Chapter III
A Detailed Survey of the Nature of Deposit Taking Activity in India

Section I
An Overview of the Indian Financial System

India has an extensive financial infrastructure consisting of a vast network of institutions deploying varied instruments in the task of financial intermediation for overall economic development. These institutions in the organized sector consist of the Reserve Bank of India (RBI), the commercial banks, the Regional Rural Banks (sponsored by public sector commercial banks exclusively for rural development) and the cooperative banks, the all-India and State-level Development Financial Institutions (DFIs), various non-banking financial institutions (including insurance companies), the Unit Trust of India (UTI), the money market and other mutual funds, and the stock market.

3.2 A conspicuous aspect of the Indian financial system is the dominance of the public sector, which, however, is waning, particularly since 1991, when the financial sector reform measures were initiated. Within this broad framework, the financial infrastructure in the country in general has witnessed rapid growth, innovation, diversification and institutional development.

3.3 The Reserve Bank, with its traditional functions as a central bank and promotional and developmental roles, has been continuously playing an active role in developing and strengthening the financial system. There is a functionally varied and geographically widespread system of commercial and cooperative banks. These commercial and cooperative banks hold a substantial chunk of total assets of the financial system. Traditionally, the primary task of these banks has been to mobilize savings and provide working capital to producing units in different segments of the economy. However, of late, as the financial markets are integrating owing to the reform process, they have begun rendering medium- and long-term assistance. The contribution of these banks to the government and other approved securities in the public sector is also substantial.

3.4 The rendering of medium- and long-term assistance was traditionally being done by a variety of all-India and State-level DFIs for five broad economic sectors: industry, agriculture, exports, tourist resorts and hotels, and housing. However, their functions have undergone metamorphosis, and they have started short-term lending too, once the exclusive area of banks. Invasion of banks into term lending on one hand and that of DFIs into short-term lending on the other have brought to sharp focus the need for adopting universal banking in the country, an issue which is being intensely debated.

3.5 A large and heterogeneous set of non-banking financial institutions, which include the UTI, other mutual funds, the life and general insurance corporations, investment corporations, hire purchase and leasing companies, constitutes the third component of the financial system. For some of these, mobilization of savings is the prime activity, while others aim at rendering financial assistance. While commercial banks have been providing merchant banking services and housing finance for quite some time, some commercial banks have diversified and expanded their activities into related areas, such as, leasing, mutual funds, venture capital and

miscellaneous financial services (in addition to housing finance and merchant banking) by establishing non-banking subsidiaries for the purpose.

3.6 A major component of the organized financial system is the capital market, which facilitates the raising of primary capital and provides scope for promoting secondary market in private corporate and government securities.

3.7 Besides, there is a large number of non-financial companies in the public and private sectors, which raise loan or debenture or bond capital and deposits directly from the market.

3.8 Post Office Savings Bank, Provident Funds, other small savings and certain special bonds constitute important avenues for financial savings by households, as also important sources of finance for the Central and State Governments, apart from the dated government securities.

3.9 The short-term money market has links with the entire spectrum of the financial system, and comprises: (a) the call money market in which banks, national-level development banks, specialized financial institutions, investment institutions, the Primary Dealers, etc., operate, (b) the inter-bank deposit market, (c) bills rediscount market, (d) the Treasury Bill market, (e) repo market and (f) the inter-corporate funds market.

3.10 Apart from the organized financial system, moneylenders and indigenous bankers, trading, leasing, hire purchases, investment loans and mutual benefit companies and chit funds continue to play a role in the unorganized financial sector.

3.11 The following sections of this chapter discuss, in detail, the whole gamut of deposit taking activity of the banks (commercial and co-operative), the NBFCs, the FIs and the NBNFCs, respectively.

Section II
Deposit Taking Activity by Banks

3.12 Banks are considered as the financial engine for the real sector progress. Banks do this prime moving function by (a) mobilizing *liquid* deposits from the public, (b) lending the *liquid* deposits to borrowers who, in turn, invest the money in rather *illiquid* assets, and (c) providing the payments system, which is the basic lubricant for smooth functioning of the economic system. The first two functions represent a significant potential source of bank failures. The *liquid* bank deposits, along with the *illiquid* loans, make banks inherently vulnerable to depositor runs or panic withdrawal of deposits. The danger is compounded by two additional phenomena. First, a significant portion of the deposits mobilized by banks from the public is owned by small, unsophisticated depositors and second, it is very difficult to assess the riskiness of a bank; even professional analysts go wrong this. These characteristics of the bank functioning help create incentives for runs at the first sight of trouble.

3.13 Section 5(b) of the Banking Regulation Act (1949) defines “banking” as the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawal by cheque, draft, order or otherwise. Demand liabilities, according to the Act, mean liabilities, which must be met on demand, and time liabilities mean

liabilities, which are not demand liabilities.

3.14 Three categories of deposits are recorded in the Schedule 3 of the balance sheets of banks. These are: (i) Demand Deposits, (ii) Savings Bank Deposits and (iii) Term Deposits. Except (ii), the other two are further classified into two categories as: (i) from banks and (ii) from others. Banks with international presence, such as, the State Bank of India (SBI) show the deposits of branches in India and deposits of branches outside India, separately.

3.15 Demand deposits (Current Accounts) do not earn any interest; on the contrary, the holders of such accounts pay service charges to banks. These accounts are operated through cheques and there is no restriction on the number of transactions in a demand deposit account. Normally, businessmen hold this kind of accounts for their day-to-day operations. Further, the account holder can avail of overdraft facility through this type of account.

3.16 Savings bank deposits earn some rate of interest although the holders of such accounts enjoy tremendous flexibility in terms of depositing and withdrawal. Currently, the rate of interest on savings bank deposits is 4.5 per cent. This type of account is preferred by individuals, who hold it basically for transaction purposes. These are operated through cheques and no service charge is levied on the account holder. However, one has to maintain a stipulated minimum balance to avail of the cheque book facility. Corporate entities are not allowed to open savings bank accounts.

3.17 Term or fixed deposits mean deposits repayable after the expiry of a certain period. In the Banking Regulation Act (1949), the term of fixed deposits is nowhere mentioned. However, the term now varies between 15 days to 10 years. As per the RBI guidelines, interest on term deposits is paid on quarterly rests. The term deposits offered by banks can further be classified into three categories:

3.18 Fixed Deposit Accounts: In the case of fixed deposits the period of the deposits is usually fixed at the time of depositing the money. The fixing of the period enables the banker to invest money or otherwise employ it in business without having to keep a reserve and this is one of the reasons why fixed deposits are so popular with banks in India. Customers usually keep their money as fixed deposits with a view to earning interest as well as withdrawing the same on the expiry of the stipulated period in case they need it either for meeting certain expenses or employing it in more profitable manner. A good number of smaller investors prefers this to shares and debentures. A fixed deposit account holder can opt for premature withdrawal but with loss of interest income on his fixed deposit. The rates of interest on term deposits vary over the length of the maturity period. Consequent upon interest rate deregulation, various banks are offering term deposits with various maturity periods and various interest rates. Traditional term deposit accounts are the recurring deposit accounts and plain fixed deposit accounts. Of late, banks are also offering certain hybrid term deposit accounts, which combine the features of recurring deposits, savings bank deposits and term deposits.

3.19 Reinvestment Deposits: These are the deposits where interest payable every quarter is further reinvested and a lump sum amount is payable on maturity date. The yield calculated on simple interest rates works out to be higher in such deposit schemes.

3.20 Recurring Deposits: Recurring deposits are those where a monthly instalment is deposited in the accounts every month. The deposit amount, along with interest accrued, is paid on the date of maturity.

3.21 Bank deposit accounts can be held individually or jointly. The holder of the account also enjoys the facility of nomination. The interest income from bank deposits is taxable under Income Tax Act if such income is more than Rs.10,000 per year. Term deposit holders can avail of loans against the term deposit, subject to a margin. The interest rate to be charged by the bank for this loan is free but cannot be below the PLR of the bank.

3.22 Besides, there are Certificates of Deposits (CDs) through which banks mobilize short-term high-value deposits from the cash-rich corporate entities. The instrument, introduced in India in 1989, is a document of title to a time deposit. Technically speaking, CDs are unsecured negotiable promissory notes issued by scheduled commercial banks (excluding the RRBs) and the DFIs and issued at discount to face value. The difference from the traditional deposits lies in their being tradable and in the nature of being wholesale deposits and interest rates or the discount rates being market determined. Two major features of the CDs are their liquidity and marketability. CDs can be issued to individuals, corporates, trust funds, associations as well as NRIs (with certain conditions). Banks can also invest in CDs of other banks and financial institutions. CDs are freely transferable by endorsement and by delivery but only after the lock-in period of 15 days after the date of issue. Banks cannot grant loans against CDs nor can they buy back their own CDs before maturity.

Deposit Schemes for Non-resident Indians (NRIs)

3.23 The NRIs constitute an important source of foreign exchange for the Indian economy, which is deficient in foreign exchange. Banks have been permitted to open accounts in designated foreign currencies (now five, namely, USD, STG, DM, Yen, Euro) to facilitate foreign exchange remittance by the NRIs. Classification of bank deposit accounts relating to the NRIs is based on two criteria: (a) repatriation and (b) currency of account. Under the first classification, there are two types of accounts, namely, ordinary accounts without any repatriation facilities and external accounts with full repatriation rights. Under the second classification, the NRIs can maintain their accounts either in Indian rupees or in specified foreign currencies. Currently, there are four different kinds of bank accounts for NRIs. These are: (a) Ordinary Non-Resident Accounts in Rupees (NRO), (b) Non-resident (External) in Rupees (NRE), (c) Foreign Currency (Non-Resident) Accounts (Bank) Scheme, and (d) Non-resident Non-Repatriable (Rupee) Account (NRNR) and Non-resident (Special) Rupee (NRSR) Account.

3.24 NRE Accounts: NRE accounts can be opened in the form of a) savings bank, b) current accounts, c) term deposits, d) special term deposits, e) recurring deposits and f) cash certificates. Accounts can be opened/credited with remittances from abroad/transfer from existing NRE/FCNR accounts/deposit of foreign exchange brought into India, during visits to India. Accounts can be opened jointly with any other NRI. The NRIs can authorize residents to operate NRE accounts for local payments through a Power of Attorney/Letter of Authority. Transfer of funds between NRE accounts of different persons or genuine personal purposes is freely permitted. Withdrawals for local payments or payments abroad in any convertible currency are allowed without the Reserve Bank‘s approval. Loans against deposits are available for purposes other than relending/carrying on agricultural /plantation activities/real estate business.

3.25 FCNR (Bank) Account: Term deposits for periods from 1 year to three years can be maintained in US Dollars, Pound Sterling, Deutsche marks, Japanese Yen and Euro. There is no exchange loss, as interest and principal are payable in the above mentioned currencies. Other features are similar as in the case of NRE Accounts.

3.26 NRNR Accounts: These accounts can be opened by NRIs by way of transfer of funds from abroad or from existing NRE/FCNR accounts. Deposits are accepted for maturities of six months to three years. Interest rate offered is at competitive rates, higher than those offered on the NRE accounts. These can accounts can be opened jointly with residents also. Loans against deposits are available in India for purposes other than investments.

3.27 NRO Account: These accounts can be opened in the form of a) savings bank, b) current accounts, c) term deposits, d) special term deposits, e) recurring deposits and f) cash certificates. Accounts can opened/credited with legitimate local funds of the non-resident; foreign exchange funds may also be credited into accounts. Accounts can be opened jointly with non-residents/residents. Funds in the accounts cannot be remitted abroad, but can be used only for local payments. Interest rates are the same as in the case of domestic deposits. Interest earned on the accounts is repatriable subject to production of the appropriate certificate from the Chartered Accountant/Income Tax authorities. Interest earned is subject to deduction of tax at source at the rate of 30%. Loans against deposits are available for purposes other than relending, carrying on agricultural/plantation activities/real estate business.

3.28 Non-resident (Special) Rupee Account: The account has the same facilities/restrictios as are applicable to NRO accounts except for the following: a) Transactions in the account are allowed freely without the need to inform the bank about the details of sources of credits and purposes of debits and b) interest earned on the account is not repatriable.

Section III
Regulation over Bank Deposits

Scheduled Commercial Banks

3.29 For banks to carry out their deposit taking activities in India they must fulfil three basic regulatory requirements. These are meeting the: (a) Cash Reserve Ratio (CRR) requirements, (b) Statutory Liquidity Ratio (SLR) requirements and (c) Deposit Insurance requirements. The former two also serve as direct, but complementary, monetary control instruments through which RBI exercises control over liquidity in the banking system. Until recently, the deposit taking activity by banks was heavily regulated in terms of interest rates and maturity pattern. The journey to interest rate (both deposit and lending) deregulation started in the 1990s and currently banks enjoy full freedom in determining their deposit rates. Annexure III.I presents, in brief, the deposit rate regulation in its historical perspective. The details of the deposit insurance requirement are dealt with in Chapter IV.

Primary (Urban) Co-operative Banks

3.30 The Primary (Urban) Co-operative Banks (PCBs), like other co-operative societies are registered and governed by the State Governments under respective Co-operative Societies Acts of the States concerned. With the passage of time, the size and operations of the PCBs had

increased significantly and, therefore, it was considered necessary to bring them under the purview of the Banking Regulation Act, 1949. Besides, there was a demand from certain quarters, particularly after introduction of the Deposit Insurance Scheme for commercial banks in 1962, that co-operative banks should also get the benefit of this scheme. In view of these factors, effective March 1, 1966, certain provisions of the Banking Regulation Act, 1949 were made applicable to the PCBs. With the extension of the provisions of the Banking Regulation Act, 1949 to the PCBs, they came under the dual control of respective State Governments and the Reserve Bank. While the managerial aspects of these banks, namely, registration, constitution of management, administration and recruitment, amalgamation, liquidation, etc. are controlled by the State Governments under the provisions of the respective State Co-operative Societies Act, the matters related to banking are governed by the directives/guidelines issued by the Reserve Bank.

3.31 Section 5 cc (v) of the Banking Regulation Act, 1949 (as applicable to cooperative societies), defines a PCB as a co-operative society, other than a primary agricultural credit society and should comply with the following requirements.

the primary object or principal business of which is the transaction of banking business;
the paid-up share capital and reserves of which are not less than Rs.1 lakh; and
the by-laws of which do not permit admission of any other cooperative society as a member.

3.32 Traditionally, the area of operation of the PCBs was confined to metropolitan**,** urban or semi-urban centres and these banks mainly catered to the credit needs of small borrowers including small scale industries, retail traders, small entrepreneurs, professionals and salaried classes. Pursuant to the recommendations of the Committee on Licensing of New Urban Cooperative Banks (Marathe Committee) (1992), the Reserve Bank permitted these to extend their area of operation to the entire district in which they are registered including the rural areas without its prior approval. They can also finance agricultural activities subject to certain conditions. Further, banks proposed to be organized in the least developed States, such as, those in the North-Eastern region, etc., can extend their area of operation to two or three districts or even to the whole State depending upon the viability of the bank. In the case of PCBs included in the Second Schedule to the RBI Act, 1934, the area of operation is made co-extensive with the territorial jurisdiction of the State of registration. With a view to creating a level playing field for well managed banks, the PCBs with deposits over Rs.50 crore are permitted to extend their area of operation beyond their respective States of registration subject to their complying with certain norms.

3.33 As some of the large-sized PCBs had developed their banking business comparable to the size of private sector scheduled commercial banks, there was a demand to include them in the Second Schedule to the RBI Act, 1934. Accordingly, in the year 1988, it was decided by RBI to include the names of well-managed PCBs with deposits of Rs.50 crore and above in the Second Schedule to the RBI Act, 1934. Subsequently, on acceptance of the recommendations of the Marathe Committee, only such of the PCBs, which have DTL of not less than Rs.100 crore, are being considered for inclusion in the Second Schedule to the RBI Act 1934. At present, there are 36 scheduled PCBs.

Section IV
Deposit Taking Activity by Non-Banking Finance Companies

3.34 The non-banking finance companies (NBFCs) are a heterogeneous lot, in terms of activity and size. The NBFCs, an integral part of the Indian financial system, perform an important financial intermediation role contributing to economic development. These companies offer tailor-made services to both borrowers and savers in the wholesale and retail segments. The common feature of the diverse segment is acceptance of deposits from the public, borrowing from banks and accessing the capital market, in the case of companies organized as public limited companies.

Definition of Non-Banking Finance Companies
According to the Reserve Bank (Amendment Act), 1997:
"A Non-banking Finance Company (NBFC) means

- a financial institution which is a company;
- 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;
- such other non-banking institution or class of such institutions as the Bank may with the previous approval of the Central Government specify."
- The definition excludes financial institutions and institutions, which carry on agricultural operations as their principal business.

3.35 NBFCs are broadly of eight types: (i) equipment leasing companies, (ii) hire-purchase finance companies, (iii) loan companies, (iv) investment companies, (v) mutual benefit financial companies (Nidhis), (vi) miscellaneous non-banking companies, (chit funds), (vii) residuary non-banking companies, and (viii) housing finance companies.

Regulation of Deposit Taking Activities of Non-Banking Companies
3.36 The scheme of regulation of the deposit taking activities of the non-banking companies was conceived in the sixties not only as a supplement to the monetary and credit policy but also to provide an indirect protection to the depositors. Accordingly, RBI was vested with certain powers to supervise, control and regulate the deposit acceptance activities of these institutions. The focus of the regulation was on the acceptance of deposits and related matters. In pursuance of the powers conferred under the RBI Act, 1934, separate directives were issued by RBI in 1966 to NBFCs and Non-banking Non-financial Companies (NBNFCs) relating to the acceptance of deposits and governing their period, quantum, rate of interest, etc. In 1973, directions were issued to the miscellaneous non-banking companies (conducting chits and related business) as well. Subsequently, in 1975, NBNFCs were exempted from the application of the RBI directions and instead, brought under the regulatory ambit of the Department of Company Affairs under (Acceptance of Deposits) Rules 1975 framed under Section 58A of the Companies Act.

Inadequacy of Legislative Framework prior to the 1997 Amendment
3.37 The provisions of Chapter III B of the RBI Act, 1934 vested very limited powers in RBI in as much as RBI was only empowered to regulate or prohibit issue of prospectus or advertisement

soliciting deposits, collect information as to deposits and to give directions on matters relating to receipt of deposit. For violation of directions, RBI could issue orders prohibiting erring companies from accepting further deposits. So long as the directions relating to deposit acceptance were complied, no stringent action could be initiated on other adverse features found out, if any, during inspection. The legislative intent and the focus were, thus, mainly aimed at moderating the deposit mobilization by NBFCs and thereby providing indirect protection to the depositors by linking the quantum of deposit to their Net Owned Fund (NOF). Thus, the directions were restricted to the liability side, that to solely to deposit acceptance activities. It did not extend to the asset side of the balance sheets of NBFCs. Several expert/working groups, which thereafter examined the functioning of NBFCs, were unanimous about the inadequacy of the legislative framework and recommended introduction of suitable legislation not only for ensuring sound and healthy functioning of NBFCs but also to safeguard interest of depositors. The Joint Parliamentary Committee, which went into irregularities in securities transactions in 1992, had also observed in paragraph 6.61 of the Report that the Government should examine whether the provisions in Chapter III B of the RBI Act were sufficiently wide to cover the necessary regulation. If not, the question of reinforcing the existing legislation or to enact a separate legislation for NBFCs be examined.

3.38 In the light of these developments, RBI appointed in 1992 a Working Group on Financial Companies (Chairman: Dr. A.C. Shah) to make an in-depth study of the role of NBFCs and to suggest regulatory and control measures to ensure healthy growth of these companies. The Working Group, in its report submitted in September 1992, made wide-ranging recommendations for ensuring sound functioning of NBFCs.

3.39 Accordingly, RBI initiated a series of measures including: (i) widening of the definition of regulated deposits to include inter-corporate deposits, deposits from shareholders and directors and borrowings by issue of debentures secured by immovable property (April 1993), (ii) introduction of a scheme of registration of NBFCs having NOF of Rs.50 lakh and above (April 1993), (iii) the issuance of guidelines on prudential norms so as to regulate the asset side of the balance sheet of NBFCs (June 1994). The measures relating to registration and prudential norms could not be given statutory backing at that time since the provisions of the RBI Act 1934 did not confer adequate powers to make them mandatory.

Amendments to RBI Act 1934

3.40 An ordinance was issued by the Government in January 1997 effecting comprehensive changes in the provisions of the RBI Act, 1934. This was subsequently replaced by the RBI (Amendment) Act, 1997. The salient features of the amended provisions, based on the Shah Committee recommendations, pertain to the entry point norm of Rs.25 lakh as minimum NOF (which has been raised to Rs.2 crore effective from April 21, 1999), compulsory registration with RBI, maintenance of certain percentage in the form of unencumbered approved securities, creation of reserve fund and transfer thereto every year an amount not less than 20 per cent of the net profit, determination of policy and issuing directions by RBI on prudential norms, prohibition of NBFCs from accepting deposits and seeking winding applications for violation of directions. Unincorporated bodies were prohibited from issuing any advertisement for soliciting deposits. The Company Law Board was empowered to direct the defaulting NBFCs to repay any deposit. Stringent penal provisions were also included empowering RBI to impose, *inter alia,* pecuniary penalty for violation of the provisions of the RBI Act.

3.41 Insurance companies, housing finance companies, stock broking companies and stock exchange companies were granted exemptions from certain provisions of the amended Act. Nidhi companies and chit funds were also exempted from certain core stipulations including maintenance of percentage of assets and reserve funds.

3.42 In May 1997, certain malpractice pertaining to a NBFC came to light. This consequently raised a number of questions including the ones of extending deposit insurance and of bringing about stronger supervisory mechanisms on these companies.

New Regulatory Framework

3.43 Exercising the powers derived under the amended Act and in the light of the experience in monitoring the activities of NBFCs, a new set of regulatory measures was announced by RBI in January 1998. As a result, the entire gamut of regulation and supervision over the activities of NBFCs was redefined, both in terms of the thrust and the enforcement. The salient features of the new framework are as under:

- NBFCs have been classified into three categories for purposes of regulation, namely,
- those accepting public deposits
- those, which do not accept public deposits but are engaged in the financial business, and
- core investment companies, which hold at least 90 per cent of their assets as investments in the securities of their group/holding/subsidiary companies.

While NBFCs accepting public deposits are subject to the entire gamut of regulations, those not accepting public deposits are regulated in a limited manner. Therefore, the regulatory attention is focussed primarily on NBFCs accepting public deposits. Borrowings by way of inter-corporate deposits, issue of secured debentures/bonds, deposits from shareholders by a private limited company and deposits from directors by both public as well private limited companies have been excluded from the purview of the public deposits. The RBI regulation on quantum, rate of interest, period of deposit are applicable only with respect to public deposits. The term ‘public deposit’ was defined on the lines of the definition provided by the Companies (Acceptance of Deposits) Rules, 1975 framed under the Companies Act 1956 and RBI Act 1934. Public deposits include fixed, recurring, etc. deposits received from public, deposit received from relatives and friends, deposits from shareholders by a public limited company and the money raised by issue of unsecured debentures/bonds. The overall ceiling on borrowing by NBFCs has been removed and sought to be decided on the basis of capital adequacy requirement.

3.48. It is also expected that during the three-year period, NBFCs could obtain/improve their credit rating, improve their NOF, substitute public deposits by other forms of debt, and arrange for alternative sources of funds. NBFCs have been debarred from charging an interest rate exceeding 16 per cent per annum and a brokerage fee of over 2 per cent on public deposits. NBFCs accepting public deposits only are required to submit to RBI annual statutory returns and financial statements. NBFCs ot accepting public deposits are exempted from this requirement. For the first time, prudential norms have been prescribed for NBFCs for mandatory compliance under the statutory powers vested with RBI. The companies, which accept public deposits, are required to comply with all the norms pertaining to income recognition, accounting standards, asset classification, provisioning of bad and doubtful debts, capital adequacy, credit/investment

concentration norms, etc.

3.49 To improve the liquidity of NBFCs, the proportion of liquid assets required to be maintained by them has been enhanced from 12.5 per cent to 15 per cent April 1, 1999.

3.50. With regard to the risk profile of the assets of NBFCs, capital adequacy ratio has been enhanced from 8 per cent to 10 per cent w.e.f. April 1, 1998 and further to 12 per cent w.e.f. April 1, 1999. The loan/investment companies accepting/holding public deposits must have a CRAR of 15% effective from December 18, 1998.

3.51. NBFCs not accepting public deposits have been exempted from the regulations on interest rates, period, ceiling on quantum of borrowings. However, prudential norms, which have a bearing on the true and fair status or the financial health of these companies as reflected in their balance sheets, have been made applicable to these companies except those relating to capital adequacy and credit investment concentration norms. Core investment companies are exempt from all the regulation of RBI except registration and reserve fund. The responsibility of ensuring compliance of these regulations has been entrusted to the statutory auditors of these companies, and RBI has issued directions to the statutory auditors for this purpose. Statutory auditors of NBFCs are required to report by exception to RBI any irregularity or violation of the RBI regulation on acceptance of public deposits and prudential norms.

3.52. The contents of the deposit application forms have been further modified to make the depositors aware of the forums for redressal of their grievances and also to give them a proper perspective regarding the role and responsibility of the regulatory authority. The deposit taking companies were directed to certify the correctness of the financial position to state that their operations complied with the RBI directions. NBFCs were also required to disclose the levels of their rating and the names of the rating agency in their application forms. The depositors were also enjoined to satisfy themselves about the financial details of the company before placing their deposits and to declare in their deposit application forms that they had gone through the declarations made by the company regarding its conformity with the RBI regulations. As a move towards greater disclosure and transparency, NBFCs accepting public deposits have been asked to furnish certain essential information regarding their financial activities in their forms for application for deposits and advertisement for soliciting deposits. Depositors have been cautioned not to be lured by offered interest rate alone and be careful to understand the financial position of the concerned company.

Acceptance of Deposits by Unincorporated Bodies

3.53. Before the introduction of Chapter III C in the RBI Act, 1934, there was no control on the acceptance of deposits by unincorporated bodies, such as, individuals, partnership firms and association of individuals. With a view to curbing the deposit acceptance activities by the unincorporated bodies and to offering a degree of protection to the small and unwary depositors and also as a measure of bringing about some discipline in the sector, the RBI Act was amended, and a new Chapter III C was inserted, which came into force with effect from February 15, 1984. The provisions of Chapter III C, as it existed till the January 1997 amendments, sought to prohibit unincorporated bodies from acceptance of deposits from public except to the extent of specified number of depositors. In terms of those provisions, an individual could not have

accepted deposits from more than 25 depositors and a partnership firm or an unincorporated association of individuals from more than 25 depositors per partner/individual and from more than 250 depositors in all, excluding in either case depositors who are relatives of the individuals/partner. Despite these provisions, unincorporated bodies circumvented the statutory restrictions by floating different partnership firms as and when a firm reached a level of 250 depositors. Further, it was also noticed that several unincorporated bodies were advertising aggressively soliciting deposits from the public by offering high rates of interest and other incentives. In view of this, Section 45 S of the RBI Act was amended in January 1997.

3.54. The amendment Act has modified the erstwhile provisions of Section 45 S of the RBI Act relating to acceptance of deposits by unincorporated bodies. The amended provisions have come into effect from April 1, 1997. As per the amended provisions, unincorporated bodies, such as, individuals, firms, or unincorporated associations of individuals, have been prohibited from accepting deposit if: (a) business of such unincorporated bodies, either wholly or partly, includes any of the activities of financing, or acquisition of securities, letting or delivering of goods under hire purchase agreement, managing, conducting or supervising as foreman of chits or kuries, and (b) the principal business of unincorporated bodies is that of receiving deposits or lending in any manner.

3.55. An individual or a partner carrying on such activities is, however, permitted to accept deposits from relatives and borrow money from certain institutions as specified in the Act for any purpose. Besides, there is no restriction on the unincorporated body for accepting deposits from public for their own business purpose other than the activities stated above.

3.56. Any person other than a body corporate who holds any deposit as on April 1, 1997, which is not in accordance with the provisions of the Act, is required to repay such deposits other than on the maturity of deposits or within a period of three years from April 1, 1997 whichever is earlier. RBI may, if it is satisfied on an application made to it by any person that such person is unable to repay a part of the deposits for reasons beyond its control or such repayment shall cause extreme hardship to him, by an order in writing, extend such period by a period not exceeding one year subject to such conditions as may be specified by it.

3.57. For the purpose of the above provisions, the term deposit has been defined in the RBI Act, to include any receipt of money by way of deposit or loan or in any other form but will not include receipt of money by any person by way of share capital, contribution by partners to the capital of the firm, amounts received from banks and specified financial institutions, amounts received in the ordinary course of business by way of security deposit, dealership deposit, earnest money, advance against orders for goods, properties or services, subscription in respect of chit or any other money received from any unincorporated body registered under any Act, relating to money lending. Unincorporated bodies engaged in financial business are prohibited from issuing any advertisement in any form for soliciting deposit with effect from April 1, 1997. Receipt of deposit in contravention of the above provisions, would amount to an offence punishable with imprisonment for a term which may extend to two years or with fines which may extend to twice the amounts of deposits so received or Rs.2,000/- whichever is more or with both.

Acceptance Deposits by RNBCs

3.58. A residuary non-banking company (RNBC) is a company which receives deposit under any scheme or arrangement, by whatever name called, in one lump sum or in installments or in any other manner and which is not: (a) an equipment leasing company, (b) a hire purchase finance company, (c) a housing finance company, (d) an insurance company, (e) an investment company, (f) a loan company, (g) a mutual benefit financial company or (h) a miscellaneous non-banking company.

3.59. The operations of RNBCs were characterised by certain undesirable features like payment of high rates of commission, forfeiture of deposits, low or negligible rate of return on deposits, appropriation of capital received to revenue account and the consequent non-disclosure of the entire deposit liability in their books of accounts/balance sheets, negative or negligible NOF, levy of service charges on the depositors, etc.

3.60 Accordingly, RBI had taken several measures to remove all these undesirable features. The deposit taking activity of RNBCs are governed under the provisions of Residuary Non-banking Companies (Reserve Bank) Directions, 1987 issued by RBI under the provisions of Chapter IIIB of the RBI Act. In view of low or negligible NOFs, the quantum of deposits that could be accepted by these companies cannot be linked to their NOFs. For safeguarding depositors' interest, these companies have been directed to invest at least 80 per cent of their deposit liabilities in bank deposits and approved securities. These securities are required to be entrusted to a public sector bank designated for the purpose and can be withdrawn only for the purpose of repayment of deposits. Furthermore, such companies are required to pay interest on their deposits, which shall not be less than 6 per cent per annum in respect of daily deposit schemes and 8 per cent per annum for other deposit schemes. Other provisions of the directions relate to minimum and maximum periods of deposits, prohibition from forfeiture of any part of the deposit or interest payable thereon, disclosure requirements in applications forms and the advertisement soliciting deposits and need to furnish periodical return and information to RBI.

3.61 With the new regulated framework, RBI has extended the prudential norms to RNBCs for mandatory compliance.

Acceptance Deposits by Chit Fund Companies

3.62 The deposit taking activities of chit fund companies are regulated by RBI under the Miscellaneous Non-banking Companies (Reserve Bank) Directions, 1977. Such companies are allowed to accept up to 25 per cent of their NOF as deposits from public and up to 15 per cent of their NOF from their shareholders. The other provisions of the directions are similar to those pertaining to NBFCs in general. However, these companies are exempted from the requirements of compulsory registration with RBI because they are primarily engaged in conventional chit fund business and the Registrar of Chits of the concerned State Government would be monitoring their activities. The requirement of credit rating has also not been made mandatory for these companies.

Acceptance Deposits by Mutual Benefit Finance Companies (Nidhis)

3.63 Mutual Benefit Finance Companies (Nidhis), which mobilize deposits from and lend to their members, were exempted from most of the core regulations set out in the Non-banking Financial Companies (Reserve Bank) Directions, 1977 relating to quantum, tenure, ceiling on rate of interest, etc. and also advertisements rules. They were only required to submit the annual

returns prescribed under the relative directions. This was because traditionally the nidhis were localized and running on the principles of co-operation and mutuality of interest and confining their dealings amongst members. Funds raised from members were being lent to the needy ones at reasonable rates of interest.

3.64 During 1995-96, it was observed that some of these companies were resorting to aggressive advertisements and offering very high rates of interest on deposits, which were not at all in alignment with the market rates. Consequently, in July 1996, RBI imposed a ceiling of 15 per cent (presently 16 per cent) on interest rate, which could be offered by these companies on deposits and prohibited from issuing advertisement in any form and paying any brokerage on deposits. In view of the rationalization measures taken for the registered NBFCs in August 1996, RBI freed deposit interest rates for those nidhis which were functioning on sound lines and complied with certain terms and conditions one of which was that the ratio of NOF to deposits is not exceeding 1:20 as on the date of application. The specified ratio is applicable only on the incremental deposit liabilities over the deposit liabilities as on January 15, 1997. Such companies were required to apply to RBI for exemption, furnishing relevant information and documents. However the scheme of exemption st5ands withdrawn now.

Vasudev Committee:
3.65 The January 1998 Directions put severe restrictions on deposit mobilization by NBFCs. The linking of credit rating with the quantum of deposit was viewed as a panic reaction by RBI. There was an active lobbying especially by the hire purchase and leasing companies and their trade associations. The then Finance Minister announced in 1998 the setting up of a Task Force headed by Mr.C.M.Vasudev, Special Secretary, Banking in the Ministry of Finance. The Task Force submitted its report in October 1998. The highlights of the recommendations are as under:

- De-linking of credit rating with quantum of deposits. All hire purchase finance companies and equipment leasing companies having at least minimum investment grade of credit rating to be allowed to have four times of NOF as public deposits.
- All unrated or underrated hire purchase finance companies and equipment leasing companies having NOF of at least 25 lakh to be allowed to have 1.5 times of NOF or Rs.10 crore, whichever is lower, as public deposits provided they attain a higher capital adequacy ratio of 15 per cent.
- SLR to be maintained at a higher level of 25 per cent.
- Investments in marketable securities, other than the liquid assets already maintained, to be made at the rate of 25 per cent of reserves.
- Increase in the minimum capital requirements for entry.
- Increased protection of interests of depositors by constituting Depositors' Grievances Redressal Authority, first charge of unsecured depositors on liquid assets maintained, formation of information cells by State Governments, etc.
- Rejection of deposit insurance.
- Unincorporated bodies to be allowed to take loans from companies.

3.66 In December 1998, the recommendations of the Task Force were accepted by the Government of India and RBI. The first, second and eighth recommendations mentioned above have been implemented. RBI has said that the recommendations requiring statutory amendments

will be processed for necessary action in due course. RBI has further said that other recommendations like increase in SLR, investments in marketable securities etc. would be implemented in a phased manner.

Section V
Deposit Taking Activity by Financial Institutions

3.67 Traditionally, the DFIs have been the providers of long-term loans to the entrepreneurs. DFIs, in turn, used to source their funds from: (i) the the Reserve Bank's long-term operations fund (LTO) at concessional rates, (ii) the soft loan windows of multilateral/bilateral agencies, (iii) the issuance of bonds qualifying as the SLR investments in banks. The winds of reforms, that started blowing in 1991 and engulfed the banking sector, also struck the DFIs. First, the availability of concessional funds to the DFIs was compressed, forcing them to mobilize funds, both short- and long-term, at market-related rates. For instance, 1990s witnessed drying up of LTO funds from the Reserve Bank. Secondly, the regulations, that earlier disfavoured commercial banks to lend long-term and the DFIs to lend short-term, were relaxed to a great extent. This led to not only blurring of the borderline but also emboldening of competition between the two. Now, the DFIs, in addition to their fundamental role of performing as development institutions, are keen to take up commercial banking operations, which include mobilization of short-term deposits.

3.68 The DFIs, during the past few years, have been given limited access to short-term sources like fixed deposits (FDs), certificates of deposits (CDs) and term money borrowings (TMBs). Various restrictions have been placed on such borrowings. The overall ceiling for the DFIs' mobilization of resources by FDs (maturities of 1 - 5 years), CDs (maturities of 1 - 3 years) and TMBs (maturities of 3 - 6 months) has been fixed at 100 per cent of NOF of the DFIs. Some DFIs have also been permitted to raise inter-corporate deposits within the above ceiling. The DFIs are not permitted to raise deposits from the public with maturity of less than one year. Further, interest rate on deposits of the DFIs is capped at interest rates offered by the State Bank of India for similar maturities. There is also a restriction relating to minimum size of deposit (currently, Rs.10,000) and lock-in period of 2 years has been stipulated. There is no deposit insurance facility available to the DFIs mobilizing deposit. The DFIs are also not required to maintain CRR and SLR.

Section VI
Deposit Taking Activity by NBNFCs

3.69 A non-banking non-financial company is defined as an industrial concern or a company whose principal activity is agricultural operations or trading in goods and services or real estate and which is not classified as a financial or a miscellaneous or a residuary non-banking company.

3.70 The deposit taking activity of the NBNFCs is regulated by the Department of Company Affairs, Government of India under the Companies (Acceptance of Deposits) Rules, 1975, as applicable to such companies, which are neither banking companies nor financial companies, framed under Section 58A of the Companies Act, 1956. Deposits of such companies include any deposit of money with it including any amount borrowed by it but does not include any amount

received from the Government or guaranteed by the Government, loan from any banking company and financial institution, any amount received by way of security deposit, subscriptions to its shares, any amount received from any other company, any amount received from its directors, any amount raised by the issue of bonds or debentures secured by the mortgage of any immovable property and unsecured loans brought in by the promoters. Such a company is required to deposit or invest a sum, before the 30th of April of each year, which should not be less than 15 per cent of the amount of its deposits maturing during the year ending on the 31st March next in any one or more of the following methods, namely, in a current or other deposit account with any scheduled bank free from charge or lien, in unencumbered securities of the Central or the State Government, specified trusts and Housing Development Finance Corporation. Such amount deposited or invested should not be utilized for any purpose other than the repayment of deposits maturing during the year. Every NBNFC intending to invite deposits should issue an advertisement for the purpose in a leading English newspaper and in one vernacular newspaper circulating in the State of its registered office. An NBNFC should not accept or renew any deposit unless an application is made by the intending depositor for the acceptance of such deposit and such application contains a declaration by such person that the amount is being deposited neither out of borrowed funds nor by accepting deposits from any other person. The company should issue a receipt acknowledging the receipt of money. Such companies should keep at its registered office registers furnishing the particulars of the depositors and their deposits. Each company should file a return of deposits with the registrar on or before 30th of June every year. The company, which acts in contravention to the Rules, is punishable with a fine of up to Rs.500 or more depending on the continuation of the violation.

3.71 Department of Company Affairs, government of India has constituted Investors Protection and Education Fund under Section 205C of the Companies Act, 1956. All the companies are required to transfer the unclaimed deposits remaining outstanding for more than 7 years to the fund.