a view to setting out Fair Lending Practices in a transparent manner, XYZ Ltd. has decided to adopt the following as Lenders' Fair Practices Code.

BACKGROUND

The Reserve Bank of India, by its notification no. RBI / 2006-07 / 138 DNBS (PD) CC No. 80 / 03.10.042 / 2005-06 dated September 28, 2006 has prescribed the broad guidelines on fair practices that are to be framed and approved by the Board of Directors of all Non-Banking Financial Companies (NBFCs), which should be published and disseminated on the web-site of the Company, if any, for the information of the Public.

XYZ Ltd. (the "Company") is a company incorporated under the Companies Act, 1956. The Company has been granted the Certificate of registration (Certificate No. --------- Dated ----------) by RBI, permitting to commence and carry on the business of a non-banking financial institution. The company is not engaged in activity of accepting public deposits.

OBJECTIVE

The code has been developed with an object to:

• Promote fair practices and transparency by setting minimum standards in dealing with customer

• Increase customer confidence in the Company.

CONTENTS

The Company has adopted the code for fair practices, in pursuance of the directions issued by the RBI. The Fair Practice Code (FPC) is intended to cover the following areas:

- Application for loans and their processing
- Loan appraisal and terms/conditions
- Disbursement of loans, including changes in terms and conditions
- General Provisions and
- Grievance redressal mechanism

1. Application for loans and their processing:

A. Loan application forms of the company should include necessary information, which are likely to affect the interests of the prospective borrower, so that a meaningful comparison with the terms and conditions offered by other Non Banking Financial Companies can be made and an informed decision can be taken by the prospective borrower.
B. The loan application form shall indicate the documents required to be submitted along with the application form.
C. The company shall provide to the prospective borrower an acknowledgement for receipt of all loan applications.
D. An indicative time frame, within which loan applications will be disposed off, will be mentioned in such acknowledgement.

2. Loan appraisal and terms/conditions

A. Loan applications shall be assessed in accordance with the company's credit appraisal process.
B. The company shall convey in writing to the prospective borrower the fate of the loan application by means of sanction letter or otherwise.
C. In case of sanction of loan, the sanction letter shall contain the terms and conditions including annualized rate of interest and method of application thereof. The acceptance of the terms and conditions communicated by the borrower shall be preserved by the company in its records.

3. Disbursement of loans including changes in terms and conditions

A. The company shall give notice to the borrower of any change in the terms and conditions including disbursement schedule, interest rate, service charges,

prepayment charges etc. The company shall ensure that changes in interest rates and other charges are affected only prospectively. The loan agreement shall contain a specific clause to this effect.

B. The decision of the company to recall / accelerate payment or performance shall be in consonance with the terms of the loan agreement.
C. No Objection Certificate (NOC) to be issued on recovery of all dues. The company shall release all securities upon repayment of all dues or on realization of the outstanding amount of loan subject to any legitimate right or lien for any other claim it may have against borrower. If such right of set off is to be exercised, the borrower shall be given notice about the same with full particulars about the remaining claims and the conditions under which the company is entitled to retain the securities till the relevant claim is settled / paid.

4. General Provisions

A. The company will refrain from interfering in the affairs of the borrower except for the purposes provided in the terms and conditions of the loan agreement, unless new information, not earlier disclosed deliberately or otherwise by the borrower, has come to the notice of the company.
B. In case of receipt of request from the borrower for transfer of a borrower account to other NBFC, bank or financial institution, the consent or otherwise shall be conveyed within 21 days from the date of receipt of such request. Such transfer shall be in accordance with the contractual terms entered into with the borrower and in consonance with the statutes, rules, regulations and guidelines, as may be applicable from time to time.
C. In the matter of recovery of loans, the company shall resort only to remedies which are legally and legitimately available to it and will avoid the undue harassment viz. persistently bothering the borrowers at odd hours, use of muscle power for recovery of loans, etc.

5. Grievance redressal mechanism

A. The company will guide customers who wish to lodge a compliant and also provide a guidance to do in case the customer is not happy with the company's practices.
B. In case of any complaints/grievances, the applicant / borrower may contact through any of these channels:
    - Mail:
      XYZ Ltd.
      (contact address)

- Telephone:
- Fax:
- Email:

C. After examining the matter, it will be our endeavour to provide the borrower / applicant with our final or other response, within a period of two (2) weeks and within a maximum period of six (6) weeks from receipt of such complaint / grievance.

The FPC shall come into effect from October 28, 2006.

Clarification regarding repossession of vehicles financed by NBFCs

(Vide RBI notification RBI/2008-09/454 DNBS (PD) CC.No.139 /03.10.001/2008-09 dated April 24, 2009)

NBFCs must have a built in re-possession clause in the contract/loan agreement with the borrower which must be legally enforceable. To ensure transparency, the terms and conditions of the contract/loan agreement should also contain provisions regarding: (a) notice period before taking possession; (b) circumstances under which the notice period can be waived; (c) the procedure for taking possession of the security; (d) a provision regarding final chance to be given to the borrower for repayment of loan before the sale / auction of the property; (e) the procedure for giving repossession to the borrower and (f) the procedure for sale / auction of the property.
A copy of such terms and conditions must be made available to the borrowers in terms of DNBS.PD/ CC. No. 107 / 03.10.042 /2007-08 dated October 10, 2007 wherein it was stated that NBFCs may invariably furnish a copy of the loan agreement along with a copy each of all enclosures quoted in the loan agreement to all the borrowers at the time of sanction / disbursement of loans, which may form a key component of such contracts/loan agreements

11. MONITORING OF FRAUDS

The Reserve Bank has issued guidelines (Master Circular No. RBI/2009-10/7

DNBS.PD.CC. No. 149 / 03.10.042 / 2009-10 dated July 1, 2009) to NBFCs (including RNBCs) on classification of frauds, approach towards monitoring of frauds and reporting requirements from time to time under Section 45K and 45 L of the RBI Act, 1934.

While the primary responsibility for preventing frauds lies with NBFCs themselves, a reporting system for frauds prescribed by the abovementioned Master Circular is given in the following paragraphs:

- NBFCs should ensure that a reporting system is in place so that frauds are reported without any delay.
- NBFCs should fix staff accountability in respect of delays in reporting of fraud cases to the Reserve Bank.
- NBFCs may, strictly adhere to the fixed timeframe fixed for reporting fraud cases to the Reserve Bank failing which NBFCs would be liable for penal action as prescribed under the provisions of Chapter V of the RBI Act, 1934.
- NBFCs should specifically nominate an official of the rank of General Manager or equivalent who will be responsible for submitting all the returns
- In order to have uniformity in reporting, frauds have been classified as under based mainly on the provisions of the Indian Penal Code:

  (a) Misappropriation and criminal breach of trust.

  (b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.

  (c) Unauthorised credit facilities extended for reward or for illegal gratification.

  (d) Negligence and cash shortages.

  (e) Cheating and forgery.

  (f) Irregularities in foreign exchange transactions.

  (g) Any other type of fraud not coming under the specific heads as above.

- Cases of ‘negligence and cash shortages’ and ‘irregularities in foreign exchange transactions’ referred to in items (d) and (f) above are to be reported as fraud if the intention to cheat / defraud is suspected / proved. However, the following cases where fraudulent intention is not suspected / proved, at the time of detection, will be treated as fraud and reported accordingly:

(a) cases of cash shortages more than Rs.10,000/- and

(b) cases of cash shortages more than Rs. 5000/- if detected by management /auditor / inspecting officer and not reported on the occurrence by the persons handling cash.

- NBFCs having overseas branches/offices should report all frauds perpetrated at such branches/offices also to the Reserve Bank as per the given format and procedure
- Frauds involving Rs. 1 lakh and above
  Fraud reports should be submitted in all cases of fraud of Rs. 1 lakh and above perpetrated through misrepresentation, breach of trust, manipulation of books of account, fraudulent encashment of FDRs unauthorised handling of securities charged to the NBFC, misfeasance, embezzlement, misappropriation of funds, conversion of property, cheating, shortages, irregularities, etc.
- Fraud reports should also be submitted in cases where central investigating agencies have initiated criminal proceedings suo moto and/or where the Reserve Bank has directed that they be reported as frauds.
- Wherever information is available, NBFCs may also report frauds perpetrated in their subsidiaries and affiliates/joint ventures. Such frauds should, however, not be included in the report on outstanding frauds and the quarterly progress reports referred to below.
- The fraud reports in the prescribed format should be sent to the Central Office (CO) of the Reserve Bank of India, Department of Banking Supervision, Frauds Monitoring Cell where the amount involved in fraud is Rs 25 lakhs and above and to Regional Office of the Reserve Bank of India, Department of Non-Banking Supervision under whose jurisdiction the Registered Office of the NBFC falls where the fraud amount involved in fraud is less than Rs 25 lakh , in the format given in FMR – 1, within three weeks from the date of detection.
- A copy of FMR-1 where the amount involved in the Fraud is Rs 25 lakhs and above should also be submitted to the Regional Office of the Department of Non-Banking Supervision of Reserve Bank of India under whose jurisdiction the Registered Office of the NBFC falls.
- Frauds involving Rs. 25 lakh and above
  In respect of frauds involving Rs. 25 lakh and above, in addition to the requirements given above, NBFCs may report the fraud by means of a D.O. letter addressed to the Chief General Manager-in-charge of the Department of Banking Supervision, Reserve Bank of India, Frauds Monitoring Cell, Central Office and a copy endorsed to the Chief General Manager-in-charge of the Department of Non-

Banking Supervision, Reserve Bank of India, Central Office within a week of such frauds coming to the notice of the NBFC. The letter may contain brief particulars of the fraud such as amount involved, nature of fraud, modus operandi in brief, name of the branch/office, names of parties involved (if they are proprietorship/ partnership concerns or private limited companies, the names of proprietors, partners and directors), names of officials involved, and whether the complaint has been lodged with the Police. A copy of the D.O. letter should also be endorsed to the Regional Office of Reserve Bank, Department of Non-Banking Supervision under whose jurisdiction the Registered Office of the NBFC is functioning.

- NBFCs should submit a copy of the Quarterly Report on Frauds Outstanding in the format given in FMR – 2 to the Regional Office of the Reserve Bank of India, Department of Non-Banking Supervision under whose jurisdiction the Registered Office of the NBFC falls irrespective of amount within 15 days of the end of the quarter to which it relates.
- NBFCs should furnish a certificate, as part of the above report, to the effect that all individual fraud cases of Rs. 1 lakh and above reported to the Reserve Bank in FMR – 1 during the quarter have also been put up to the NBFC's Board and have been incorporated in Part – A (columns 4 and 5) and Parts B and C of FMR – 2.
- Progress Report on Frauds - NBFCs should furnish case-wise quarterly progress reports on frauds involving Rs. 1 lakh and above in the format given in FMR – 3 to the Central Office (CO) of the Reserve Bank of India, Department of Banking Supervision, Frauds Monitoring Cell where the amount involved in fraud is Rs 25 lakhs and above and to Regional Office of the Reserve Bank of India, Department of Non-Banking Supervision under whose jurisdiction the Registered Office of the NBFC falls where the fraud amount involved in fraud is less than Rs 25 lakh within 15 days of the end of the quarter to which it relates.
- NBFCs should ensure that all frauds of Rs. 1 lakh and above are reported to their Boards promptly on their detection. Such reports should, among other things, take note of the failure on the part of the concerned officials, and consider initiation of appropriate action against the officials responsible for the fraud.
- Quarterly Review of Frauds
- Annual Review of Frauds
- Guidelines to be followed for reporting Frauds to the Police

12. CORPORATE GOVERNANCE

Listed NBFCs which are required to adhere to listing agreement and rules framed by SEBI on Corporate Governance are already required to comply with SEBI prescriptions on Corporate Governance.

The Guidelines on Corporate Governance (Master Circular RBI/2009-10/17 DNBS (PD) CC No. 156 / 03.10.001 / 2009-10 dated July 1, 2009) are applicable to

1. All Deposit taking NBFCs with deposit size of Rs 20 crore and above
2. All non-deposit taking NBFCs with asset size of Rs 100 crore and above (NBFC-ND-SI).

In order to enable NBFCs to adopt best practices and greater transparency in their operations following guidelines are proposed for consideration of the Board of Directors of the class of NBFCs to whom this circular is addressed :

Constitution of Audit Committee

i) In terms of extant instructions, an NBFC having assets of Rs. 50 crore and above as per its last audited balance sheet is already required to constitute an Audit Committee, consisting of not less than three members of its Board of Directors, the instructions shall remain valid.
ii) In addition, NBFC-D with deposit size of Rs 20 crore may also consider constituting an Audit Committee on similar lines.

Constitution of Nomination Committee

iii) The importance of appointment of directors with 'fit and proper' credentials is well recognised in the financial sector. In terms of Section 45-IA(4)(c) of the RBI Act, 1934, while considering the application for grant of Certificate of Registration to undertake the business of non-banking financial institution it is necessary to ensure that the general character of the management or the proposed management of the non-banking financial company shall not be prejudicial to the interest of its present and future depositors. In view of the interest evinced by various entities in this segment, it would be desirable that NBFC-D with deposit size of Rs 20 crore and above and NBFC-ND-SI may form a Nomination Committee to ensure 'fit and proper' status of proposed/existing Directors.

Constitution of Risk Management Committee

iv) The market risk for NBFCs with Public Deposit of Rs.20 crore and above or having an asset size of Rs.100 crore or above as on the date of last audited balance sheet is addressed

by the Asset Liability Management Committee (ALCO) constituted to monitor the asset liability gap and strategize action to mitigate the risk associated. To manage the integrated risk, a risk management committee may be formed, in addition to the ALCO in case of the above category of NBFCs.

Disclosure and transparency

v) The following information should be put up by the NBFC to the Board of Directors at regular intervals as may be prescribed by the Board in this regard:

- progress made in putting in place a progressive risk management system, and risk management policy and strategy followed
- conformity with corporate governance standards viz. in composition of various committees, their role and functions, periodicity of the meetings and compliance with coverage and review functions, etc.

Connected Lending

vi) The companies should comply with the instructions on connected lending relationships, as detailed in Annex. The instructions relate to credit facilities to the Directors, loans and advances to relatives of the NBFC's Directors or to the Directors of other companies and their relatives and other entities, timeframe for recovery of such loans, etc.

3. NBFCs shall frame their internal guidelines on corporate governance, enhancing the scope of the guidelines without sacrificing the spirit underlying the above guidelines and it shall be published on the company's web-site, if any, for the information of various stakeholders.

Annex

Instructions on Connected Lending Relationships

The NBFCs should evolve appropriate operating procedures and information systems for ascertaining the interest of their own Directors as also the interest of the Directors of other companies for the purpose of implementing these instructions and for monitoring ongoing compliance therewith.

1. Credit facilities to the Directors

1.1 In order to obviate conflict of interest in the lending operations of the NBFC, it should not grant any loan, advance or non-fund based facility or any other financial accommodation / facility to:

a) its directors or their relatives;

b) to any firm in which any of its Directors is interested as Partner, Manager, Employee or Guarantor;

c) any individual in respect of whom any of its Directors is a Guarantor;

d) any company of which, or the subsidiary or the holding company of which, any of the Directors of the NBFC is a Director, Managing Agent, Manager, Employee or Guarantor or any firm in which he holds substantial interest;

e) any entity, whether incorporated or not which uses as a part of its name or in connection with its business, the name of the NBFC or any such word as would show its association with the NBFC.

1.2 Any existing arrangements may be allowed to continue up to the date when they are due. They should, however, not be renewed or extended any further.

1.3 NBFCs are required to submit information pertaining to loans and advances granted to their directors, relatives and other entities referred to in item 1.1 above for each quarter end (i.e. as on 31st March, 30th June, 30th September and 31st December) in the enclosed Proforma 1 to the Regional Office concerned of the Department of Non-Banking Supervision within 15 days from the close of the respective quarter. If there is nothing to report, a nil statement may be submitted.

2. Timeframe for recovery of loans

2.1 In cases where the NBFC has already provided credit facilities to its directors as prohibited in 1.1 above, immediate steps should be initiated to recover the amounts of the loan or advance together with interest, if any, as soon as the loan or advance falls due for repayment in terms of the loan agreement.

2.2 In case there is no repayment date fixed for any facility, the same may be recovered within a period of one year from the date of this circular.

3. Definitions

3.1 The term 'substantial interest' for the purpose of these guidelines:

(i) in relation to a company, means the holding of a beneficial interest by an individual or his spouse or minor child, whether singly or taken together, in the shares thereof, the amount paid-up on which exceeds five lakhs of rupees or ten per cent of the paid-up capital of the company, whichever is less;

(ii) in relation to a firm, means the beneficial interest held therein by an individual or his spouse or minor child, whether singly or taken together, which represents more than ten per cent of the total capital subscribed by all the partners of the said firm;

3.2 The scope of the term 'relative' shall be as defined in the Companies Act, 1956.

Proforma 1

Information in respect of loans and advances sanctioned to the Directors of NBFCs, their relatives and other entities mentioned in paragraph 1.3 of Annex

Name of the NBFC :

Position as on :

Sr.	Name of the Borrowers (relationship)	Limits Sanctioned (Rs. in lakhs)						
		Date of Sanction/ Renewal	Type of Facility		Secured	Un-secured	Nature and Value of Security	Due Date/ Date of Maturity
			Funded	Non-funded				
1	2	3	4	5	6	7	8	9

Amount Outstanding (Rs. in Lakhs)

Secured	Unsecured	Total (100% of Funded and 50% of Non-funded Limits)	Whether in excess of exposure norms/limits stipulated by RBI	Action initiated in case of Overdue/ NPA Accounts
10	11	12	13	14

Note: Different types of facilities sanctioned to a borrower should be indicated separately against columns 4 and 5.

NOTE:

As per RBI Notification no. RBI/2007-2008/92 DNBS.PD/ CC 104 / 03.10.042 /2007-08 DATED July 11, 2007 addressed to

1. All Deposit taking NBFCs with deposit size of Rs 20 crore and above
2. All non-deposit taking NBFCs with asset size of Rs 100 crore and above (NBFC-ND-SI).

The Bank has received suggestions with reference to paragraph 2(vi) (containing instructions on connected lending) of the above Notification (No. DNBS.PD/ C.C. 94 / 03.10.042 /2006-07 dated May 8, 2007) on Guidelines on Corporate Governance.

The suggestions are being studied and the instructions contained in paragraph 2 (vi) of the circular will become operational after final evaluation of the suggestions and modifications, if any considered necessary. All other instructions issued vide, Company Circular dated May 8, 2007 may be complied meticulously.

13. MICRO FINANCE

The Indian state put stress on providing financial services to the poor and underprivileged since independence. The commercial banks were nationalized in 1969 and were directed to lend 40% of their loan able funds, at a concessional rate, to the priority sector. The priority sector included agriculture and other rural activities and the weaker strata of society in general. The aim was to provide resources to help the poor to attain self sufficiency. To

supplement these efforts, the credit scheme Integrated Rural Development Programme (IRDP) was launched in 1980. In India the micro finance revolution began in the 1980s with the formation of pockets of informal Self Help Groups (SHG) engaging in micro activities financed by Microfinance. But India's first Microfinance Institution 'Shri Mahila SEWA Sahkari Bank was set up as an urban co-operative bank, by the Self Employed Women's Association (SEWA) soon after the group (founder Ms. Ela Bhatt)was formed in 1974. The first official effort materialized under the direction of NABARD(National Bank For Agriculture And Rural Development).

What is micro finance?

Microfinance means providing very poor families with very small loans (micro credit) to help them engage in productive activities /small businesses. Micro finance is defined as the provision of thrift (savings), credit and other financial services and products of very small amounts to the poor for enabling them to raise their income levels and improve living standards.

In India, micro finance is provided by apex development financial institutions (such as National Bank for Agriculture and Rural Development - NABARD, Small Industries Development Bank of India, and Rashtriya Mahila Kosh), commercial banks, regional rural banks, co-operative banks, non banking financial companies (NBFCs) and various not-for-profit entities.

The Eleventh Five Year Plan aims at inclusive growth and faster reduction of poverty. Micro Finance can contribute immensely to the financial inclusion of the poor without which it will be difficult for them to come out of the vicious cycle of poverty.

Micro finance in India

There are two main models of micro credit in the country and they are 'banking model' and the 'MFI (Micro Finance Institution) model'.
In the case of the banking model Self Help Groups are formed and financed by banks. In some cases SHGs are formed by formal agencies/NGOs and financed by banks. In the 'MFI model' SHGs are formed and financed by the MFIs that obtain resource support from various channels. In India, majority of mirco credit activity is under the 'Banking model'(NABARD's Bank-SHG Linkage) and 10-15% of the activity is through 'MFI model'.

MFI Models:

The specialized MFIs (Micro Finance Institutions) or micro-finance movement since the 1990's is a new avenue of reaching the poor for their micro-credit needs. Some of the MFIs are based on the Grameen Model, which entails formation of a Centre comprising eight solidarity groups of five borrowers. Members of each solidarity group mutually guarantee each other loan. Ten Centres form a Cluster and seven clusters form a (bank) branch [and several branches together presumably form the Bank]. This is typically based on the model of Grameen Bank of Bangladesh . All members save regularly and loan proposals are approved by the Centre; all loans are, moreover, repayable in 50 weekly instalments.

MFIs in India register themselves either as societies (under the Societies Registration Act, 1960), as trusts under the Trust Acts, as Non-Banking Financial Companies (NBFCs), or as Local Area Banks (LABs). All NBFCs requiring registration with the Reserve Bank of India should have a minimum capital of Rs.2 crore. NBFCs intending to accept public deposits have to satisfy stipulated criteria and have to obtain specific authorisation from the RBI. The issue of covering of NBFCs' deposits by Deposit Insurance and Credit Guarantee Corporation (DICGC) was examined several times, and it was found neither desirable nor feasible to extend such coverage.

Flow of Micro Finance

There are different mechanisms through which the delivery of micro credit loans takes place. Banks may lend directly to customers. Second, NABARD sponsors the Self Help Group-Bank Lending Programme (SBLP). Under SBLP, self help groups (SHGs) need to save regularly for a minimum of six months and maintain prescribed records and accounts in order to become eligible to be linked to local banks. This programme provides credit to 22.38 lakh SHGs. Third, commercial banks or apex institutions lend to micro finance organizations (MFOs) for further lending to groups or individuals (see chart below).

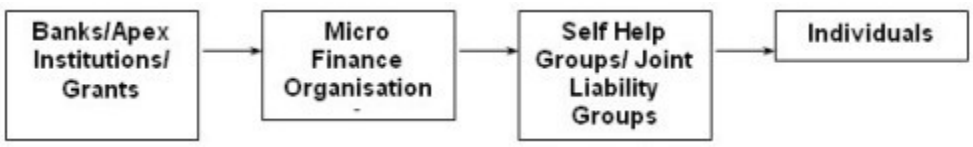

Chart: Institutional flow of micro finance

MFOs lend to SHGs and joint liability groups (JLGs, which are also known as grameen groups). The number of MFOs in India involved in lending activities is estimated to be

around 800. These MFOs vary significantly in size, outreach and credit delivery methodologies. Presently, the lending activities of MFOs are not regulated except for those registered as NBFCs.

Difference between SHGs and Grameen/JLGs

	SHGs	**Grameen/JLGs**
Size	Upto 20 members	5-15 members
Nature of Loan	Single loan to the SHG as a whole, which decides how it should be allocated.	Loan recorded in the names of Individual borrowers.
Source: Microfinance in India: A State of the Sector Report, 2006, Prabhu Ghate, CARE, Swiss Agency for Development and Cooperation, and Ford Foundation<		

Micro Financial Sector (Development and Regulation) Bill 2007

The Micro Financial Sector (Development and Regulation) Bill 2007 was tabled in the Lok Sabha on Tuesday, March 20,2007.

The Bill had been referred to the Standing Committee on Finance. Currently, the Bill is Pending in Parliament.

The Bill makes the National Bank for Agriculture and Rural Development (Nabard) the regulator for the micro-financial sector.

The Micro Financial Sector (Development and Regulation) Bill, 2007 seeks to promote the sector and regulate micro financial organisations (MFO).

On its enactment, the Bill makes registration of micro-finance organisations with Nabard mandatory and no institution (including existing) can carry out business of offering thrift services without obtaining certificate of registration. Every MFO that accepts deposits needs to be registered with NABARD. Conditions for registration include (a) net owned funds of at least Rs 5 lakh; and (b) at least three years in existence as an MFO. All MFOs, whether registered or not, shall submit annual financial statements to NABARD

The Bill qualifies any amount not exceeding Rs 50,000 as a micro-finance service, with this limit set at Rs 1.50 lakh for housing purposes. For safeguarding interests of the people depositing their money, the Bill proposes constitution of a reserve fund, where minimum 15 per cent of the net profit or surplus realised out of thrift services will be parked.

The Bill also empowers Nabard to frame a scheme for the appointment of one or more Micro Finance Ombudsmen for settlement of disputes between clients and micro finance institutions.

Banks and deposit taking Non-Banking Financial Companies (NBFCs) have to comply with Reserve Bank of India's (RBI) prudential norms designed to safeguard depositors' funds. While the Bill enables NABARD to prescribe norms for MFOs, it specifies some norms which are less stringent than for banks and NBFCs. Unlike banks regulated by RBI, the Bill does not exempt registered MFOs from the Usurious Loans Act, 1918 or state laws which cap interest rates.

14. CHIT FUNDS

Chit funds are the Indian equivalent of the Rotating Savings and Credit Associations (ROSCA) that are famous throughout the world. ROSCAs are a means to 'save and borrow' at the same time. It is considered one of the best instruments to cater to the needs of the poor.

The concept of chit funds originated more than 1000 years ago. Initially it was in the form of an informal association of traders and households within communities, wherein the members contributed some money in return for an accumulated sum at the end of the tenure. Participation in chit funds were mainly for the purpose of purchasing some property or, in other words, for 'consumption' purposes. However, in recent times, there has been tremendous alteration in the constitution and functioning of chit funds.

With the advent of the Chit Funds Act, initially in the year 1961 (Madras Act) and amended subsequently in the year 1982 (Central Act), chit funds have been highly regulated and governed by stringent rules. The purpose of the said Act and its proposed benefit to the chit funds industry is, however, questionable

Chit Fund Monitoring Authorities:

1. Reserve Bank of India
2. Ministry of Finance – Department of Financial Services – (Banking)

Chit funds in India are governed by various state or central laws, like Travancore Chit Act of 1945, Chit Funds Act, 1982 and Madras Chit Fund Act, 1961. Organised chit fund schemes are required to register with the Registrar of Firms, Societies and Chits.

Meaning of 'Chit'

"Chit" means a transaction (whether called chit fund, chit, kuri or by any other name), by which the foreman enters into an agreement with a number of subscribers that everyone of them shall subscribe a certain sum for a certain period and each subscriber in his turn as determined by lot or by auction, shall be entitled to a prized amount.

Meaning of Chit Fund

A Chit Fund is a kind of savings scheme practiced in India. In a chit scheme, a specific number of individuals come together to pool a specific amount of money at periodic intervals.

A totally Indian concept, the chit fund system has now won universal acclaim. In the villages of Kerala, many centuries ago, a small group of farmers operated a unique scheme. Each farmer gave a fixed quantity of grains periodically to a selected TRUSTEE. The Trustee, after keeping aside a portion for himself, gave the rest to a member of the group to help him to meet his social commitments and other needs. The farmer who received the lot continued to give the fixed quantity till every member of the group received his lot. The additional benefits when receiving the lot earlier led to competition. Some members were even willing to forgo a certain portion (like a discount) of the lot, in order to get an earlier chance. So, an auction was held and the lowest bidder got the lot. This was the basis of what we know today as the "Chit Fund Scheme"

The Chit Company forms different group each consisting of a certain number of subscribers. They agree to contribute a specific amount as instalment for a certain number of months. As soon as the group is complete and the Government Certificate of Commencement is secured, an auction is held. On the date of the auction, the subscribers in the particular group assemble, either in person or through proxy. They bid for the amount and the person offering the highest discount receives the chit amount. Out of the discount foregone, the Company's commission (5% of the chit amount) is deducted and the balance

is divided equally among the subscribers in the group. The subscribers then deduct the dividend and pay only the balance in their next instalments. Before the successful bidder draws the amount, he proposes securities - immovable properties, Life Insurance Policies, Debentures of good companies, Unit Trust of India Certificates, Bank Guarantee etc. Personal sureties of persons employed in government offices, government undertakings and reputed public limited companies are also accepted. The prize amount is given as soon as the securities/sureties are accepted.

How Chit Fund Help?

Chit Funds have the advantage both for serving a need and as an investment. Money can be readily drawn in an emergency or could be continued as an investment. Interest rate is determined by the subscribers themselves, based on mutual decisions and varies from auction to auction. The money that you borrow is against your own future contributions. The amount is given on personal sureties too; unlike in banks and other financial institutions which demand a tangible security. Chit funds can be relied upon to satisfy personal needs. Unlike other financial institutions, you can draw upon your chit fund for any purpose - marriages, religious functions, medical expenses, just anything... and Cost of intermediation is the lowest.

15. MONEY LENDING

Landlords, local shopkeepers, traders, suppliers and professional money lenders, and relatives are the informal sources of micro-credit for the poor, both in rural and urban areas. Some of the perceived advantages of informal loans are:
(a) contractual flexibility,
(b) lower discrepancies between loan sanctioned and loan received and
(c) less reliance on collateral.

The interest charged on informal loans is stated to vary between 24 per cent to 48 per cent per annum (or 4 per cent per month). In certain regions, it goes up to 120 per cent per annum (or 10 per cent per month).

State Money Lending Acts

The Money Lender's Acts enacted by various states are intended to check the exploitation of the poor by the money lenders. They cannot charge exorbitant rates of interests; in fact, in most cases there is an upper ceiling on interest rates and the total recoveries cannot

exceed twice the amount of 'the principal'. However, such provisions are rarely enforced due to various reasons.

The various Money Lending Acts enacted by the different states have not been successful in ensuring any discipline on the non-formal banking sector.
Illegal (loan) contracts, though not judiciable, are enforced by the money lenders through the muscle power tactics as well as the desire of the poor themselves not to lose credibility for taking loans in the next cycle.

As per the Money Lender's Acts which are in force at present, registration and license for money lending are mandatory. As an incentive, the professional money lenders who are so registered may be allowed access to refinancing facility, same as the MFIs, if they allowed their accounts to be audited by the authorised regulator regularly.

Money Lending in India

Lending by money lenders is an activity that antedates contemporary banking system from ancient times. They have been organized in the form of family or individual business. They vary in their size from small petty money lenders to substantial indigenous bankers whose businesses, at times, have exceeded that of commercial banks.

In India, historically, money lenders have had a prominent position in the capital and credit markets. They are usually aligned along ethnic lines and are variously called as shroffs, seths, sahukars, mahajans, chettis etc. in different parts of the country.

Money lenders lend money, act as money-changers and finance loan trade by means of bills of exchange. They usually use working capital of their own, and do not generally get deposits or solicit savings from the public. They grant loans on personnel recommendation and guarantee to persons well-known to them. They also sometimes grant loans against securities such as gold, jewellery, land, promissory notes etc. Money lenders usually do not have contact with other suppliers/institutions as they usually depend on their own funds. But they do borrow from joint stock banks and other financial institutions in times of high demand, thus creating a channel where formal funds are channeled to the informal sector .

Money Lenders in India come under control of the Money Lenders Act, promulgated by each of the different states. The Act essentially sets out the appointment of a Registrar-General of Money-Lenders who maintains a Register of Money-lenders in their

jurisdiction. The Registrar provides for a license to money lenders to carry out their business, regulates the terms and conditions under which a loan is provided to borrowers, and arbitrates in disputes between money-lenders and borrowers in cases of default or other aspects. Compliance with the Act is rare however, and majority of the money-lenders do not obtain such a license to operate.

Power to Legislate on Money Lending

Under the Constitution of India (Seventh Schedule), money lending is a State Subject :

Money Lending : Entry 30 of List II: State List
"30. Money-lending and money-lenders; relief of agricultural indebtedness."

Any other law enacted in this context is, therefore is subservient to the law passed by the state legislature. The Seventh Schedule does not mention Private Money Lending. As such, all kinds of money lending whether through institutional or non-institutional sources can get covered.

The Constitution of India has conferred the power to legislate on matters relating to money lending and moneylenders to the States. Most of them have enacted the laws. Many of these are comprehensive legislations providing detailed and stringent provisions for regulation and supervision of the money lending business. These legislations contain provisions aimed at protecting the borrowers from malpractices of the moneylenders.

Some States have enacted separate legislations governing the business of pawn-broking, while others have incorporated separate provisions for pawnbrokers within the money lending legislation itself.

A particular Money Lending Act (of a state) may thus come in conflict with another Act, enacted let us say, on behalf of RBI. One way to overcome this difficulty, may be the Centre preparing a model "Money Lending Act" and passing it down to the states for enactment of a similar legislation.

Various attempts have been made by the Reserve Bank of India (RBI) - to regulate and bring into its preview, the functioning of money lenders and indigenous bankers.

Recommendations from RBI that detailed accounting styles, rediscounting and deposit taking functions, support by commercial banks etc. were not accepted by associations and unions of lenders, disagreeing with some of the provisions made by RBI.

Model Legislation

As per the Report of the Technical Group of the Reserve Bank of India set up to review legislations on money lending, it recommends a model legislation for the consideration and adoption by the State Governments that do not presently have a comprehensive legislation in place.
Money Lenders & Accredited Loan Providers' Bill, 2007 (Model Legislation)
The Technical Group also recommends some modifications in the existing legislations like a quick, informal and easy dispute resolution mechanism for better enforcement and mandatory provision for registration to undertake money lending activity in States that have no such provisions.

Money Lending

The name by which moneylenders are called may vary from country to country but they can be found performing similar activities all over the world. In many countries, the moneylenders (as we understand in India) are known as “consumer credit providers” (United Kingdom) or “credit providers” (South Africa).

Who is a Money Lender?

The definition of the term ‘moneylender’ in legislation is generally all-inclusive, and means a person who is in the business of lending money (loans), whether as principal business or otherwise. However, nearly all legislations expressly exclude certain categories of persons from the definition. The excluded categories are either incorporated bodies or institutions in the business of banking, insurance, dealing in securities etc., which are otherwise regulated by formal regulatory bodies.
There are certain other non-incorporated but registered bodies, such as, registered co-operative societies, which are also excluded from the definition of moneylenders.

In addition to individuals being expressly excluded, some international laws also exclude either a class of loans or loans provided by a class of persons from being regarded as "loans" for the purpose of the money lending legislation thereby taking them out of the purview of those laws.

The various Moneylenders Acts of different States define a moneylender as a person whose main or subsidiary occupation is the business of advancing and realising loans. Banks and Co-operative Societies are excluded from the purview of the Acts of many States. Generally, the laws have been made applicable to individuals, firms, association of individuals and companies. However, Nagaland and Andhra Pradesh (as applicable to the Andhra Region Scheduled Areas) have excluded companies from the purview of their respective enactment

Generally all the legislations define a moneylender to be a person advancing loans. Exemptions from the applicability of the provisions of the money lending laws are of various types:
(i) exemption provided under the definition of moneylender(Rajasthan Moneylenders Act),
(ii) exemption provided under the definition of loan (generally in many legislations);
(iii) provisions expressly exempting persons / entities from the provisions of the legislations (Madhya Pradesh Moneylenders Act, 1934);
(iv) Provisions empowering Government to exempt persons / entities from the provisions of the legislations;
(iv) limited exemption is granted under certain legislations (Bombay Moneylenders Act, 1946 – applicable to Maharashtra and Gujarat) to banks, companies, unincorporated bodies etc.

Money Lending Laws

The object of legislation pertaining to money lending is to regulate and control the business of moneylenders.

The nature of the money lending laws is regulatory, with emphasis being on protecting the interests of the borrowers by providing definite upper limits on rates of interest and curbing coercive recovery practices by penalizing such acts as also by denying the benefits of legal remedies to moneylenders to recover loans to the extent to which they are tainted with illegalities. Coercive recovery practices are also sought to be curbed by

providing definite recovery procedures generally through Courts. Where there are violations, procedures are also prescribed to provide a remedy to the injured.

An examination of the money lending legislations of States shows that the provisions are generally similar. The salient features are:

1. Requirement of registration/license for carrying on the business of money lending within a State/a portion of the State;
2. Duties of the moneylenders with respect to maintaining and providing statement of accounts to the debtors;
3. Penalties for carrying on business without licence and for intimidating the debtors or interfering with their day-to-day activities, including the cognizability of such offences;
4. Maximum rates of interest that can be charged;
5. Matters that the Courts are required/empowered to decide in suits filed by moneylenders;
6. Applicability to companies engaged in the money lending business. However, some States in exercise of their general exemption powers, have granted exemptions to companies from the applicability of the legislations.
7. Exemption to loans from a trader to another trader, loans by banks, co-operative societies, financial institutions, etc.

Common Features of the Money Lending Legislations of the States

1. Registration/Licensing

All the moneylending legislations provide that moneylenders are required to register and obtain a licence. All the State legislations, except those of Punjab and the National Capital Territory of Delhi, also provide for penalties if any person carries on business without registration/licence. Some States provide for enhanced punishments for second and subsequent offences.

Kerala and Karnataka provide for the payment of a security deposit by the moneylender at the time of applying for the licence, which is liable to be forfeited in the event of his contravening any of the provisions of the respective Acts/Rules, falsification of accounts, and commission of certain offences.

Almost all laws, except of Kerala, Nagaland and Andhra Pradesh (Andhra Region Scheduled Areas) Moneylenders Regulation, 1960, also impose a bar on suits filed by unregistered moneylenders.

2. Loans in kind, goods and materials

Most State Acts include the advance of both money and kind within the definition of the term "loan".

3. Keeping, Filing and Furnishing of Accounts

Almost all the States have provisions requiring moneylenders to keep statement of accounts in the form and manner prescribed in the Rules.

Moneylenders are also required in some states to file statement of accounts with the registering/licensing authorities and generally they are required to do so annually. Another requirement is to furnish a statement of accounts to the borrowers as prescribed under the Rules.

Delhi, Punjab and Haryana do not contain provisions for the keeping of accounts, filing statement of accounts/returns with registering authorities and furnishing of account details to the borrowers.

Some States enable the State authorities to inspect the books of accounts and related documents. Some States even have powers of search and seizure of books of accounts and documents relating to money lending. Most of the States also prescribe penalties for the falsification of accounts/entry of wrong sums in accounts.

4. Interest Rates

Interest rates chargeable by moneylenders are either fixed by Statute or the Statutes empower the respective Governments to fix the interest rate by issue of notification from time to time.

The same forms a bench-mark for the Courts to determine whether the interest rates charged are excessive in the given facts and circumstances of a case. The Courts are also empowered to examine whether or not interest rates charged on a loan transaction are excessive under a central legislation, namely, the Usurious Loans Act, 1918.

5. Molestation

Some State money lending legislations have provisions defining an offence of ‘molestation’ and prescribing penalty for the commission or abetment to commit the same. The term ‘molestation’ has been defined to include use of violence/intimidation against the debtor or family members/loitering near the house or work place/doing of any act calculated to annoy the debtor, etc.

6. Reopening of transactions by Court

With the exception of some States, some permit the Courts to reopen the transactions pertaining to the loan, settle accounts between the parties and reduce the amount charged to the debtor in respect of any excessive interest.

7. Trade credit

Loans from one trader to another (trade credit) have been exempted, expressly or impliedly in some states.

Special features of Money Lending Legislations of some states

Apart from the general provisions common to the legislations of all the States, there are certain special features unique to some of them:

1. Loan

The Bengal Moneylenders Act, 1940 has a provision defining "commercial loan" (Section 2(4)) to mean a loan advanced to any person to be used by such person solely for the purposes of any business relating to trade, commerce, industry, mining, planting, insurance, transport, banking or entertainment, or to the occupation of wharfinger, warehouseman or contractor or any other venture of a mercantile nature, whether as proprietor or principal or agent or guarantor. Interest rate permitted is higher for such loans.

The Andhra Pradesh (Telangana Area) Moneylenders Act, 1349 F has a provision (Section 2(9)) defining the meaning of "trader" and read with the provisions of Section 2(4)(g), providing for exemption to certain categories of loans, which include loan by a trader to another trader.

The Kerala Act, while defining "loan", has excluded an advance made by a trader bona fide carrying on business, other than money lending, if such loan is advanced in the regular course of such business.

2. Penalty for taking salami, batta, gadiana

The Bihar Moneylenders Act, 1974 contains provision providing for penalty on moneylenders who takes from a debtor at the time of advancing loans or deducts out of the principal of such loan any salami, batta, gadiana or other extraction of a similar nature.

3. Composition of Offences

Certain legislations provide for compounding some of the offences made punishable under the Moneylenders legislations.

4. Debt collectors

The AP (Andhra Region Scheduled Areas) Moneylenders Regulation, 1960 has a provision for employing debt collectors by moneylenders after obtaining authorisation from the authority in terms of section 11.

The Nagaland Moneylenders Act, 2005 prohibits employment of persons by moneylenders for the purpose of demanding or recovering any loan due to him unless such person is in possession of a certificate (issued by the designated authority of the State) authorising him to act as a debt collector

5. Security Deposits

Kerala and Karnataka require registered moneylenders to keep security deposits with the Government. The law provides a detailed table specifying the amount of money required to be deposited by a moneylender, and it is linked to the amount of money lent in a year.

The security deposits specified under the Kerala Moneylenders Act, 1958 range from a minimum of five thousand rupees to a maximum of two lakh rupees. The security deposits specified under the Karnataka Moneylenders Act, 1961 range from a minimum of five thousand rupees to a maximum of fifty thousand rupees.

6. Audit by Chartered Accountants

The Kerala Moneylenders Act, 1958, is the only Act, which provides that the accounts of every moneylender be audited at least once in every year by a person who is a chartered accountant and the audit report submitted to the specified authority.

Report of the Technical group of the RBI to review legislations on money lending

The context for setting up the group was provided by unprecedented farmers' suicides. As the report says, since high indebtedness to moneylenders can be an important reason for distress among farmers, the group was asked to review the efficacy of the existing legislative framework and enforcement machinery governing money lending and to make recommendations for their improvement.

The main purpose of the report is to devise a new legislation for "incentivising good conduct" among moneylenders so that they can become part of the solution to the crisis of credit in rural India.

The report summarises the history and impact of legislation to control usurious money lending across 22 States in the country. The report says that money lending legislation has been almost impossible to enforce.

The report also reviews international experience from eight countries to explore the possibility of linking moneylenders to banks and concludes that any attempt to put too many onerous oversight obligations on banks will be counterproductive as the "moneylenders will not be happy."

The sample includes developed as well as the developing countries.
1. Hong Kong - Moneylenders' Ordinance, 1997
2. Singapore - Moneylenders' Act, 1959
3. Japan - Money Lending Business Control and Regulation
Law, 19835
4. Lesotho - Moneylenders' Order, 1989
5. United Kingdom - Consumer Credit Act, 19746
6. West Pakistan - The Punjab Moneylenders Ordinance, 19607
7. USA (S. Dakota) - Title 54 of the South Dakota State Laws (Debtor and Creditor)8
8. South Africa - The National Credit Act, 20059

Enforcement Machinery under the Laws of various Countries

Country / State	Law	Licensing Authority
United Kingdom	Consumer Credit Act, 1974	Office of Fair Trading (http://www.oft.gov.uk)
Hong Kong	Money Lenders Ordinance, 1997	Office of the Registrar (under the Financial Secretary)
Singapore	Money Lenders Act, 1959	Office of the Registrar (under the Minister)
Japan	Money Lending Business Control and Regulation Law, 1983	Financial Services Authority (http://fsa.gov.jp)
Lesotho	Money Lenders Order, 1989	Commissioner of Financial Institutions
South Dakota	Title 54 of the State Laws of South Dakota	Division of Banking of the Department of Revenue and Regulation
West Pakistan	Punjab Money Lenders Ordinance, 1960	Collector
South Africa	National Credit Act, 2005	National Credit Regulator

(Source: Report of the Technical group of the RBI to review legislations on money lending)

The report notes that all national and international legislation empowers the government to notify maximum rates of interest that can be charged by moneylenders. But argues that this is "out of sync with market reality" and suggests linking interest rates to a market determined bench-mark as this will make "moneylenders view the legislation favourably." The report also rejects existing laws that prescribe audit of moneylenders' books by Chartered Accountants, because this is "impractical and may not necessarily add value."

The report outlines a "model legislation" called the Money Lenders & Accredited Loan Providers' Bill, 2007. This bill seeks to formalise the relationship of banks with moneylenders to take advantage of their dominant presence, knowledge base, informality and easy access. Moneylenders would now be transformed into Accredited Loan Providers. Banks would facilitate them to set up business by providing required funds for on-lending.

These advances will even be treated as part of the mandatory priority sector lending by banks.

Three important laws identified in the report:

1. The Rule of "Damdupat"
Some of the State law contain a provision providing for the maximum amount of interest recoverable on loans made by moneylenders, incorporating the rule of damdupat. The rule of damdupat is a branch of the Hindu law of debt. According to this rule, the amount of interest recoverable at any one time cannot exceed the principal.

2. Usurious Loans Act, 1918.

The Usurious Loans Act, 1918 is also currently applicable to transactions relating to money lending. The Usurious Loans Act, 1918 (ULA) was enacted with the object of preventing the Civil Courts being used for the purpose of enforcing harsh and unconscionable loans carrying interest at usurious rates.

The provisions of ULA enable the Courts to reopen transactions by way of money or grain loans in cases where the Court is satisfied (a) that the interest or other return is excessive and (b) that the transaction is substantially unfair and after investigation of the circumstances, both attendant and antecedent, to revise the transaction between the parties and, if necessary, to reduce the amount payable to such sum as the Court, having regard to the risk and all circumstances of the case, may decide to be reasonable.

The State Government has been empowered to exempt, by way of notification in Official Gazette, any area, class of transactions or class of persons from the applicability of ULA.

ULA has been made applicable to suits for (a) recovery of a loan, (b) enforcement of any security taken or any agreement, made in respect of any loan and (c) redemption of any security given in respect of any loan.

The ULA is applicable to all suits as mentioned irrespective of the parties involved in the disputes. Therefore, the Act is also applicable to suits in which a moneylender is a party.

3. Interest Act, 1978
Though not a part of the overall body of laws relating to money lending, there is one more Act, viz, the Interest Act, 1978 which can also be applied by Courts while granting interest

in suits. The Act is a Central Act and it was enacted with a view to consolidate and amend the law relating to allowing of interest in certain cases.

List of some Money lending legislations in India

List Of Money Lending Laws In India

Sl No.	State	Legislation
1	Karnataka	Karnataka Money Lenders Act, 1961
2	Kerala	Kerala Money Lenders Act, 1958
3	Uttar Pradesh	Uttar Pradesh Regulation of Money Lending Act, 1976
4	Tamil Nadu	Tamil Nadu Money Lenders Act, 1957
5	Maharashtra	Bombay Money Lenders Act, 1946
6	Punjab	The Punjab Registration of Money-Lenders Act, 1938
7	NCT Delhi	Adopted the Punjab Legislation
8	Haryana	Adopted Punjab Legislation vide Haryana Adaptation of Laws Order, 1968
9	West Bengal	Bengal Money-Lenders Act, 1940
10	Orissa	Orissa Money Lenders Act, 1939
11	Bihar	Bihar Money Lenders Act, 1974
12	Rajasthan	Rajasthan Money Lenders Act, 1963
13	Gujarat	Adopted Bombay Money Lenders Act, 1946
14	J & K	No legislation
15	Madhya Pradesh	Madhya Pradesh Money Lenders Act, 1934
16	Chhattisgarh	Same as M.P.
17	Andhra Pradesh	Andhra Pradesh (Telangana Area) Money Lenders Act, 1349 F Andhra Pradesh (Andhra Region Scheduled Areas) Money Lenders Regulation, 1960
18	Assam	The Assam Money Lenders Act, 1934
19	Meghalaya	Adopted the Assam Legislation
20	Tripura	Adopted Maharashtra Legislation

21	Nagaland	Nagaland Money Lenders Act, 2005
22	Uttrakhand	Same as Uttar Pradesh

(Source: Report of the Technical group of the RBI to review legislations on money lending)

16. HOUSING FINANCE COMPANIES

In terms of the National Housing Bank Act, 1987, National Housing Bank is expected, in the public interest, to regulate the housing finance system of the country to its advantage or to prevent the affairs of any housing finance institution being conducted in a manner detrimental to the interest of the depositors or in a manner prejudicial to the interest of the housing finance institutions. For this, National Housing Bank has been empowered to determine the policy and give directions to the housing finance institutions and their auditors.

Besides the regulatory provisions of the National Housing Bank Act, 1987, National Housing Bank has issued the Housing Finance Companies (NHB) Directions, 2001 as also Guidelines for Asset Liability Management System in Housing Finance Companies. These are periodically updated through issue of circulars and notifications.

As part of the supervisory process, an entry level regulation is sought to be achieved through a system of registration of housing finance companies.

National Housing Bank supervises the sector through a system of on-site and off-site surveillance.

National Housing Bank

The National Housing Bank (NHB) was established on 9th July 1988 under an Act of the Parliament viz. the National Housing Bank Act, 1987 to function as a principal agency to promote Housing Finance Institutions and to provide financial and other support to such institutions.

The Act, inter alia, empowers NHB to:

» Issue directions to housing finance institutions to ensure their growth on sound lines

» Make loans and advances and render any other form of financial assistance to scheduled banks and housing finance institutions or to any authority established by or under any Central, State or Provincial Act and engaged in slum improvement and

» Formulate schemes for the purpose of mobilisation of resources and extension of credit for housing

The principal mandate of the Bank is to promote housing finance institutions to improve/strengthen the credit delivery network for housing finance in the country. The Bank has played a facilitator role in this regard instead of itself opening such dedicated housing finance institutions. For this purpose, NHB has issued the Model Memorandum and Articles of Association. NHB has also issued guidelines for participating in the equity of housing finance companies. All housing finance companies registered with NHB u/s 29A of the National Housing Bank Act, 1987 and scheduled commercial/co-operative banks are eligible for refinance support subject to terms and conditions as laid down under the respective refinance schemes.

As a part of its promotional role NHB has also formulated a scheme for guaranteeing the bonds to be issued by the housing finance companies.

Considering the need for trained personnel for the sector NHB has designed and conducted various training programmes

Housing Finance Institution

Section 2(d) of the NHB Act defines HFI as follows: "housing finance institution" includes every institution, whether incorporated or not, which primarily transacts or has as one of its principal objects, the transacting of the business of providing finance for housing, whether directly or indirectly;

Legislations-

- National Housing Bank Act, 1987
- NHB General Regulations, 1988

A HFC is a company which mainly carries on the business of housing finance or has one of its main object clause in the Memorandum of Association of carrying on the business of providing finance for the housing.

For commencing the housing finance business, an HFC is required to have the following in addition to the requirements under the Companies Act, 1956:

(a) Certificate of registration from NHB
(b) Minimum net owned fund of Rs. 200 lakhs (w.e.f. 16.02.2002)

Apart from registration as Company by the Registrar of Companies a HFC also requires registration with National Housing Board for commencing or carrying on the business of housing finance.

A HFC cannot commence business immediately after making an application for registration with NHB, it has to obtain the certificate of registration from NHB and also have the minimum Net Owned Fund (NOF).

HFCs incorporated after June 12, 2000 cannot conduct business of housing finance without obtaining a certificate of registration from NHB. Conduct of business without obtaining certificate of registration is an offence punishable under the provisions of the NHB Act. NHB can also file application for winding up of such HFCs.

However an existing HFC (existing as on June 12, 2000) without minimum NOF and registration can continue the housing finance business provided it has applied for certificate of registration with NHB before December 12, 2000 and the application has not been rejected by NHB. Such companies, have to achieve the minimum NOF of Rs 25.00 lakhs within a period of three years, i.e. before June 12, 2003 unless further extended by NHB.

Registration

To obtain a certificate of registration from NHB, an HFC, after incorporation, is required to make an application to NHB in a specified form.

The conditions upon the fulfillment of which a certificate of registration is granted by NHB are given in sub-section (4) of Section 29A of the National Housing Bank Act, 1987. Briefly, the conditions are:

(a) The HFC shall be in a position to pay its depositors in full as and when their claims accrue;

(b) The affairs of HFC are conducted in a manner not detrimental to the interest of its depositors;
(c) The management of HFC is not prejudicial to the public interest or to the interests of its depositors;
(d) HFC had adequate capital and earning prospects;
(e) The public interest is served by the grant of such certificate of registration;
(f) Grant of certificate is not prejudicial to the growth of housing finance sector;
(g) Such other conditions which NHB considers necessary for granting the certificate of registration.

An appeal lies against the order of rejection of certificate of registration. The HFC can appeal to the Central Government within a period of 30 days from the date on which such order of rejection is communicated to it.

The certificate of registration granted to an HFC by NHB can be cancelled in the following circumstances:-

(a) where it ceases to carry on the business of housing finance;
(b) where such HFC has failed to comply with any condition subject to which the certificate of registration had been issued to it;
(c) where at any time it fails to fulfill any of the conditions enumerated above for the grant of certificate of registration;
(d) where it fails –
(i) to comply with any direction issued by NHB;
(ii) to maintain accounts in accordance with the requirement of law;
(iii) to submit or offer for inspection its books of accounts and other relevant documents to the officials of NHB, when so demanded;
(e) where it has been prohibited from accepting deposit by an order made by NHB and such order has been in force for a period of not less than three months.

An appeal lies against the order of cancellation of certificate of registration by NHB. The HFC can appeal to the Central Government within a period of 30 days from the date on which such order of rejection is communicated to it.

Net Owned Fund (NOF)

Net Owned Fund is:

(a) the aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance-sheet of the housing finance institution after deducting therefrom -
(i) accumulated balance of loss;
(ii) deferred revenue expenditure, and
(iii) other intangible assets; and

(b) further reduced by the amounts representing -
(1) investments of such institution in shares of-
(i) its subsidiaries;
(ii) compaines in the same group;
(iii) all other housing finance institutions which are companies; and
(2) the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with,-
(i) subsidiaries of such company; and
(ii) companies in the same group,
to the extent such amount exceeds ten per cent. of (a) above;

Note: "subsidiaries" and "companies in the same group" shall have the same meanings assigned to them in the Companies Act, 1956.

Acceptance of Deposits

The expression public deposit has been defined in detail in clause (w) of sub-paragraph (1) of paragraph 2 of The Housing Finance Companies (NHB) Directions, 2001. However, the definition of public deposit specifically excludes certain deposits like amount received from Central or State Governments, banks, public financial institutions and other institutions, from other companies, mutual funds etc.

Which HFCs can accept public Deposits:

For acceptance of public deposits HFCs can be divided into two categories, i.e. HFCs carrying on the business of housing finance before June 12, 2000 and HFCs commencing housing finance business after that date.

(a) Companies carrying on business of housing finance before June 12, 2000 can accept deposits provided they have NOF of over rupees twenty five lacs and have applied for certificate of registration with NHB before December 12, 2000 and either have been

granted the certificate of registration valid for acceptance of deposits by NHB or their application is still pending for issue of certificate of registration with NHB.

(b) Companies commencing the business of housing finance after June 12, 2000 can accept public deposits only after:

(i) obtaining certificate of registration from NHB valid for acceptance of deposits; and
(ii) having minimum net owned funds (NOF) of [rupees two crores or more]*.

*this amount was rupees twenty five lacs or more for HFCs which commenced business before February 16, 2002.

In terms of the Housing Finance Companies (NHB) Directions, 2001, HFCs can accept public deposits for periods of one year and above and upto seven years only.

Public deposits of HFCs are not guaranteed by NHB. The depositor has to satisfy himself about the financial position and all relevant aspects before placing his deposit with the HFC.

A person making public deposits with HFCs should satisfy himself that it holds a valid certificate of registration for accepting public deposits from NHB. NHB while issuing certificate of registration to an HFC specifically mentions whether or not it can accept public deposits.

Ceiling on the maximum amount of public deposit which can be accepted by an HFC :

HFCs having credit rating from approved credit rating agencies not below 'A' and complying with all prudential norms requirements can accept deposit not exceeding five times of its net owned fund. The HFCs having no credit rating can accept deposit only upto two times of its net owned fund or rupees ten crores whichever is lower provided such HFC complies with all prudential norms and also has capital adequacy ratio of not less than fifteen percent as per the last audited balance sheet.

Although credit rating is not compulsory for acceptance of public deposits by an HFC, however the HFC having credit rating can accept more deposits as per the conditions laid down for acceptance of deposits in such a case as compared to an HFC without such rating.

Approved Credit rating agencies for the purpose of HFCs:

The following credit rating agencies have been approved for the purpose
(i) The Credit Rating Information Services of India Ltd. (CRISIL)
(ii) ICRA Ltd.
(iii) Credit Analysis and Research Limited (CARE)
(iv) FITCH Ratings India Pvt. Ltd.

Ceiling on the rate of interest which can be offered by an HFC on public deposits

The Housing Finance Companies (NHB) Directions, 2001 provide for ceiling on the maximum rate of interest which can be offered by an HFC on public deposits. The present ceiling is twelve and half per cent per annum compounded at intervals not shorter than monthly rests. However, there is no stipulation with regard to the minimum rate of interest required to be offered on public deposits by an HFC.

Premature withdrawal of Deposit by a Depositor

Subject to anything on the contrary an HFC, on a request being made by a depositor, may consider making premature payment of the deposit subject to the following:
(i) No deposit can be repaid within three months from the date of its acceptance.
(ii) No interest shall be paid if the deposit is repaid within six months from the date of deposit.
(iii) Where deposit has run from six months to one year the interest not exceeding ten per cent can be paid.
(iv) Where the deposit has run for a period of twelve months, the rate of interest applicable shall be one percentage point less than that HFC's rate applicable for the period for which the deposit has actually run.
(v) In case of death of the depositor the deposit may be repaid with interest at the contracted rate upto the date of repayment of such deposit.

Important Note:

A HFC on its own cannot repay the deposit prematurely. Acceptance of public deposit is a contract between the HFC and the depositor for a definite period of time. However, any novation of the contract has to be mutually agreed between the parties and should be in conformity with the provisions of Housing Finance Companies (NHB) Directions, 2001.

Remedies available to a depositor when the HFC does not re-pay the deposits on maturity :

The depositor can file a civil suit for recovery of the amount of deposit. He can also make a complaint to the Consumer Forums set up under the Consumer Protection Act, 1986. The depositor should also bring such cases to the notice of NHB for taking action against the defaulting companies under the provisions of the NHB Act. On being satisfied that the company has defaulted in repayment of deposits NHB may issue directions prohibiting it from acceptance of further deposits and alienation of its assets. NHB may also impose financial penalties and take action for imposition of other penalties. NHB may also file winding up petition against such companies.

Details an HFC is required to furnish in the application form soliciting public deposits

While soliciting public deposits, an HFC has to indicate, inter-alia, the following:

- Particulars of the specified category of the depositors,
- Credit rating assigned for its deposits,
- Information relating to aggregate exposure to group companies and other entities in which Directors of the HFC/ HFC have substantial interest ,
- Other statements pertaining to Redressal fora available in case of any deficiency, effect of non-payment of deposits, financial position of the company, regulatory framework etc. as detailed in Paragraph 6 to the Housing Finance Companies (NHB) Directions, 2001,
- Particulars specified in the Non-Banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977, made under section 58A of the Companies Act, 1956 (1 of 1956).

Regulation

The provisions for regulation of the HFCs as provided under the NHB Act, 1987 are:

- Requirement of Registration and Net Owned Fund
- Maintenance of percentage of assets in specified securities
- Creation of Reserve Fund by the HFCs
- Regulation or prohibition of issue of prospectus or advertisement soliciting deposits
- Determination of Prudential Norms for HFCs
- Collection of information as to deposits and to give directions
- Issue of directions to the auditors of the HFCs relating to financial statements and disclosure requirements
- Prohibition of acceptance of deposits and alienation of assets
- Penalty for violation of the provisions of the Act or the directions issued thereunder. Filing of winding up petition against erring HFCs.

Housing Finance Companies (NHB) Directions, 2001

NHB has issued general directions to HFCs under the NHB Act, 1987 from time to time. The Directions currently in force are known as Housing Finance Companies (NHB) Directions, 2001. These Directions relate to :

- Acceptance of deposits by HFCs,
- Prudential Norms relating to Income Recognition,
- Capital Adequacy,
- Classification of assets,
- Credit Concentration etc.

They also contain directions to auditors of the HFCs regarding disclosure requirements.

Periodical returns, statements, etc. required to be submitted by the HFCs to NHB

The returns/ statements required to be submitted by the HFCs to NHB are enumerated below:

- Annual Return
- Half-yearly Return on Prudential Norms
- Quarterly Return on maintenance of Liquid Assets
- Auditor's Certificate on annual basis certifying the capability of the HFC to repay deposits
- Copy of financial statements / Annual Report
- Returns on changes pertaining to address of the registered office of the HFC, its Directors etc.
- Filing a copy of the advertisement soliciting Public Deposits or statement in lieu thereof

Action which can be taken by NHB against the HFCs not complying with the provisions of the Act or the Housing Finance Companies (NHB) Directions, 2001

As per the NHB Act, 1987, NHB is empowered to take the following actions:

(a) Issuing specific directions prohibiting acceptance of deposits and alienation of assets
(b) Cancellation of certificate of registration.

(c) Filing of applications for winding up petition
(d) Imposition of financial penalties on the HFC and its principal officers
(e) Filing of complaints before the Magistrate for imposition of penalties

Provisions under the NHB Act, 1987 and Housing Finance Companies (NHB) Directions, 2001 for safeguarding the interest of the depositors

Some of the safeguards under the NHB Act, 1987 and Housing Finance Companies (NHB) Directions, 2001 are enumerated below:

(i) Imposition of ceiling on the amount that can be accepted by an HFC
(ii) Imposition of ceiling on the rate of interest on deposits
(iii) Provision for nomination facility
(iv) Requirement of disclosures to the depositors
(v) Imposition of ceiling on brokerage to be paid by HFC for raising deposits
(vi) Prohibition on alienation of assets in case of default in repayment of deposits
(vii) Requirement of maintenance of Liquid Assets by HFC
(viii) Creation of Reserve Fund
(ix) Collection of data periodically to verify compliance with the provisions of the NHB Act and directions by an HFC to ensure its soundness

17. MORTGAGE GUARANTEE COMPANIES

While announcing proposals for the Union budget 2007-08, the Finance Minister of India had announced:

'Our people want housing loans. Banks and housing finance companies that lend against mortgages would have greater comfort if the mortgage can be guaranteed through a three way contract among borrower, lender and guarantor. Regulations will be put in place to allow the creation of mortgage guarantee companies'.

Accordingly, the Reserve Bank of India had drawn up a draft scheme for considering proposals from Mortgage Guarantee Company for grant of Certificate of Registration. The draft scheme was discussed with the stakeholders and after examination of comments/suggestions received in this regard and with the previous approval of the Central Government, it was decided to specify Mortgage Guarantee Company as non-banking financial company.

Mortgage Guarantee Company as NBFC

In terms of powers under Section 45 I (f) (iii) of the RBI Act, 1934, the RBI vide Notification (Notification No. DNBS (MGC)1/CGM(PK) -2008 dated January 15, 2008) a Mortgage Guarantee Company, that is, a company registered with the Bank under the scheme for registration of Mortgage Guarantee Companies notified by the Bank in this regard, will be treated as Non-Banking Financial Company under the provisions of the Act.

Further, Mortgage Guarantee Company will be exempted vide Notification No. DNBS (MGC) 2 /CGM(PK) -2008 dated January 15, 2008 from the following provisions of RBI Act 1934 as a separate regulatory framework is being prescribed for such companies:

- Section 45-IA (requirement of registration),
- Section 45-IB (maintenance of liquid assets) and
- Section 45-IC (creation and transfer to Reserve Fund a certain percentage of the net profit)

Registration

The Company desirous of registration as Mortgage Guarantee Company may apply to Reserve Bank of India in application form in duplicate, duly filled in, as per format enclosed / placed on the Bank's web-site www.rbi.org.in .

Guidelines on Registration and Operations of Mortgage Guarantee Company

Under Section 45L(1)(b) of the Reserve Bank of India Act, 1934, the RBI has laid down Guidelines on Registration and Operations of Mortgage Guarantee Company vide Notification (Notification DNBS(PD)MGC No.3 /CGM (PK) - 2008 dated February 15, 2008)

These guidelines have to be complied by every non-banking financial company undertaking the business of Mortgage Guarantee as defined herein.

The Text of the Notification DNBS(PD)MGC No.3 /CGM (PK) - 2008 dated February 15, 2008 - Guidelines on Registration and Operations of Mortgage Guarantee Company under Section 45L(1)(b) of the Reserve Bank of India Act, 1934, is reproduced below.

1. Short title, commencement and applicability of the directions:

(i) These guidelines shall be known as the 'Mortgage Guarantee Company (Reserve Bank) Guidelines, 2008'.
(ii) These guidelines shall come into force with immediate effect.

Scope

(iii) These guidelines provide a framework for the registration and operation of mortgage guarantee companies in India.

Definitions

2. (1) In these guidelines unless the context otherwise requires,

(a) 'bank' means-

(i) a banking company; or
(ii) a corresponding new bank; or
(iii) the State Bank of India; or
(iv) a subsidiary bank; or
(v) such other bank which the Reserve Bank may, by notification, specify for the purposes of these guidelines; and
(vi) a cooperative bank as defined under the Banking Regulation Act, 1949 (10 of 1949);

(b) 'banking company' means a banking company as defined in Section 5(c) of the Banking Regulation Act, 1949 (10 of 1949);

(c) 'borrower' means any person or any entity who has been granted a housing loan by any creditor institution or any other entity which may be specified by Reserve Bank of India from time to time;

(d) "creditor institution" means a bank or housing finance company;

(e) 'company' means a company registered under Section 3 of the Companies Act, 1956;

(f) 'corresponding new bank' means as defined in clause (da) of Section 5 of the Banking Regulation Act, 1949;

(g) 'default' means non-payment on the due date of any principal debt or interest thereon payable by a borrower to any creditor institution ;

(h) 'guarantee' means a contract of guarantee as defined in the Indian Contract Act, 1872 (9 of 1872);

(i) 'housing finance company' means a company which primarily transacts or has as one of its principal objects, the transacting of the business of providing finance for housing, as defined in the National Housing Bank Act, 1987;

(j) 'housing loan' means any loan or advance granted to an individual or any other entity which may be specified by Reserve Bank of India from time to time for the purpose of construction/ repairs/ upgradation of a house or residential property or acquisition of a house or residential property or both i.e. house and residential property;

Explanation:- 'Other entities' would include housing societies and housing co-operatives in the above definition of 'housing loan'.

(k) 'mortgage guarantee' means a guarantee provided by a mortgage guarantee company for the repayment of an outstanding housing loan and interest accrued thereon up to the guaranteed amount to a creditor institution, on the occurrence of a trigger event;

(l) 'mortgage guarantee company' means a company which primarily transacts the business of providing mortgage guarantee;

(m) "mortgage guarantee contract" means a tri-partite contract among the borrower, the creditor institution and the mortgage guarantee company, which provides the mortgage guarantee;

(n) 'National Housing Bank' means the National Housing Bank established under the National Housing Bank Act, 1987 (53 of 1987);

(o) "net owned fund" is as notified in the Prudential Norms for Mortgage Guarantee Companies;

(p) 'non-performing asset' means account of a borrower, which has been classified by a creditor institution as sub-standard, doubtful or loss asset, in accordance with the directions or guidelines relating to asset classification issued by the Reserve Bank or the National Housing Bank as the case may be;

(q) 'Reserve Bank' means the Reserve Bank of India constituted under the Reserve Bank of India Act, 1934 (2 of 1934);

(r) 'substantial interest' means holding of a beneficial interest by an individual or his spouse or minor child, whether singly or taken together in the shares of a company, the amount paid up on which exceeds ten percent of the paid up capital of the company; or the capital subscribed by all partners of a partnership firm;

(s) "trigger event" means classification of the account of a borrower as non-performing asset in the books of the creditor institution;

(t) ‘turnover or business turnover’ means the total mortgage guarantee contracts entered during the year together with the volume of business arising out of other activities (specially permitted by RBI), undertaken during the year;

2. (2) Words or expressions used but not defined herein and defined in the Companies Act, 1956 (1 of 1956) or Accounting Standards issued by the Chartered Accountants of India, shall have the same meaning as assigned to them in that Act / Accounting standards.

Registration with the Reserve Bank of India

3. A mortgage guarantee company shall commence the business of providing mortgage guarantee after -

(a) obtaining a certificate of registration from the Reserve Bank of India; and

(b) having a net owned fund of one hundred crore rupees or such other higher amount, as the Reserve Bank of India may, by notification, specify.

4. Every mortgage guarantee company shall make an application for registration to the Reserve Bank of India in such form as may be specified by the Reserve Bank of India for the purpose.

5. The Reserve Bank of India, for the purpose of considering the application for registration, shall require to be satisfied that the following conditions are fulfilled:-

(a) that the mortgage guarantee company shall primarily transact the business of providing mortgage guarantee. A mortgage guarantee company shall be deemed to comply with the above when at least 90% of the business turnover is mortgage guarantee business or at least 90% of the gross income is from mortgage guarantee business (which includes the income derived from reinvesting the income generated from mortgage guarantee business);

(b) that the mortgage guarantee company is or shall be in a position to pay its liabilities arising from the contracts of guarantee it may enter into;

(c) that the mortgage guarantee company has adequate capital structure as stipulated in paragraphs 11 to 13 below and adequate earning prospects from mortgage guarantee business;

(d) that the general character of the management or the proposed management of the mortgage guarantee company shall not be prejudicial to the public interest;

(e) that the Board of Directors of such mortgage guarantee company does not consist of more than half of its total number of directors who are either nominees of any shareholder with substantial interest or associated in any manner with the shareholder with substantial interest or any of the subsidiaries of the shareholder with substantial interest if such a shareholder is a company;

(f) (i) Mortgage guarantee company shall have a well diversified shareholding;

(ii) Mortgage guarantee company shall not be a subsidiary of any other company including a company registered or incorporated under any law in force outside India;

(iii) No individual, association or body of individuals whether incorporated or not, partnership firm, company or company registered or incorporated under any law in force outside India shall, directly or indirectly, have any controlling interest in mortgage guarantee company;"

(g) the Foreign Direct Investment to be eligible for investment in the equity of a mortgage guarantee company should have prior approval of FIPB. If the foreign entity which has received FIPB / FED approval is having substantial interest in the applicant mortgage guarantee company, it should be regulated by a home country financial regulator and should itself preferably be a mortgage guarantee company and have a good track record of operating as a mortgage guarantee company. However, the above clauses would not be applicable if the investor in the equity of a mortgage guarantee company is international financial institution;

(h) that the public interest shall be served by the grant of certificate of registration to the mortgage guarantee company to commence or to carry on the business in India;

(i) that the grant of certificate of registration shall not be prejudicial to the operation and growth of the housing finance sector of the country;

(j) that the mortgage guarantee company is compliant with the applicable norms for foreign investment in such companies; and

(k) any other condition, fulfillment of which in the opinion of the Reserve Bank of India, shall be necessary to ensure that the commencement of or carrying on the business in India by a mortgage guarantee company shall not be prejudicial to the public interest and the housing finance sector in India.

6. The Reserve Bank of India may, after being satisfied that the conditions specified in sub paragraphs of paragraph 5 are fulfilled, grant a certificate of registration subject to such conditions which it may consider, fit to impose.

7. The mortgage guarantee company shall be under the regulatory and supervisory jurisdiction of the Reserve Bank of India.

8. The Reserve Bank of India may cancel a certificate of registration granted to a mortgage guarantee company, if such company-

(a) ceases to carry on the business of providing mortgage guarantee in India; or
(b) has failed to comply with any condition subject to which the certificate of registration has been issued to it; or
(c) has failed to honour, in a timely manner, the claims arising from the contract of guarantee it has entered into or may enter into; or

(d) at any time fails to fulfill any of the conditions referred to in paragraphs 5 and 6; or
(e) fails to -

i) comply with any direction issued by the Reserve Bank of India; or
ii) maintain accounts, publish and disclose its financial position in accordance with the requirements of any law or any direction or order issued by the Reserve Bank of India; or
iii) submit or offer for inspection its books of account or other relevant documents when so demanded by the Reserve Bank of India.

Essential features of a mortgage guarantee

9. The essential features of a mortgage guarantee contract shall be as follows:

(a) it shall be a contract of guarantee under Section 126 of the Indian Contract Act, 1872;

(b) the mortgage guarantee contract shall be unconditional and irrevocable and the guarantee obtained shall be free from coercion, undue influence, fraud, misrepresentation, and/or mistake under Indian Contract Act, 1872 ;

(c) it shall guarantee the repayment of the principal and interest outstanding in the housing loan account of the borrower, up to the amount of guarantee;

(d) the guarantor shall pay the guaranteed amount on invocation without any adjustment against the realisable value of the mortgage property;

(e) it shall be a tri-partite contract among the borrower, the creditor institution and the mortgage guarantee company, which provides the mortgage guarantee.

10. The mortgage guarantee company shall not carry on insurance business.

Minimum Capital requirement

11. A mortgage guarantee company shall have a minimum net owned fund of Rs.100 crore at the time of commencement of business, which shall be reviewed for enhancement after 3 years.

Capital Adequacy

12. A mortgage guarantee company shall maintain a capital adequacy ratio of ten percent (10%) of its aggregate risk weighted assets of on balance sheet and of risk adjusted value of off-balance sheet items or any other percentage that may be prescribed by the Reserve Bank of India for the purpose, from time to time.

13. A mortgage guarantee company shall maintain at least six percent (6%) of its aggregate risk weighted assets of on balance sheet and of risk adjusted value of off-balance sheet items as Tier I capital.

Prudential and accounting norms

14. The mortgage guarantee company shall be required to comply with various prudential guidelines including those relating to income recognition, asset classification, provisioning, classification and valuation of investments and prudential exposures that are issued by the Reserve Bank of India from time to time.

15. The mortgage guarantee company shall also comply with all the relevant Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India from time to time.

16. No single guarantee shall exceed 10% of the company's Tier I and Tier II capital.

Funding options

17. (1) Acceptance of public deposits - Mortgage guarantee companies shall not accept public deposits.

17. (2) External Commercial Borrowings - Mortgage guarantee companies shall not avail External Commercial Borrowings.

Creation and maintenance of Reserves

Contingency Reserves:

18. A mortgage guarantee company shall create and maintain a "Contingency Reserve" on an ongoing basis. The mortgage guarantee company:

(a) Shall appropriate each year at least forty percent (40%) of the premium or fee earned during that accounting year or twenty five percent (25%) of the profit (after provisions and tax), whichever is higher, to the Contingency Reserve;

(b) In case of inadequate profits, such appropriation shall either result in or increase the amount of carry forward loss;

(c) May appropriate a lower percentage of the premium or fee earned during any accounting year when the provisions made each year towards losses on account of settlement of mortgage guarantee claims exceeds thirty-five percent (35%) of the premium or fee earned during that accounting year;

(d) Shall ensure that the Contingency Reserve is built up to at least five percent (5%) of the total outstanding mortgage guarantee commitments;

(e) Shall retain the amounts appropriated each year to the Contingency Reserve for a minimum period of seven (7) subsequent years which shall be eligible for reversal only in the eighth year subject to the condition in 18(d) above;

(f) Shall utilize the Contingency Reserve only with the prior approval of the Reserve Bank of India;

(g) Shall show the amount of ‘Contingency Reserve’ as a separate line item on the liability side of the balance sheet; however, Contingency Reserve may be treated as 'free reserve' for the purpose of net owned fund.

Accounting of Unearned Premium

19. A mortgage guarantee company shall account the premium or fee on the mortgage guarantee contracts as an income in the profit and loss account in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India. The amount of unearned premium shall be shown as a separate line on the liability side of the balance sheet.

Provision for losses on invoked guarantees

20. A mortgage guarantee company is exposed to a potential loss when its guarantee is invoked. Mortgage guarantee companies shall hold provisions for losses in respect of such

invoked guarantees pending recovery of assets. The amount of provisions required to be held shall be equal to the contract-wise aggregate of 'amount of invocation' after adjusting the realisable value of the assets held by the company in respect of each housing loan where the guarantee has been invoked. In case the realisable value of the assets held in respect of any invoked guarantee is more than the amount of invocation, the excess shall not be adjusted against the shortfall in other invoked guarantees. In case the amount of provisions already held is in excess of the amount as computed above, the excess shall not be reversed. The amount of provisions made each year shall be shown as a separate line item in the Profit and Loss Account. The amount of provision held for losses on settlement of invoked guarantees shall be shown as a separate line item on the liability side of the balance sheet.

Provision for 'Incurred But-Not-Reported (IBNR) losses'

21. A mortgage guarantee company is exposed to a potential loss when there is a default in a housing loan guaranteed by it. Mortgage guarantee companies shall hold provisions in respect of such defaulted housing loans where the trigger event is yet to occur or the guarantee is yet to be invoked. The potential loss to which the guarantee company is exposed to is referred to as 'Incurred-But-Not-Reported (IBNR) losses'. The amount of provisions required to be held shall be arrived at on an actuarial basis depending upon the estimates of loss frequency and loss severity for incurred but not reported losses which are derived from historic data, trends, economic factors and other statistical data in relation to paid claims, the provisions held for claims settled, risk statistics, etc. In case the amount of provisions already held is in excess of the amount as computed above, the excess shall not be reversed. The amount of provisions made each year shall be shown as a separate line item in the Profit and Loss Account. The amount of provision held for Incurred But-Not-Reported (IBNR) losses shall be shown as a separate line item on the liability side of the balance sheet.

Requirement of maintaining Register of guarantees

22. Every mortgage guarantee company shall keep one or more registers in which shall be entered the particulars of guarantee provided by the company, namely,

(a) name and address of the borrower/co-borrower,
(b) date and amount of loan sanctioned to the borrower,
(c) brief description of the property including the site/location of the property,
(d) the nature of security available for the loan,

(e) tenure of the loan,
(f) amount of each installment and due date for the payment of each installment,
(g) name and address of the bank or housing finance company to whom the guarantee has been provided,
(h) date and amount of the guarantee, and
(i) duration of the guarantee.

Mortgage guarantee company's obligations

23. The liability of the mortgage guarantee company in respect of a secured housing loan granted by a creditor institution where the mortgage guarantee company has provided a guarantee shall be as stipulated in the contract of guarantee entered into by and between the mortgage guarantee company, the creditor institution and the borrower.

24. On any day after a trigger event, the creditor institution, which has obtained a mortgage guarantee from a mortgage guarantee company, shall be entitled to invoke the guarantee against the mortgage guarantee company.

25. The mortgage guarantee company shall make good the guarantee liability without demur as and when a notice of demand for the payment of the guarantee liability in respect of the mortgage guarantee provided by it in favour of a bank or a housing finance company is received by it.

26. If a housing loan turns into a non-performing asset and the creditor institution prefers first to realize the loan by resorting to speedy recovery procedures prescribed in the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 and the creditor institution, realizes some amount of the loan from the borrower, the liability of the mortgage guarantee company in respect of the loan, will stand reduced to that extent.

27. No mortgage guarantee company shall provide mortgage guarantee for a housing loan with 90% and above LTV ratio.

Due diligence to be exercised by a mortgage guarantee company

28. Before offering to provide a guarantee for the repayment of a housing loan, the mortgage guarantee company shall be required to be satisfied, amongst others, with the following;

(a) that the loans are secured by a valid mortgage;

(b) that the creditor institution has verified title to the property, marketability of the property and credit worthiness of the borrower;

(c) that the creditor institution has verified the use of the land on which a house or residential property is constructed or proposed to be constructed out of the loan obtained from it;

(d) that the creditor institution has verified and obtained a copy of the permission obtained by the borrower from the proper authorities for the purpose of construction of the house or residential property; and

(e) that the loan granted by a creditor institution to a borrower is not more than 90% of the value of the property.

Prohibitions

29.(1) A housing loan which is not secured by a valid mortgage of the house / residential property that is or is proposed to be acquired by such loan shall not be eligible for a mortgage guarantee from a mortgage guarantee company.

No commissions, rebates or inducements

29.(2) A mortgage guarantee company shall not pay commissions, rebates, or other inducements for referral of mortgage guarantee business to any person.

Prohibition on guaranteeing mortgage originations of Related Party

29.(3) A mortgage guarantee company shall not provide guarantees on mortgage originations of promoters, its / their subsidiaries, associates and related parties or subsidiaries, associates and related parties of mortgage guarantee company including companies where the mortgage guarantee company has a material investment or interest of five percent (5%) or more of the shareholding.

Investments

29.(4) A mortgage guarantee company shall not invest in notes or other evidences of indebtedness secured by a mortgage or other lien upon real property. This section shall not apply to obligations secured by real property, or contracts for the sale of real property, which obligations or contracts of sale are acquired in the course of the good faith settlement of claims under policies issued by the mortgage guarantee company, or in good faith disposition of real property so acquired.

Constitution of Audit Committee

30. A mortgage guarantee company shall constitute an Audit Committee consisting of not less than three non-executive Directors of the Board of the company, at least one of whom will be a Chartered Accountant.

Policy for grant of guarantee

31. The Board of Directors of a mortgage guarantee company shall frame a policy for the company for providing mortgage guarantee to creditor institutions. Such policy shall, inter alia, stipulate the following:-

(a) the fee or premium chargeable for providing a mortgage guarantee based on specific identified criteria including the quantum of loan; LTV ratio; credit quality of the borrower; and credit appraisal / credit risk management skills of the bank or housing finance company,

(b) delegation of power for providing a mortgage guarantee and to enter into a contract of guarantee,

(c) delegation of power for taking a decision to make good the claims received from banks and housing finance companies, and

(d) delegation of power for initiating proceedings for the recovery of its dues from the borrowers.

Scheme of Mortgage Guarantee

32. For the purpose of providing mortgage guarantee, the mortgage guarantee company shall prepare a detailed scheme duly approved by its Board of Directors. The scheme shall contain, amongst others, the following matters:

(a) the quality of a housing loan,

(b) the maximum portion of a housing loan granted by a bank or a housing finance company to a borrower, that may be covered under the contract of guarantee,

(c) the minimum and the maximum LTV ratio of a housing loan proposed to be covered under the contract of guarantee,

(d) the fee or premium or charge indicating the manner for the payment there of, payable by a borrower to the mortgage guarantee company in consideration for the contract of guarantee,

(e) the liability of the mortgage guarantee company as to whether the liability will be co-extensive with that of the borrower or otherwise, and

(f) the conditions governing the issue as to which party of the mortgage guarantee company or a bank/ housing finance company will be required to effect recoveries from the borrower after the mortgage guarantee is invoked and the guarantee liability is made good by the mortgage guarantee company to the bank or housing finance company.

Counter-guarantee

33. Whenever a mortgage guarantee company obtains counter-guarantee cover in respect of the housing loans guaranteed by it from another mortgage guarantee company, the mortgage guarantee company and the counter-guarantee company shall establish and maintain the reserves required for a mortgage guarantee company in India in appropriate proportions in relation to the risk retained by the original mortgage guarantee company and ceded to the assuming counter-guarantee company so that the total reserves established shall not be less than the reserves required under Indian law for a mortgage guarantee company. In case the counter-guarantee company is not regulated by the regulator(s) in India, the mortgage guarantee company guaranteeing the claim shall hold relevant reserves and provisions in respect of all outstanding mortgage guarantee contracts issued by it.

Exemptions

34. The Reserve Bank of India may, if it considers necessary for avoiding any hardship or for any other just and sufficient reason, grant extension of time to comply with or exempt

any mortgage guarantee company or class of mortgage guarantee companies or all mortgage guarantee companies, from all or any of the provisions of these guidelines either generally or for any specified period, subject to such conditions as the Reserve Bank of India may impose.

35. The Reserve Bank of India can give any clarification in respect of the above guidelines and such clarification shall be treated as part of these guidelines. The guidelines can be amended by the Bank from time to time.

Prudential Norms and Investment Norms applicable to Mortgage Guarantee Company

The Prudential Norms and Investment Norms as applicable to Mortgage Guarantee Company have also been framed as per Notification DNBS(PD)MGC No.4 /CGM (PK) - 2008 and Notification DNBS(PD)MGC No.5 /CGM (PK) - 2008 both dated February 15, 2008 for meticulous compliance by the Mortgage Guarantee Companies.

The Text of the Notification is reproduced below.

Notification DNBS(PD)MGC No.5 /CGM (PK) - 2008 dated February 15, 2008

The Reserve Bank of India, having considered it necessary in the public interest, and being satisfied that, for the purpose of enabling the Bank to regulate the credit system to the advantage of the country, it is necessary to issue the directions relating to the prudential norms as set out below, in exercise of the powers conferred by Section 45JA of the Reserve Bank of India Act, 1934 (2 of 1934) and of all the powers enabling it in this behalf, gives to every Mortgage Guarantee Company the directions hereinafter specified.

Short title, commencement and applicability of the directions:

1. (i) These directions shall be known as the 'Mortgage Guarantee Companies Investment (Reserve Bank) Directions, 2008'.

(ii) These directions shall come into force with immediate effect.

(iii) The provisions of these directions shall apply to every Mortgage Guarantee Company which has been granted Certificate of Registration by the Reserve Bank of India.

Definitions

2. (1) For the purpose of these directions, unless the context otherwise requires:

(i) "break up value" means the equity capital and reserves as reduced by intangible assets and revaluation reserves, divided by the number of equity shares of the investee company;

(ii) "carrying cost" means book value of the assets and interest accrued thereon but not received;

(iii) "earning value" means the value of an equity share computed by taking the average of profits after tax as reduced by the preference dividend and adjusted for extra-ordinary and non-recurring items, for the immediately preceding three years and further divided by the number of equity shares of the investee company and capitalised at the following rate:

(a) in case of predominantly manufacturing company, eight per cent;
(b) in case of predominantly trading company, ten per cent; and
(c) in case of any other company, including a non-banking financial company, twelve per cent;

NOTE : If, an investee company is a loss making company, the earning value will be taken at zero;

(iv) "fair value" means the mean of the earning value and the break up value;

(v)"Mortgage Guarantee Company" means a company registered with the Bank as mortgage guarantee company as defined in "Mortgage Guarantee Companies Prudential Norms (Reserve Bank) Directions, 2008;

(vi) "net asset value" means the latest declared net asset value by the mutual fund concerned in respect of that particular scheme;

(vii) ‘non-performing asset’ (NPA) for the purpose of income recognition on investments by mortgage guarantee companies means an asset, in respect of which, interest or principal or amortization obligations have remained overdue for a period of **90 days** or more.

(2) Other words or expressions used but not defined herein and defined in the Reserve Bank of India Act, 1934 (2 of 1934) or Mortgage Guarantee Company Prudential Norms (Reserve Bank) Guidelines, 2008 contained in Prudential Norms (MGC) No. DNBS.(PD) MGC 4 /CGM (PK) - 2008 dated February 15, 2008, shall have the same meaning as assigned to them under that Act or that Directions. Any other words or expressions not defined in that Act or that Directions, shall have the same meaning assigned to them in the Companies Act, 1956 (1 of 1956).

Investment Policy for Mortgage Guarantee Companies

3. (i) A mortgage guarantee company shall invest only in the following instruments:

a) Government Securities;
b) Securities of corporate bodies / public sector undertakings guaranteed by Government;
c) Fixed Deposit/Certificate of Deposits/bonds of Scheduled Commercial banks/PFIs;
d) listed and rated debentures/bonds of corporates;
e) fully debt oriented Mutual Fund Units;
f) unquoted Government securities and Government guaranteed bonds.

(ii)No other investment including investment in subsidiaries and joint ventures would be permitted. However, a mortgage guarantee company may hold investments in equity shares of any company which may be quoted or unquoted or other unquoted investments acquired in satisfaction of its debts which shall be disposed of by the mortgage guarantee company within a period of three years or within such period as extended by the Bank, from the date of such acquisition.

Pattern of Investment

4. (i) A mortgage guarantee company shall hold not less than 25% of its total investment portfolio in Central and State Government securities.

(ii) The remaining investments may be invested as the Board considers prudent, but with a ceiling of 25% in any one category i.e. listed and rated corporate bonds and debentures or debt oriented mutual fund units, etc.

(iii) The Board may fix an appropriate sub-limit for individual investments within each category of instruments as specified in paragraph 3(i) above of these directions.

(iv) The Minimum Investment Grade Rating (MIGR) assigned by the SEBI registered Rating Agencies would be the requirement for investment by MGC in bonds/debentures and debt oriented Mutual Funds.

Income recognition

5. (i) Mortgage Guarantee Companies may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of inertest and repayment of principal have been guaranteed by the Central Government or a State Government, provided interest is serviced regularly and as such is not in arrears.

(ii) Mortgage Guarantee Companies may book income from dividend on shares of corporate bodies on accrual basis provided dividend on the shares has been declared by the corporate body in its Annual General Meeting and the owner's right to receive payments is established.

(iii) Mortgage Guarantee Companies may book income from Government securities and bonds and debentures of corporate bodies on accrual basis, where interest rates on these instruments are pre-determined and provided interest is serviced regularly and as such is not in arrears.

(iv) Mortgage Guarantee Companies should book income from units of mutual funds on cash basis.

Accounting of investments

6. (1) All investments shall be marked to market;

Quoted investments shall, for the purposes of valuation, be grouped into the following categories, viz.,

(a) Government securities including treasury bills,
(b) Government guaranteed bonds/securities;
(c) bonds of banks/ PFIs;
(d) debentures/bonds of corporates; and
(e) Units of mutual fund.

Quoted investments for each category shall be valued at cost or market value whichever is lower. For this purpose, the investments in each category shall be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the

aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored. Depreciation in one category of investments shall not be set off against appreciation in another category.

(2) Investments in unquoted Government securities or Government guaranteed bonds shall be valued at carrying cost.

(3) Unquoted investments acquired in satisfaction of its debts shall be valued as under:

(a) Unquoted investments in the units of mutual funds shall be valued at the net asset value declared by the mutual fund in respect of each particular scheme;

(b) Unquoted equity shares shall be valued at cost or break up value, whichever is lower. However, mortgage guarantee companies may substitute fair value for the break up value of the shares, if considered necessary. Where the balance sheet of the investee company is not available for two years, such shares shall be valued at Rupee one per company;

(c) Unquoted preference shares shall be valued at cost or face value, whichever is lower.

Note: Unquoted debentures shall be treated as term loans or other type of credit facilities depending upon the tenure of such debentures for the purpose of income recognition and asset classification.

7. The MGC with the approval of the Board shall frame an investment policy in tune with these directions.

18. FOREIGN EXCHANGE INVESTMENT IN NBFCs

The relevant regulations are laid down in Foreign Exchange Management (Deposit) Regulations, 2000 [FEMA-5]. Accordingly, Effective from April 24, 2004, NBFCs cannot accept deposits from NRI except deposits by debit to NRO account of NRI provided such amount do not represent inward remittance or transfer from NRE/FCNR (B) account.

Schedule 6 of the said regulation contains the procedure regarding Acceptance of deposits by a Company incorporated in India (including a NBFC registered with RBI) on repatriation basis from a NRI or a person of Indian origin resident outside India

Schedule 7 of the said regulation contains the procedure regarding Acceptance of deposits by Indian Proprietorship concern/ firm or company (including a NBFC registered with RBI) on non-repatriation basis from a NRI or a person of Indian origin resident outside India

Inbound Investment- Sectoral cap on Investments by Persons Resident outside India – Annexure B- schedule I of FEMA 20 [Foreign Exchange Management (Transfer or issue of Security by a Person Resident outside India) Regulations, 2000]

Item 2

FDI /NRI/ investments allowed in the following 19 NBFC activities shall be as per the levels indicated below:

a) Activities covered:

1. Merchant Banking
2. Under writing
3. Portfolio Management Services
4. Investment Advisory Services.
5. Financial Consultancy
6. Stock-broking
7. Asset Management
8. Venture Capital
9. Custodial Services
10. Factoring
11. Credit Reference Agencies
12. Credit Rating Agencies
13. Leasing & Finance

14. Housing Finance

15. Forex-broking

16. Credit Card Business

17. Money-changing Business

18. Micro-credit

19. Rural credit

Note: The Union Cabinet on 30th January 2008 reviewed and approved the FDI policy for further liberalization and deleted 'Credit Reference Agencies' from the list

b) Minimum Capitalisation norms for fund based NBFCs

i. for FDI upto 51%, US $ 0.5 million to be brought in upfront

ii. If the FDI is above 51 % and upto 75 %, US $ 5 million to be brought upfront

iii. If the FDI is above75 % and upto 100 %, US $ 50 million out of which $ 7.5 million to be brought in upfront and the balance in 24 months

c) Minimum Capitalisation norms for non-fund based activities.

Minimum Capitalisation norm of US$0.5 million is applicable in respect of non-fund based NBFCs with foreign investment.

d) Foreign investors can set up 100% operating subsidiaries without the condition to disinvest a minimum of 25% of its equity to Indian entities, subject to bringing in US $ 50 million as at b) (iii) above (without any restriction on number of operating subsidiaries without bringing in additional capital)

e) Joint Venture operating NBFCs that have 75% or less than 75% foreign investment will also be allowed to set up subsidiaries for undertaking other NBFC activities, subject to the subsidiaries also complying with the applicable minimum capital inflow i.e, (b)(i) and (b)(ii) above.

f) FDI in the NBFC sector is put on automatic route subject to compliance with guidelines of the Reserve Bank of India. RBI would issue appropriate guidelines in this regard

19.0 THE FINANCIAL COMPANIES REGULATION BILL 2000

The Government of India framed the Financial Companies Regulation Bill, 2000 to consolidate the law relating to NBFCs and unincorporated bodies with a view to ensure depositor protection.

The salient features of this Bill are:

§ All NBFCS will be known as Financial Companies instead of NBFCs;

§ NBFCs holding public deposits would not be allowed to carry on any non-financial business without the prior approval of RBI;

§ RBI would have the powers to prescribe minimum net-worth norms;

§ Unsecured depositors would have first charge on liquid assets and assets created out of deployment of part of the reserve fund;

§ Financial Companies would require prior approval of RBI for any change in name, management or registered office;

§ Regulation of unincorporated bodies would be in the hands of the respective State Governments;

§ Penalties have been rationalized with the objective that they should serve as a deterrent and investigative powers have been vested with District Magistrates and Superintendents of Police;

§ RBI would be empowered to appoint Special Officer(s) on delinquent financial companies;

§ Any sale of property in violation of RBI order would be void;

§ The Company Law Board will continue to be the authority to adjudicate the claims of depositors.

Financial companies would have no recourse to the CLB to seek deferment of the depositors' dues.

The Bill has been introduced in Parliament in 2000 and has since been referred to the Standing Committee on Finance.