

Amendments to NBFC Regulations

Ref.DNBS.(PD).CC.No. 12 /02.01/99-2000

January 13, 2000.

**To All Non-Banking Financial Companies
including Residuary Non-Banking Companies**

Dear Sirs,

Amendments to NBFC Regulations

As you are aware, Reserve Bank has put in place a comprehensive regulatory and supervisory framework in January 1998, in terms of which certain measures were taken for protecting the interests of depositors and for ensuring that the NBFCs function on sound and healthy lines. Reserve Bank has since received a number of suggestions for fine tuning the regulations with a view to enhancing the protection to the interests of the depositors and ensuring that the NBFCs continue to play their legitimate role in the Indian Financial System. Accordingly, the following changes are being effected in the regulations :

A. Statutory changes

(1) NBFCs engaged in micro-financing activities

In the backdrop of the need for a suitable national policy framework for implementation of many credit linked poverty alleviation programmes to meet the needs of hard core and asset-less poor, a High Powered Working Group on Micro Financing in India was constituted by NABARD to recommend a policy framework for sustainable growth of micro finance in the country with participation of community based organisations at the grass root level. The Task Force submitted its Report on October 18, 1999.

The Working Group has, inter alia, recommended that the policy and regulatory framework should give a fillip to the Self Help Groups (SHGs) or Non-Governmental Organisations (NGOs) engaged in micro-financing activities. Accordingly, it has been decided to exempt such NBFCs which are engaged in (i) micro financing activities, (ii) licensed under Section 25 of the Companies Act, 1956 and (iii) which are not accepting public deposits from the purview of Sections 45-IA (registration), 45-IB (maintenance of liquid assets) and 45-IC (transfer of profits to Reserve Fund) of RBI Act, 1934.

(2) Un-notified nidhi companies

(i) A Nidhi company notified under section 620-A of the Companies Act is classified at present as "Mutual Benefit Financial Company" by RBI and regulated by the Bank for its deposit taking activities and by DCA for its operational matters as also the deployment of funds. These Companies enjoy exemption from core provisions of the RBI Act viz. requirement of registration, maintenance of liquid assets and creation of reserve fund, and RBI Directions except those relating to interest rate on deposits, prohibition from paying brokerage on deposits,

ban on advertisements and the requirement of submission of certain Returns. Such companies, however, are allowed to deal with their shareholders only, for the purpose of accepting deposits and making loans. There are a number of companies functioning on the lines of Nidhi companies but not yet notified by DCA. As RBI Directions to classify them as loan companies disallowed them the special dispensation available to Notified Nidhi companies; Bank and the Government received representations from a large number of such companies and their associations. Government decided to give them a special dispensation and notified that applications of companies incorporated on or before January 9, 1997 shall be considered for notifying as Nidhi Company under section 620-A of the Companies Act, 1956 only if they have minimum NOF of Rs.10 lakh or more. These companies shall be required to have net owned fund of Rs.25 lakh by December 31, 2002 like companies already declared as Nidhis. Government has also clarified that NOF shall have the same meaning as assigned to it in the RBI Act, 1934. Thus a new class of companies has been created i.e. the potential Nidhi companies. To distinguish them from the notified Nidhi companies (Mutual Benefit Financial Companies) the term Mutual Benefit Companies (MBC) is being used.

(ii) Since the notified nidhi companies are exempted from the provisions of Section 45-IA (Compulsory Registration with RBI), Section 45-IB (Maintenance of Liquid Assets) and Section 45-IC (Creation of Reserve Fund), it has been decided on the lines of Government advice to exempt the MBCs in existence as on January 9, 1997 and having NOF of Rs.10 lakh from the above mentioned provisions of the Act in terms of powers vested with the Bank under Section 45 NC of the Act and also from those provisions of NBFC Directions on Acceptance of Public Deposits and Prudential Norms which do not apply to notified nidhi companies.

(3) Government NBFCs

(i) There are a number of Government NBFCs which fall within the ambit of RBI Regulations. The Government Department or the Ministry or the Bureau of Public Enterprises to which such companies are attached, are expected to prescribe the norms for their operations on healthy lines and monitor their financial health. Such companies being Government companies pose little supervisory concern regarding repayment of the deposits held by them and protection of interests of the depositors. Needless to mention, all these companies are required to be audited by the statutory auditors as per the provisions of Companies Act and the irregularities, if any, in their functioning are brought to the notice of Government by the auditors for corrective steps.

(ii) Although, we do not intend to discriminate among the NBFCs on the basis of ownership but in view of the role being played by these companies in discharge of their social obligations and the norms prescribed for their working by their respective supervisory departments and for avoiding dual control over them, we have decided, in consultation with Government, to exempt the Government companies as conforming to Section 617 of the Companies Act from applicability of the provisions of RBI Act relating to maintenance of liquid assets and creation of reserve funds, and the Directions relating to acceptance of public deposits and prudential norms. The requirement of statutory registration of these companies under Section 45-IA of the RBI Act, 1956 shall, however, continue.

(4) Term deposits with banks to be reckoned as part of liquid assets along with Government papers

(i) The NBFCs have been voicing their problems in securing desired lots of Government securities in small towns and localities in the country. In order to increase operational ease in maintenance of liquid assets, the NBFCs have been permitted to maintain upto 5 percent of the public deposits in the form of term deposits with scheduled commercial banks out of present requirement of 15 percent of public deposits to be invested in liquid assets. It is expected that it would enable the NBFCs in establishing a relationship with their bankers and securing services as the banker. These instructions are effective retrospectively from the first day of the quarter beginning January 1, 2000.

(ii) The NBFCs are, however, advised to strictly adhere to the requirements of maintenance of liquid assets. It may also be reiterated that the NBFCs holding public deposits should scrupulously furnish the liquid asset return on quarterly basis and the delay in submission or non-submission thereof would be viewed seriously and the concerned NBFC would expose itself to levy of penal interest and adverse action under Section 58-B(6) of the RBI Act.

(5) Additional terms and conditions for
grant of Certificate of Registration

Prior RBI approval for change
in names of NBFC.

(i) Instances have been brought to our notice of some NBFCs changing their name, more particularly to add Infotec tag with a view to taking advantage of the capital market sentiments, which may not only jeopardise the interest of the depositors, but also of the investors. Such a change in the name and the business plan of the company may also result into the principal business of the NBFC becoming non-financial, thereby affecting its eligibility for grant and holding of Certificate of Registration under Section 45-IA (4) of the RBI Act. It has, therefore, been decided in the public interest that an NBFC intending to change its present name would need to obtain prior permission of RBI before approaching the Registrar of Companies for change of name. Any violation of these directions would attract serious action against the company as provided for under the RBI Act including cancellation of the Certificate of Registration if already granted, or rejection of its application for registration, as the case may be.

Submission of information on Permanent
Account Numbers (PAN) allotted by I.T.
Department in respect of all the Directors
of NBFCs.

(ii) There are reports of some companies including NBFCs vanishing after mobilisation of capital, deposits, etc. from public, raising grave supervisory concerns. Since the present regulatory framework is aimed at ensuring that registration is granted only to serious and bonafide players in the NBFC sector, it has been decided to place on record details of Permanent Account Number issued by Income Tax Authorities, of each of the directors of all NBFCs whether registered or whose applications for Certificate of Registration are pending with the Bank. All the NBFCs are, therefore, advised to furnish the information to the respective Regional Office of RBI within 2 months of the receipt of this letter failing which the grant or continuance of the Certificate of Registration would be reconsidered.

Change in management
and mergers/amalgamation

(iii)(a) A reference is invited to paragraph 2 (b) of our circular DNBS (PD). CC.No.11/02.01/99-2000 dated November 15, 1999 in terms of which the NBFCs have been directed to give 3 months prior public notice of the intention of sale or transfer of the ownership by sale of shares or transfer of control whether with or without sale of shares in one leading national and another leading local vernacular newspaper. It has been observed that the change in management also takes place by way of amalgamation / merger of an NBFC with another NBFC or a non-financial company and as such, these mergers / amalgamations would tantamount to the change in the management, as aforesaid.

(b) It has further been decided that it would be obligatory on the part of such an NBFC seeking change in management or merger or amalgamation with any other company to give an option to every depositor to decide whether to continue the deposits with the company under the new management or the transferee company or not. The company would also be obliged to make the payment to the depositors who seek the repayment of their deposits. The Bank would view the non-compliance of the above instructions very seriously and penal action would be initiated against the defaulter company on the merits of each case.

B. Amendments to NBFC Directions on

Acceptance of Public Deposits

(1) Need for introduction of the depositors of NBFCs

It has been brought to the notice of the Bank that some of the NBFCs were holding benami deposits. In order to curb this practice, it has been decided that the NBFCs should obtain proper introduction of the new depositors before opening their deposit accounts and accepting the deposits. They should also obtain written confirmation from their introducers. In the absence of such introduction, any other document of identity of the prospective deposit holders may be obtained and kept on their record the evidence on which they have relied upon for the purpose of such introduction.

(2) Minimum period of hybrid debt capital instruments and subordinated debts for exclusion from the description of public deposits

A few NBFCs introduced new deposit products, one of which was the subordinated debts having a maturity period of 17 months. The intention was to avoid the application of SEBI regulations applicable to the issue of debentures and those provisions of the RBI directions applicable to acceptance of public deposits because the hybrid debt capital instruments and subordinated debts issued by an NBFC are treated as part of Tier II capital in terms of the Prudential Norms Directions and by virtue thereof, they would be exempt from the meaning of 'public deposit'. It has, therefore, been decided that the subordinated debt instruments with a minimum maturity period of 60 months or above at the time of their initial offer which (a) are unsecured and subordinated to the claims of other creditors, (b) are free from restrictive clauses, (c) are not redeemable at the instance of the holder or without the consent of the supervisory authority of the NBFC, will only be exempted from the definition of public deposits.

(3) Deposits received from joint shareholders
by a private limited company

Some of the private limited NBFCs have reportedly started accepting deposits from all the joint shareholders. This practice has been found to be irregular, undesirable and circumventing the NBFC Directions on Acceptance of Public Deposits. Accordingly, it has been decided that the deposits accepted by a private limited NBFC from the first named shareholders will only be exempted from the purview of public deposit. The deposits accepted from the rest of the joint shareholders will be treated as public deposit.

(4) Control over opening and closing of branches

Absence of control on opening/closing of branches/offices by the NBFCs and non-specification of operational area of their agents have raised many regulatory concerns. Indiscriminate opening of branches not only increases risk for protection of depositors interest, it creates supervisory difficulties for RBI as the registered office of the company may be in the jurisdiction of one Regional Office of RBI whereas major chunk of business may be in the jurisdictional area of other Regional Offices and thus the actual operations of the company remain unnoticed by the Regional Office having jurisdiction over the company's affairs. Similarly, sudden closure of branches also evokes adverse public reaction. Though a strict control over opening of branches/offices by NBFCs or non-specification of area of operations of agents is neither intended nor desirable in the present era of liberalisation, a surveillance over opening and closing of branches/offices is considered necessary from the view point of prudential supervision and protecting the interests of depositors. Accordingly, it has been decided that

NBFC other than RNBCs

- (i) an NBFC having a Certificate of Registration and otherwise entitled to accept public deposits as per NBFC Directions on Acceptance of Public Deposits is allowed to open its branch/office or allow its agents to operate for mobilisation of public deposits -
- (a) within the State where its registered office is situated if its NOF is upto Rs.50 crore; and
 - (b) any where in India if its NOF is more than Rs.50 crore and its fixed deposits programme has been rated by one of the approved credit rating agencies at 'AA' or above.

RNBCs

- (ii) An RNBC registered with the Bank and otherwise complying with all the statutory requirements is allowed to open additional branches/offices and/or allow its agents to operate for mobilisation of deposits -
- (a) within the State of the location of its registered office if its NOF is upto Rs.50 crore; and
 - (b) any where in India if its NOF is above Rs.50 crore.

Prior intimation to RBI and public notice

- (iii) The NBFCs/RNBSs would be required to give 30 days' notice to RBI prior to the opening of any branch/office for mobilisation of public deposits within the specified area

of operation and prior public notice of three months in leading newspapers before closing a branch. However, it is clarified that the area of operation of the agents, if appointed by the company for mobilisation of public deposits, would be congruous with the area of operation of the branch/office to which such agents are attached. A system of reporting the name, address, date of opening and deposits held at each existing branch as also information on opening and closing of branches has been put in place. These directions are applicable prospectively to the existing as well as new NBFCs/RNBCs. For the purpose of abundant clarification, it is advised that these Directions govern only the deposit taking activities of the companies. Opening of branches or engaging the services of agents for other than deposit taking business is not intended to be governed by RBI.

(5) Responsibilities of the Auditors to report to RBI on compliance with branch control directions

In keeping with the existing policy of RBI to enlist the support of the statutory auditors in ensuring compliance by the NBFCs of the RBI regulations, the auditors of these companies have been entrusted with the responsibility of direct reporting to RBI, along with other contraventions, if any, on the matters of non-compliance with the directions of RBI on control over opening and closing of branches and engaging the services of agents for mobilisation of public deposits by the NBFCs.

C. Amendments to NBFC Directions on Prudential Norms

(1) Compulsory Internal Audit System and Constitution of Audit Committees

On the lines of scheduled commercial banks, it has been decided that all NBFCs having asset size of Rs.50 crore or above should have compulsory internal audit system accountable to the Chief Executive Officer of the company. All these companies should also mandatorily constitute an Audit Committee from among the members of their Board of Directors. This provision is applicable to all NBFCs whether holding/accepting public deposits or not.

(2) Information on suit filed accounts

In order to monitor the level of loan delinquencies in the NBFC sector, NBFCs are being advised to furnish, in their Prudential Norms Return, information on suit filed/decreed debts by and against them.

D. Other decisions/clarifications

It has been felt necessary to issue the following further instructions / clarifications for information and necessary action :

(1) Need for disclosure of information relating to aggregate dues from the companies in the same group and other entities

We had vide our Notification dated December 18, 1998 prescribed that every NBFC should include in its advertisement the information relating to exposure to its group companies and associates as per the recommendations of the Task Force on NBFCs. It has been recently brought to our notice that some of the NBFCs are still using the application forms in the old formats for soliciting deposits. It is clarified that the above disclosures should be included in the application form for soliciting deposits without any further delay.

(2) Clarification on interpretation of the requirement of credit rating

By an amendment made on 18 December 1998 to para 4(4) of the NBFC Directions on Acceptance of Public Deposits, the NBFCs in the category of equipment leasing and hire purchase finance (EL/HP) having minimum CRAR of 15% have been permitted to accept public deposits without credit rating. Some of the NBFCs have pointed out that Paragraph 4(1)(i) of the Directions prohibits all NBFCs from accepting public deposits, if they have not obtained the minimum investment grade credit rating. It is clarified that the regulatory provisions for acceptance of public deposits by EL/HP NBFCs are contained in paragraph 4(4) of the Directions. Accordingly, para 4(1)(i) of the Directions is being modified.

(3) Extension of time period to NBFCs having NOF of less than Rs.25.00 lakh

The NBFCs still having NOF below the prescribed minimum level of Rs.25.00 lakh and whose applications for grant of Certificate of Registration are pending with the RBI are allowed time upto January 9, 2000 as provided in the RBI Act, to achieve the minimum NOF. All such NBFCs are advised that this time limit has expired on January 9, 2000. It is further clarified that RBI may not, in the normal course, grant extension of time to those NBFCs which have not attained the prescribed minimum NOF of Rs. 25 lakh by the above stipulated date and accordingly their application may not be considered for registration. Those of the NBFCs which have since achieved the minimum level of NOF should inform Reserve Bank.

(4) Submission of Returns on liquid Assets by NBFCs not holding/accepting public deposits

In the wake of certain disquietening reports that some of the NBFCs holding public deposits were not furnishing the liquid asset returns, Bank had stipulated in January 1999 that all NBFCs (including those not holding public deposits) should also submit liquid asset returns to the Bank. The NBFCs not holding/accepting public deposits were advised to file 'Nil' reports. We have received requests from various quarters that the requirement for the NBFCs not holding public deposits to furnish the above mentioned return should be done away with. As the auditors of these companies continue to be responsible to report to RBI through exception reports in regard to the violation of the provisions of the RBI Act/Directions including non-submission of the return on liquid assets, it has been decided that the NBFCs not holding public deposits need not furnish the return to RBI on and from the quarter ended December 1999.

(5) Provisioning against NPAs -
Income reversal to be shown
on Prudential Norms Return

We have received queries from some of the NBFCs and their auditors regarding disclosure of the amount of income reversed on NPAs which was earlier taken to the credit of profit and loss account. We clarify that the amount may be disclosed in the Prudential Norms Return Part F, Item II.(A)(i)(a) col. (3) against the head "entire amount taken to the credit of profit and loss account before the asset became NPA and remaining unrealised".

(6) Aggregate ceiling on investments
in unquoted shares

We have prescribed a prudential ceiling of 10 per cent of owned funds on investments in unquoted shares by equipment leasing/hire purchase finance companies and 20 per cent in the case of loan/investment companies if they are accepting/holding public deposits. Some of the companies are treating such ceilings as exposure norms against individual investee company. It is clarified that the aforementioned ceilings are aggregate ceilings on investments in the unquoted shares of all the investee companies taken together.

(7) Issue of secured debentures by NBFCs outside
the purview of description of public deposits

The provisions of para 2(1)(xii)(f) read asunder :

"any amount raised by the issue of bonds or debentures secured by the mortgage of any immovable property of the company; or by any other asset or with an option to convert them into shares in the company provided that in the case of such bonds or debentures secured by the mortgage or any immovable property or secured by other assets, the amount of such bonds or debentures shall not exceed the market value of such immovable property/other assets"

The above provisions have been interpreted by some of the NBFCs in different manner. It is advised that -

- (a) the debentures which are partly secured,
- (b) the debentures which are secured by assets of a third party,
- (c) the debentures which have matured for redemption but have not been redeemed and are overdue, and
- (d) the debentures against which a charge has not been created in favour of the independent debenture Trustees (other than debenture holders) within the stipulated period of 90 days and extended period of further 90 days

shall be treated as part of public deposits.

2. A copy each of the amending Notifications No. 134-140 is enclosed. You are requested to ensure meticulous compliance with the regulatory framework.

3. Please acknowledge the receipt of this letter to the General Manager/Deputy General Manager of the Regional Office of the Department of Non-Banking Supervision under whose jurisdiction the registered office of your company is located.

Yours faithfully,

Sd/-

(V. S. N. Murty)

Chief General Manager In-Charge