of rural cooperative banks, except PCARDBs, for which it remained at the previous year's level. The recovery performance of CCBs, PACS, and PCARDBs improved, while that of state cooperative banks StCBs and SCARDBs worsened. Asset quality and recovery performance of the long term rural credit institutions, especially SCARDBs,has improved. Both the scheduled commercial banks (SCBs) and rural banks will need to focus on semi-urban and rural areas for future growth.

Cooperative banks are an important segment in the Indian banking structure. Effective and coordinated regulation can strengthen and revitalise this sector.

## NON-BANKING FINANCIAL COMPANIES

Non-banking financial companies (NBFCs) constitute an important segment of the financial system. NBFCs are financial intermediaries engaged primarily in the business of accepting deposits and delivering credit. They play an important role in channelizing the scarce financial resources to capital formation. NBFCs supplement the role of the banking sector in meeting the increasing financial needs of the corporate sector, delivering credit to the unorganized sector and to small local borrowers. But they differ from banks in many ways. An NBFC can accept deposit but not demand deposits and hence, they cannot raise low cost funds through savings or current accounts. Moreover, it is not a part of the payment and settlement system, cannot issue cheques drawn on itself and cannot borrow from the RBI. NBFCs have a more flexible structure than banks. As compared to banks, they can take quick decisions, assume greater risks, and tailor-make their services and charges according to the needs of the clients. Their flexible structure helps in broadening the market by providing the saver and investor a bundle of services on a competitive basis.

- NBFCs supplement the role of the banking sector in meeting the increasing financial needs of the corporate sector, delivering credit to the unorganized sector and to small, local borrowers. NBFCs have a more flexible structure than banks.

A non-banking financial company has been defined vide clause (b) of Section 45–1 of Chapter IIIB of the Reserve Bank of India Act, 1934, as (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 institutions 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.

NBFC has been defined under Clause (xi) of Paragraph 2(1) of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998, as: 'non-banking financial company' means only the non-banking institution which is a loan company or an investment company or a hire purchase finance company or an equipment leasing company or a mutual benefit finance company.

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property. A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

NBFCs provide a range of services such as hire purchase finance, equipment lease finance, loans, and investments. Due to the rapid growth of NBFCs and a wide variety of services provided by them, there has been a gradual blurring of distinction between banks and NBFCs except that commercial banks have the exclusive privilege in the issuance of cheques.

However, NBFC cannot accept demand deposits, do not form part of the payment and settlement system and cannot issue cheques drawn on itself. Moreover, deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in case of banks.

NBFCs have raised large amount of resources through deposits from public, shareholders, directors, and other companies and borrowings by issue of non-convertible debentures. In the year 1998, a new concept of public deposits meaning deposits received from public, including shareholders in the case of public limited companies and unsecured debentures/bonds other than those issued to companies, banks, and financial institutions, was introduced for the purpose of focused supervision of NBFCs accepting such deposits.

The public funds are unlike public deposits, wholly the public funds do include public deposits, intercorporate deposits, bank finance and all other fundsthat were received either directly or indirectly from external sources such as funds raised by the issue of Commercial Papers, debentures, etc. The 'deposits' are defined under the RBI Act, 1934 as acceptance of money excluding those money raised by way of capital share, money received from banks and other financial institutions, money receivedas security deposit, earnest money and advance against goods or services and subscription to chits. All other source of money received as loan or in any collectiveform of amount is treated as deposits.

All Non-Banking Financial Companies (NBFCs) are not entitled to accept public deposits. It also applies to CICs/CICs-ND-SI which cannot accept public deposits. Only those NBFCs to which the Bank had given a specific authorization and have an investment grade rating are allowed to accept or hold public deposits to a limit of 1.5 times of its Net Owned Funds. Those AFCs that do not get an investment grade rating by 31 March2016 will not be allowed to renew existing or accept fresh deposits thereafter. In the intervening period, i.e., till 31 March 2016, the unrated AFCs or those with a sub-investment grade rating can only renew their existing deposits on maturity and they cannot accept fresh deposits, till they obtain an investment grade rating.

However, as a matter of public policy, the Reserve Bank of India has decided that only the banks should be allowed to accept public deposits and as such has since 1997 not issued any Certificate of Registration (CoR) to new NBFCs for acceptance of public deposits.

Banks that also includes the state and rural co-operative banks can accept deposits and funds. Non-banking finance companies, which have been issued Certificate of Registration by RBI with a specific licence to accept deposits, are entitled to accept public deposit. In other words, not all NBFCs registered with the Reserve Bank are entitled to accept deposits but only those that hold a deposit accepting Certificate of Registration can accept deposits. They can, however, accept deposits, only for a certain extent which is permissible. The Housing Finance Companies, which are again specifically authorized to collect deposits and companies authorized by the Ministry of Corporate Affairs under the Companies Acceptance of Deposits Rules framed by the Central Government under the Companies Act, can also accept deposits also up to a certain limit. The Cooperative Credit Societies can accept deposits from their members but not from the general public. The Reserve Bank has regulated the method of accepting deposits only for f banks, cooperative banks and NBFCs.

Presently, the maximum rate of interest an NBFC can offer on deposits is 12.5 per cent. The interest may be paid or compounded at rests not shorter than monthly rests. The NBFCs are allowed to accept/renew public deposits for a minimum period of 12 months and maximum period of 60 months. They cannot accept deposits repayable on demand, cannot offer gifts/incentives or any other additional benefit to the depositorsand should have minimum investment grade credit rating. The deposits with NBFCs are not insured and the repayment of deposits by NBFCs is not guaranteed by the RBI.

**Exemptions from Provisions of Chapter III B of the RBI Act, 1934:**
The following institutions have been exempted from provisions of Chapter III B of the RBI Act, 1934 which relates to obtaining certificate of registration, provisions relating to net owned funds and maintenance of percentage of assets and reserve funds:

i. **Housing Finance Institution:** The housing finance institutionsas defined in Section 2(d) of the National Housing Bank Act, 1987.
ii. **Merchant Banking company:** The companies that are registered with the Securities and Exchange Board of India as a Merchant Banker under Section 12 of the Securities and Exchange Board of India Act, 1992 and is carrying on the business of merchant Banker in accordance with the Securities and Exchange Board of India Merchant Banking (Rules) 1992 and Securities and Exchange Board of India Merchant Banking (Regulations) 1992.
   a. It acquires securities only as a part of its merchant banking business.
   b. It does not carry on any other financial activity as referred to in Section 45I(c) of the RBI Act, 1934.
   c. It does not accept or hold public deposits as defined in paragraph 2(1)(xii) of the Notification No. DFC 118/DG(SPT)-98 as dated on 31 January 1998.
iii. **Micro Finance Companies:** The companieswhich are engaged in micro financing[5] activities, providing credit not exceeding ₹50,000 for a business enterprise and ₹1,25,000 for meeting the cost of a dwelling unit to any poor person for enabling him to raise his level of income and standard of living; and licensed under Section 25 of the Companies Act, 1956 and not accepting public deposits as defined in paragraph 2(1)(xii) of Notification No. 118/DG(SPT)-98 as dated on 31 January 1998.
iv. **Mutual Benefit Companies:** A company not notified under section 620A of the Companies Act, 1956 (1 of 1956) and carrying on the business of a non-banking financial institution.
   a. The order or notification was issued on 9th January 1997.
   b. It applies to companies having the aggregate of net owned funds and preferential share capital of not less than ten lakhs of rupees.
   c. It has applied for the issuance of certificate of registration to the Bank on or before 9th July 1997.

d. It does comply with the requirements contained in the relevant provisions of the Directions issued under Section 637A of the Companies Act, 1956 to Nidhi Companies by the Central Government.

**v. Government Companies:** The companies in which not less than 51 per centof the paid up capital is held by the Central government, or by any State government or governments or partly by the Central government and partly by one or more State governments and includes a company which is a subsidiary of a government company as thus defined.

**vi. Venture Capital Fund Companies:** The companies holding a certificate of registration obtained under Section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992) and not holding or accepting public deposit as defined in paragraph 2(1)(xii) of the Notification No. DFC.118/DG(SPT)-98 as dated on 31 January 1998.

**vii. Insurance/Stock Exchange/Stock Broker/Sub-Broker:** It includes any non-banking financial company that does not hold or accept public deposit as defined in paragraph 2(1)(xii) of the Notification No. DFC.118/DG(SPT)-98 as dated on 31 January 1998.

a. Doing the business of insurance[8], holding a valid certificate of registration issued under Section 3 of the Insurance Act, 1938 (IV of 1938).

b. Being a stock exchange, recognized under Section 4 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956).

c. Doing the business of a stock-broker or sub-broker holding a valid certificate of registration obtained under Section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992).

**viii. <u>Others</u>**

**a. Nidhi Companies:** The companiesnotified under Section 620A of the Companies Act, 1956 (1 of b).

**b. Chit Companies**(1956):The companies known as Nidhicompaniesdoing the business of chits, as defined in clause (b) of Section 2 of the Chit Funds Act, 1982 (No. 40 of 1982).

**c. Securitization and Reconstruction Companies:** The companies registered with the Reserve Bank of India under Section 3 of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

**d. Mortgage Guarantee Companies:** The companies that are notified as non-banking financial company in terms of Section 45 I (f)(iii) of the Reserve Bank of India Act, 1934 (2 of 1934) with the prior approval of the Central government and a company registered with the bank under the scheme for registration of mortgage guarantee companies.

**e. Core Investment Companies:**

i. The provisions of section 45-IA of the Act shall not apply to a non-banking financial company being a core investment company referred asin the Core Investment Companies (Reserve Bank) Directions, 2011, which is not a systemically important core investment company, as defined in clause (h) of sub-paragraph (1) of paragraph 3 of the Core Investment Companies (Reserve Bank) Directions, 2011.

ii. The provisions of section 45-IA (1)(b) of the Act shall not apply to a non-banking financial company being a systemically important core investment company as defined in the Core Investment Companies (Reserve Bank) Directions, 2011, subject to the condition that it meets with the capital requirements and leverage ratio as specified in the said directions.

[14]iii. The Non-Banking Financial (that accept or holds non-deposits) Companies Prudential Norms (Reserve Bank) Directions, 2007 shall not apply to a non-banking financial company being a core investment company referred to in the Core Investment Companies (Reserve Bank) Directions, 2011 (hereafterreferred to as ‘CIC Directions’ for brevity), which is not a systemically important core investment company as defined in clause (h) of sub-paragraph (1) of paragraph 3 of the CIC Directions.

iv. The provisions of paragraphs 15, 16 and 18 of these directions shall not apply to a systemically important core investment company as defined in the CIC Directions, subject to the condition that it submits the Annual Auditors Certificate and meets with the capital requirements and leverage ratio, as specified in the CIC Directions.

## Types of NBFCs

NBFCs are categorized a) in terms of the type of liabilities into deposit and non-deposit accepting NBFCs, b) non-deposit taking NBFCs by their size into systemically important and other non-deposit holding companies (NBFC-NDSI and NBFC-ND) and c) by the kind of activity they conduct. NBFCs whose asset size is of ₹500 croreor more as per the last audited balance sheet are considered as systemically important NBFCs. The rationale for such classification is that the activities of such NBFCs will have a bearing on the financial stability of the overall economy.

Within this broad categorization, the different types of NBFCs are as follows:

I. **Asset Finance Company (AFC)**: An AFC is a 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 equipment, moving on own power and general purpose industrial machines. The principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60 per centof its total assets and total income respectively.

II. **Investment Company (IC)**: IC means any company which is a financial institution carrying on as its principal business the acquisition of securities,

III. **Loan Company (LC):**Loan companies are typical finance institutions that carryits sole purpose of providing financial benefits either by making loans or advances otherwise for any activity rather than its own but it does not come under the asset finance companies.

IV. **Infrastructure Finance Company (IFC):** IFC is a non-banking finance company a) which deploys at least 75 per cent of its total assets in infrastructure loans, b) it has minimum net owned funds of ₹300 crore, c) it has a minimum credit rating of 'A 'or equivalent d) and a CRAR of 15%.

V. **Systemically Important Core Investment Company (CIC-ND-SI):** CIC-ND-SI is an NBFC carrying on the business of acquisition of shares and securities which satisfies the following conditions:
   a. It holds not less than 90 per centof its total assets in the form of investment in equity shares, preference shares, debt or loans in group companies.
   b. Its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies that constitutes not less than 60 per centof its total assets.
   c. It does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment.
   d. It does not carry on any other financial activity as referred to in Section 45I(c) and 45I(f) of the RBI act, 1934 except investment in bank deposits, money market instruments, government securities, loans to and investments in debt issuances of group companies or guarantees issued on behalf of group companies.
   e. Its asset size is ₹100 crore or above.
   f. It accepts public funds.

VI. **Infrastructure Debt FundNon-Banking Financial Company (IDF-NBFC):** 'IDF-NBFC' means a non-deposit taking NBFC that has net owned fundsof ₹300 crore or more and which invests only in Public Private Partnerships (PPP) and post Commencement Operations Date (COD) infrastructureprojects which have completed at least one year of satisfactory commercial operation and are a party to a tripartite agreement with the concessionaire and the project authority for ensuring a compulsory buyout with termination payment.

   The IDF shall be set up either as a trust or as a company. A trust based IDF shall normally be a Mutual Fund (MF) while a company based IDF shall normally be a NBFC. IDF- NBFC shall raise resources through issue of either Rupee or Dollar denominated bonds of minimum 5 year maturity. With a view to facilitate better ALM, IDF-NBFCs can raise funds through shorter tenor bonds and commercial papers (CPs) from the domestic market to anextent of up to 10 per cent of their total outstanding borrowings. IDF-MF shall be regulated by SEBI while IDF-NBFC shall be regulated by the Bank.

   1. **NBFCs as Sponsors of IDF-MFs:** All NBFCs shall be eligible to sponsor (sponsorship as defined by SEBI regulations for mutual funds) IDFs as mutual funds with prior approval of the bank subject to the following conditions, in addition to those prescribed by SEBI:
      i. The NBFC shall have a minimum Net Owned Funds (NOF) of ₹300 crore and Capital to Risk Weighted Assets (CRAR) of 15 per cent.
      ii. Its net NPAs shall be less than 3 per centof net advances.
      iii. It shall have been in existence for at least 5 years.
      iv. It shall be earning profits for the last three years and its performance shall be satisfactory.

v. The CRAR of the NBFC post investment in the IDF-MF shall not be less than the regulatory minimum prescribed for it.
vi. The NBFC shall continue to maintain the required level of NOF after accounting for investment in the proposed IDF-MF.
vii. There shall be no supervisory concerns with respect to the NBFC.

2. **IFCs setting up IDF-NBFCs:**IDF-NBFC is a company registered as NBFC to facilitate the flow of long term debt into infrastructure projects. IDF-NBFC raise resources through issue of rupee or dollar denominated bonds of minimum 5 year maturity. Only Infrastructure Finance Companies (IFC) can sponsor IDF-NBFCs subject to the following conditions.
   i. Sponsor IFCs would be allowed to contribute a maximum of 49 per cent to the equity of the IDF-NBFCs with a minimum equity holding of 30 per cent of the equity of IDF-NBFCs.
   ii. Post investment in the IDF-NBFC, the sponsor NBFC-IFC must maintain minimum CRAR and NOF prescribed for IFCs.
   iii. There are no supervisory concerns with respect to the IFC.

VII. **Non-Banking Financial Company andMicro Finance Institution (NBFC-MFI):** NBFC-MFI is a non-deposit taking NBFC having not less than 85 per centof its assets in the nature of qualifying assets which satisfy the following criteria:
   a. Loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding ₹1,00,000 or urban and semi-urban household income not exceeding ₹1,60,000.
   b. The loan amount does not exceed ₹50,000 in the first cycle and ₹1,00,000 in subsequent cycles.
   c. The total indebtedness of the borrower does not exceed ₹1,00,000.
   d. The tenure of the loan should not be less than 24 months for loan amount in excess of ₹15,000 with prepayment without penalty.
   e. The loan to be extended without collateral.
   f. The aggregate amount of loans, given for income generation is not less than 50 per cent of the total loans given by the MFIs.
   g. Loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower.

VIII. **Non-Banking Financial Company Factors (NBFC-Factors):** NBFC-Factor is a non-deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring business should constitute at least 50 per cent of its total assets and its income derived from factoring business should not be less than 50 per cent of its gross income. Every company seeking registration as NBFC-Factor shall have a minimum Net Owned Fund (NOF) of ₹5 crore.

IX. **Mortgage Guarantee Companies (MGC):** MGC's are financial institutions for which at least 90 per centof the business turnover is mortgage guarantee business or at least 90 per centof the gross income is from mortgage guarantee business and the net owned fund is ₹100 crore.

X. **NBFC's Non-Operative Financial Holding Company (NOFHC):** is a financial institution through which a promoter/promoter groups will be permitted to set up a new bank .It's a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators, to the extent permissible under the applicable regulatory prescriptions.

XI. **NBFC-Account Aggregator:** At present, the financial asset holders such as holders of savings bank deposits, fixed deposits, mutual funds and insurance policies, get a scattered view of their financial asset holdings if the entities with whom these accounts are held fall under the purview of different financial sector regulators. This gap will be filled by account aggregators who will provide information on various accounts held by a customer in a consolidated, organized and retrievable manner. The option to avail the services of an account aggregator by a customer will be purely voluntary.

The draft directions governing NBFC-account aggregator (AA) were issued by the Reserve Bank in March 2016. Accordingly, the activities of NBFC-AA will be regulated by the Reserve Bank to ensure that the nature and terms of its services conform to prescribed standards. As per these guidelines, the business of an account aggregator will be entirely driven by information technology (IT). The account aggregator will not support any transaction in financial assets by its customers. The account aggregator will not undertake any business other than the business of account aggregation. However, the deployment of investible surplus by the aggregator in instruments which isnot for trading will be permitted. Pricing of services will be as per the board-approved policy of the account aggregator.

The account aggregator will ensure that the provision of services to a customer, who has made a specific application for availing such services, will be backed by appropriate agreements/

authorizations between the aggregator, customer and financial service provider. The information will be shared by the account aggregator only with the customer to whom it relates or any other person authorized by the customer. The account aggregator will be bound by the terms and conditions of the licence (such as customer protection, grievance redressal, data security, audit control, corporate governance and risk management framework). The account aggregator will have a Citizen Charter that explicitly guarantees the protection of the rights of customers.

## Other Categories of NBFCs

**Residuary Non-banking Companies:** RNBCs are a class of NBFCs that cannot be classified as equipmentleasing, hire purchase, loan, investment, nidhi, or chit fund companies, but which tap public savingsby operating various deposit schemes, akin to recurring deposit schemes of banks. The deposit acceptanceactivities of these companies are governed by the provisions of Residuary Non-Banking Companies(Reserve Bank) Directions, 1987. Residuary Non-banking Companies (RNBCs) are required to be mandatorilyregistered with Reserve Bank of India RNBCs had a strong presence in the rural areas. Theymobilized a large amount of deposits from the rural population. They generally lent funds to groupcompanies, subsidiaries and associates which led to concentration of risk, thereby resulting in loanlosses and lack of public confidence. To safeguard the interest of depositors, the RBI directed RNBCsto invest not less than 80 per cent of aggregate deposit liabilities as per the investment pattern prescribedby it and to entrust these securities to all public sector banks to be withdrawn only for payment of deposits.

Subject to compliance with the investment pattern, they can invest 20 per cent of aggregate liabilitiesor ten times its net owned fund, whichever is lower, in a manner decided by its board of directors.

The RNBCs are the only class of NBFCs for which the floor rate of interest for deposits is specified by the RBI while there is no upper limit prescribed for them. The floor interest rate prescribed is 3.5 per cent per annum (to be compounded annually) on daily deposit schemes and 5 per cent per annum (to be compounded annually) on other deposit schemes of higher duration or term deposits. The RBI hasalso prescribed prudential norms for RNBCs. Compliance with prudential norms is mandatory and aprerequisite for acceptance of deposits. The RBI monitors and inspects these RNBCs from time to time.

There were three RNBCs registered with the RBI. The regulator converted one of the three companies with miniscule deposit into a non-deposit taking NBFC. The two large RNBCs such as Peerless General Finance and Investment Company and Sahara Finance Limited haveagreed to migrate to another business model and have wound up their operations.

**Mutual Benefit Financial Companies:** Mutual benefit financial companies (Nidhis) are NBFCs notified under Section 620 A of the Companies Act, 1956, and primarily regulated by the department of company affairs (DCA) under the directions/guidelines issued by them under Section 637A of the Companies Act, 1956. The Sabanayagam Committee on Nidhis defines Nidhi as a company formed with the exclusive object of cultivating the habit of thrift, savings and functioning for the mutual benefit of members by receiving deposits only from individuals enrolled as members and by lending only to individuals, also enrolled as members, and which functions as per notification and guidelines prescribed by the Department of Company Affairs (DCA). These companies are exempt from the core provisions of the RBI Act and NBFC directions relating tothe acceptance of public deposits. However, the Reserve Bank is empowered to issue directions in mattersrelating to deposit acceptance activities and directions relating to ceiling on interest rate.

They are also required to maintain register of deposits, furnish receipt to depositors, and submit returns to the RBI. In order to facilitate healthy functioning of Nidhi companies and restore the confidence of the investing public, the Government of India constituted in March 2000, an expert committee under the chairmanship of Shri P. Sabanayagam to suggest an appropriate policy framework for the overall improvement of these companies. The committee submitted its report to the government on 28 September 2000 which includedrecommendations such as entry point barriers, minimum capital funds, liquid assets requirements, restrictions on dividend, ceiling on interest rates on deposit and loans, regulations of various managerial aspects, disclosure norms, prudential norms, adequate supervisory framework, role of auditors, and other measures for protection of depositors' interest.

**Miscellaneous Non-banking Companies:** Miscellaneous Non-banking Companies (MNBCs) are companies engaged in the chit fund business. The term 'deposit' as defined under Section 45I(bb) of the Reserve Bank of India Act, 1934, does not include subscription to chit funds. The chit fund companies are exempted from all the core provisions of Chapter IIIB of the RBI Act. The RBI regulates only the deposits accepted by these companies, but it does not regulate their chit fund business. Chit fund company means a company managing, conducting or supervising, as foremen, agent or in any other capacity, chits as defined in Section 2 of the Chit Funds Act, 1982. Section 2(b) of the Chit Fund Act, 1982 defines a chit as a transaction whether called chit, chit fund, chitty, kuri or by any other name by or under which a person enters into an agreement with a specified number of persons that every one of them shall subscribe a certain sum of money (or a certain quantity of grain instead) by way of periodical instalments over a definite period and that each such subscriber shall, in his turn, as determinedbylot or by auction or by tender or in such other manner as may be specified in the chit agreement, be entitled to the prize amount.

A transaction is not a chit within the meaning of this clause, if in such transaction some alone, but not all, of the subscribers get the prize amount without any liability to pay future subscriptions; or all the subscribers get the chit amount by turns with a liability to pay future subscriptions. Thechit fund business is administered by the respective state governments through the officesof registrars of chits. Chit fund companies, as per the Miscellaneous Non-banking Companies (Reserve Bank) Directions, can accept deposits up to 25 per cent and 15 per cent of the net owned fund (NOF) from public and shareholders, respectively, for a period of 6 months to 36 months, but cannot accept deposits repayable on demand/notice.

Chit funds activity involves contributions by members in instalments by way of subscription to the chit and by rotation each member of the chit receives the chit amount. The subscriptions are specifically excluded from the definition of deposits and cannot be termed as deposits. While chit funds may collect subscriptions as above, they are prohibited by RBI from accepting deposits with effect from August 2009. Chit fund companies are regulated under the Chit Fund Act, 1982, which is a central act, and is implemented by the State governments. In case any chit fund is accepting public deposits, RBI can prosecute such chit funds.

## Regulation of NBFCs

In the 1960s, the RBI made an attempt to regulate NBFCs by issuing directions relating to the maximum amount of deposits, the period of deposits, and rate of interest they could offer on the deposits accepted. Norms were laid down regarding maintenance of certain percentage of liquid assets, creation of reserve funds, and transfer there to every year a certain percentage of profit, and so on. These directions and norms were revised and amended from time to time. In 1977, the RBI issued two separate sets of guidelines, namely, (i) NBFC Acceptance of Deposits Directions, 1977, for NBFCs and (ii) MNBD Directions, 1977, for MNBCs. These directions were related to deposit-taking activities of NBFCs. The reserve bank made an attempt to regulate the asset side of NBFCs in 1994 in pursuance of the Shah Committee recommendations. However, it was not empowered to regulate the asset side of NBFCs.

NBFCs became prominent in the first half of the 1990s. The growth in aggregate deposits of NBFCs outpaced that of banks. However, bank finance to NBFCs dried up in 1995 after the RBI cautioned banks against such lending. Therefore, NBFCs had to depend on fixed deposits often at ratesup to 26 per cent. To service high-cost deposits, NBFCs invested in bought-out deals, shares, real estate and corporate financing, the areas in which they had little experience. The slackness in the capital and real estate markets and general industrial activities resulted in sharp deterioration in NBFC's quality of assets. Crores of rupees of small investors disappeared overnight as NBFCs like CRB Capital Markets, JVG Finance, and Prudential Capital Markets failed in 1997. This shook the investor confidence which resulted in a rush of withdrawals of public deposits. This is the only sector which had a number of committees trying to regulate its working. The first was the Shah Committee in 1992. It was followed by the Shere Committee, Khanna Committee and various committees of the RBI. In 1997, the RBI Act was amended and the Reserve Bank was given comprehensive powers to regulate NBFCs. The amended act made it mandatory for every NBFC to obtain a certificate of registration and have minimum net owned funds. Ceilings were prescribed for acceptance of deposits, capital adequacy, credit rating and net-owned funds. Net owned fund (NOF) of NBFCs is the aggregate of paid-up capital and free reserves, netted by (i) the amount of accumulated balance of loss; and (ii) the deferred revenue expenditure and other intangible assets, if any, and further reduced by investments in shares and loans and advances to (a) subsidiaries; (b) companies in the same group and (c) other NBFCs, in excess of 10 per cent of owned fund. Norms relating to capital adequacy, credit rating exposure, asset classification and so on were laid down. The Reserve Bank also developed a comprehensive system to supervise NBFCs accepting/holding public deposits. Directions were also issued to the statutory auditors to report noncompliance with the RBI Act and regulations to the RBI, board of directors and shareholders of the NBFCs. The task force constituted by Government of India under the Chairmanship of Shri C. M. Vasudev submitted its report on 28 October 1998, after reviewing the existing regulatory framework for NBFCs.

The Government of India framed the Financial Companies Regulation Bill, 2000; to implement the recommendations requiring statutory changes, as also consolidatedthe law, relating to NBFCs and unincorporated bodies with a view to ensuring depositor protection. According to this bill, all the NBFCs will be known as financial companies instead of NBFCs.

The Reserve Bank of India has issued detailed directions on prudential norms, vide Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007, Non-Systemically Important Non-Banking Financial (non-deposit accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2015 and Systemically Important Non-Banking Financial (non-deposit accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2015. Applicable regulations vary based on the deposit acceptance or systemic importance of the NBFC. The directions inter alia, prescribe guidelines on income recognition, asset classification and provisioning requirements applicable to NBFCs, exposure norms, disclosures in the balance sheet, requirement of capital adequacy, restrictions on investments in land and building and unquoted shares, loan to value (LTV) ratio for NBFCs predominantly engaged in business of lending against gold jewellery, besides others. Deposit accepting NBFCs have also to comply with the statutory liquidity requirements.

**Capital Requirements:** (1) Every applicable NBFC shall maintain a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than 15 per cent of its aggregate risk weighted assets on-balance sheet and of risk adjusted value of off-balance sheet items. (2) The Tier I capital in respect of applicable NBFCs (other than NBFC-MFI and IDFNBFC), at any point of time, shall not be less than 8.5 per centby 31 March 2016 and10 per centby 31 March 2017. (3) Applicable NBFCs primarily engaged in lending against gold jewellery (such loans comprising 50 per cent or more of their financial assets) shall maintain a minimum Tier l capital of 12 per cent.

The regulation on non-deposit accepting NBFCs with asset size of less than ₹500 crore is as follows:

i. They shall not be subjected to any regulation either prudential or conduct of business regulations namely, Fair Practices Code (FPC), KYC, etc., if they have not accessed any public funds and do not have a customer interface.
ii. Those having customer interface will be subjected only to conduct of business regulations including FPC, KYC, etc., if they are not accessing public funds.
iii. Those accepting public funds will be subjected to limited prudential regulations but not conduct of business regulations if they have no customer interface.
iv. Where both public funds are accepted and customer interface exist, such companies will be subjected both to limited prudential regulations and conduct of business regulations.

## Growth of NBFCs

NBFCs in India have existed since long. They came into limelight in the second half of the 1980s and in the first half of the 1990s. NBFCs flourished during the stock market boom of the early 1990s. In the initial years of liberalization, they not only became prominent in a wide range of activities but they outpaced banks in deposit rising owing to their customized services. They have backed many small entrepreneurs. They have also lent small-ticket personal loans of size of ₹25,000 to customers and thereby fuelled the consumption boom. Total assets/liabilities of NBFCs grew at an average annual rate of 36.7 per cent during the 1990s (1991–98) as compared to 20.9 per cent during the 1980s (1981–91). The growing importance of this segment and the surfacing of some scams compelled the RBI to increase this regulatory attention.

Almost all corporate houses have set up their own NBFCS. Big banks also floated NBFCs to tap certain segments on which restrictions were imposed by the regulator. Banks through the NBFCs could generously lend funds to promoters to raise theirholdings through a creeping acquisition. 'Citi Financial' is one of the oldest foreign bank-owned NBFC and a pioneer in this segment. There has been an increase in the number of NBFCs, especially those floated by foreign banks as there are strictures on branch licensing. The Reserve Bank tightened these NBFC norms in November 2006 to reduce the regulatory arbitrage between different financial sector players. According to the guidelines, non-deposit taking NBFCs which have assets of over 100 crore will be subject to exposure and capital adequacy norms. Banks will not be able to lend indiscriminately to them. Nor will they be allowed to hold more than 10 per cent equity stake in deposit-taking NBFCs. Moreover, the foreign banks with NBFC subsidiaries will be required to include the activities of their NBFC arms in their reporting to the Reserve Bank.

Two sets of players such as small and large NBFCshave emerged in the market. The small NBFCs rely more on deposit taking while large NBFCs focus on asset financing and rely less on deposit-taking. The large NBFCs, especially M & M Finance, DBS Cholamandalam Finance and Shriram Transport Finance have specialized skills in credit intermediation and have a collective asset base of around 17,000 crore.

These NBFCs are the leaders in financing used and new commercial vehicles, tractors and automobiles. NBFCs such as Citibank and GE have built large consumer-focused asset portfolios by offering personal loans, insurance and various other services thereby directly competing with banks. Banks, too, are entering into high-yield and high-risk financing nichesegments of NBFCs. Banks have an edge over NBFCs as they have access to low-cost deposits while NBFCs have to rely more on high cost public deposits, bank and market borrowings to fund their balance sheets. Borrowings account for almost 65 per cent of total NBFC liabilities, of which, non-convertible debentures is a major component followed by bank borrowings. The NBFCs now borrow from mutual funds by placing debentures with them. Borrowing from mutual funds is simple as there are little or no margins. NBFCS get the debentures rated by a credit rating agency and a good rating helps them raise funds.

The NBFC sector continued to raise funds mainly through debentures, borrowings from banks and commercial papers. The Reserve Bank also eased the norms for external commercial borrowings (ECBs) for NBFCs that lend to the infrastructure sector, to raise ECBs with a minimum maturity of five years. In addition, the Reserve Bank also allowed NBFCs to raise funds through rupee denominated bonds overseas. Public deposits garnered by NBFCs-D have been showing a rising trend since 2010.

Consolidation has taken place within the NBFC sector resulting in a reduction in the number of both NBFCs-D and NBFCs-ND-SI. Their assets continued to register substantial growth. The accelerated growth in credit deployment by NBFCs was due to their ability to contain risks and tap demand in niche markets. The profitability of NBFCs was significantly higher as compared to commercial banks and their NPAs have grown but have remained low compared to the banks.

## CONCLUSION

NBFCs in India have become prominent in a wide range of activities like hire purchase finance, equipment lease finance, loans and investments. NBFCs have greater reach and flexibility in tapping resources.

In desperate times, NBFCs could survive owing to their aggressive character and customized services. NBFCs are doing more fee-based business than fund-based. They are focusing now on retail sector, housing finance, personal loans and marketing of insurance. Many of the NBFCs have ventured into the domain of mutual funds and insurance. NBFCs undertake both life and general insurance business as joint venture participants in insurance companies. The strong NBFCs have successfully emerged as ‘financial institutions’ in a short span of time and are in the process of converting themselves into ‘financial supermarket’, a one-stop financial shop. The NBFCs are taking initiatives to establish a self-regulatory organization (SRO). At present, NBFCs are represented by the Association of Leasing and Financial Services (ALPS), Federation of Indian Hire Purchase Association (FIHPA), and Equipment Leasing Association of India (ELA). The RBI wants these three industry bodies to come together under one roof. The RBI has emphasized the formation of SRO particularly for the benefit of smaller NBFCs.

The NBFC sector assumes a critical role in financial inclusion as it caters to a wide range of financial activities particularly in areas where commercial banks have limited penetration. NBFCs are expected to play a crucial role in fostering inclusive growth, especially in sectors like MSMEs.

## KEY TERMS

| | | | | |
|---|---|---|---|---|
| Asset Liability Management | Credit Risk | Market Risk | Payment System | Tier II Capital |
| Banking | Demand Deposits | Non-Banking Financial Companies | Regional Rural Banks | Technological Risk |
| Capital Adequacy Ratio | Liquidity Risk | Operational Risk | Time Deposits | |
| Cooperative Banks | Loan Syndication | Priority Sector Lending | Tier I Capital | |

## SUMMARY

1. Banks are one of the oldest financial intermediaries in the financial system. They play an important role in the mobilization of deposits and disbursement of credit to various sectors of the economy. The creation of credit is an important function of a bank and this function distinguishes banks from the non-banking institutions. Banks create deposits in the process of their lending operations.
2. For centuries, banks have borrowed and lent money to business, trade, and people, charging interest on loans and paying interest on deposits. These two functions are the core activities of banking.
3. In terms of ownership and function, commercial banks can be classified into four categories: public sector banks, private sector banks, foreign banks in India, and regional rural banks. There are 80 scheduled commercial banks—27 public sector banks, 21 in the private sector and 32 foreign banks.
4. Banks depend on deposits and non-deposits to meet their resource requirements. Deposits constitute the largest source of funds for the banks. Banks mobilize deposits from the household sector, corporate sector, financial institutions, rest of world-non-resident (NRI)