

CHAPTER

1

NBFC: The Concept, Evolution and Development through Various Committees

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1. The Concept and Meaning of NBFC

1.1 *Concept of NBFC*

The Financial Institutions which are not banks, but almost doing every activity of banking may be called as Non-banking Financial Companies (NBFC). Some of the NBFCs are accepting deposits from the public, providing financial assistance by way of loans and advances to the public and some specialised NBFCs are doing the business of merchant

banking, stock broking, alternative investments, etc., as their principal business. NBFCs are being regulated by the various regulatory authorities based on their activities like, RBI, SEBI, IRDAI, State Govts, etc.

The concept of NBFC is not new in India, but can be recognised even prior to the evolution of the banking system. Although at that time the concept of NBFC was not corporatized, but it can be said that it was prevailing among the indigenous bankers way back, which is called as unorganised financial sector. The indigenous bankers were providing loans and advances for the purpose of agricultural and allied activities to the farmers, financial assistance for setting up of small business shop and industrial/manufacturing activity at micro level and for personal and social causes. These indigenous bankers were also accepting deposits from their nearby villagers.

Later, in 1931 efforts were made by the Central Banking Enquiry Committee, which suggested that the indigenous bankers should be linked with the RBI but the same could not succeed. In 1964, there was an amendment in the RBI Act, 1934 and Chapter III-B was inserted, which gave the limited powers to the RBI to regulate the deposit accepted by the NBFCs. In 1984, Part III-C was inserted in the RBI Act to regulate the deposit taking activities of the Un-Incorporated Bodies (UIBs).

Though for the common public, it seems that NBFCs are alike of the Banks, but there is one basic difference, that the NBFCs cannot accept deposits which is payable on demand. Only banks are authorised to accept deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise.

Today, the NBFCs in India include not just the finance companies that the general public is largely familiar with; but the term also entails wider group of companies that are engaged in investment business, insurance, chit funds, nidhi, merchant banking, stock broking, alternative investments, etc., as their principal business. All are though not under the regulatory purview of the Reserve Bank.

1.2 *Meaning of NBFC*

An NBFC is defined under section 45-I(f) of the Reserve Bank of India Act, 1934 (RBI Act) as a:

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

Thus, a 'financial institution' that is a company is a NBFC. The term 'financial institution', is defined under Section 45-I(c) of the RBI Act. Briefly, a financial institution means any non-banking institution which carries on as its business (or part of its business) on any of the following activities (financial activities):

- (i) Lending or financing for activities other than its own;
- (ii) Acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority;

- (iii) Leasing or hire-purchase
- (iv) Insurance business
- (v) Chit business
- (vi) Collection of monies
- (vii) Acceptance of deposits

but does not include any institution, which carries on as its principal business in

- (i) Agriculture operations
- (ii) Industrial activity
- (iii) Purchase or sale of any goods (other than securities)
- (iv) Providing any services and
- (v) Sale/purchase/construction of immovable property

Sometimes, non-banking institutions which do not carry out the activities of a financial institution are still categorised as NBFCs. They are designated as NBFCs through a notification in the Gazette¹ as in the case of Account Aggregators and Peer-to-Peer Lending Platforms, which have been discussed in detail in this book. Another aspect is that a company need not be fully engaged in financial activities to be classified as an NBFC as long as it does not undertake as its principal business, non-financial activities such as agriculture, industrial activity, trading in goods, etc.

2. Regulating the Un-regulated Non-banking Entities

²[In the wake of failure of several banks in the late 1950s and early 1960s in India, large number of ordinary depositors lost their money. At this time, the Reserve Bank did note that there were deposit taking activities undertaken by non-banking companies. Though they were not systemically as important as the banks, the Reserve Bank initiated regulating them, as they had the potential to cause pain to their depositors. These institutions have thus been under the regulatory oversight of the Reserve Bank of India since 1963. Since then regulation has generally kept pace with the dynamism displayed by the sector. Later in 1996, in the wake of the failure of a big NBFC, the Reserve Bank tightened the regulatory structure over the NBFCs, with rigorous registration requirements, enhanced reporting and supervision. The Reserve Bank also decided that no additional NBFC will be permitted to raise deposits from the public. Further, in 1999, capital requirement for fresh registration was enhanced from ₹25 lakh to ₹200 lakh. Later on, when the NBFCs sourced their funding heavily from the banking system, it raised systemic risk issues. At the same time, their growing size and interconnectedness also raise concerns on financial stability. Sensing this, the Reserve Bank brought asset side prudential regulations onto the NBFCs. The Reserve Bank's endeavour has been to streamline NBFC regulation, address the risks posed by them to financial stability, address depositors' and customers' interests, address regulatory arbitrage and help the sector to grow in a healthy and efficient manner.

Some of the regulatory measures include identifying systemically important non-deposit taking NBFCs as those with asset size of ₹100 crore and above in the year 2006 and bringing them under stricter prudential norms (CRAR and exposure norms), issuing guidelines on Fair Practices Code, aligning the guidelines on restructuring

1 Notified in the Official Gazette by the RBI, with the previous approval of the Central Government, under Section 45-I (f)(iii) of the RBI Act, 1934.

2 https://www.rbi.org.in/scripts/FS_Overview.aspx?fn=14

and securitisation with that of banks, permitting NBFCs-ND-SI to issue perpetual debt instruments, etc., in November 2014, the entire regulatory framework was reviewed with a view to transitioning, over time, to an activity based regulation of NBFCs.

As a first step in this direction, certain changes to the regulatory framework are sought to be made to—

- (a) address risks wherever they exist,
- (b) address regulatory gaps and arbitrage arising from differential regulations, both within the sector as well as vis-a-vis other financial institutions,
- (c) harmonise and simplify regulations to facilitate a smoother compliance culture among NBFCs, and
- (d) strengthen governance standards.

Threshold for systemic significance has been redefined as ₹500 crore from the extant ₹100 crore in assets. Systemically important NBFCs along with deposit taking NBFCs would be subject to *inter alia*, higher minimum Tier 1 capital, higher corporate governance standards and also stricter asset classification norms.]

3. Regulation of NBFCs Historical Evolution³ (at a Glance)

The formal regulation of the NBFCs can be said to start from 1964 when the RBI Act was amended and Chapter III-B was inserted in the Act. Chapter III-B came into force with effect from 1st February, 1964. Prior to this, the business of financing was regulated by the Companies Act.

The RBI Act was amended by the Banking Laws (Miscellaneous Provisions) Act, 1963 (55 of 1963) to include Chapter III-B containing provisions relating to Non-Banking Institutions receiving deposits and financial institutions to regulate the NBFIs. Initially, the legislative intent was aimed at moderating the deposit mobilization of NBFCs and thereby to provide indirect protection to depositors by linking the quantum of deposit acceptance to Net Owned Fund (NoF). Thus, the directions were restricted to the liability-side of the balance sheet and mainly to deposit acceptance activities. It did not extend to the asset-side of the balance sheets of NBFCs.

The appended table shows the chronological events / development in the field of NBFC:

Month / Year	Particulars
February, 1964	Chapter III-B was inserted in the Reserve Bank of India Act, 1934. Gave only limited powers to Reserve Bank, i.e., on regulation of deposit acceptance by NBFCs.
1974	Chapter V (on Penalties) was inserted in RBI Act, 1934.
February, 1984	Chapter III-C (to regulate deposit taking activities of Un-Incorporate Bodies (UIBs) was inserted in RBI Act, 1934.
1992	Working Group on Financial Companies by RBI (Chairman: Dr. A.C. Shah). Reserve Bank of India Act, 1934, did not confer RBI with adequate powers to make the recommendations mandatory.

3 Annex. IV of Working Group on the Issues and Concerns in the NBFC Sector dated 29th November, 2011

Month / Year	Particulars
April, 1993	System of registration for NBFCs with NoF ₹50 lakh and above was introduced.
June, 1994	RBI prescribed prudential norms as an attempt to regulate the assets of the companies.
1995	Khanna Committee (Expert Group on Designing a Supervisory framework for NBFCs) - Recommendations laid foundation to the supervisory framework of NBFCs. The supervision of the NBFC sector was brought under the jurisdiction of the Board for Financial Supervision (BFS) (July 01).
1997	Department of Non-Banking Supervision (DNBS), was formed by segregating FCW from DoS, for focused attention to the supervision of NBFCs by 16 Regional Offices.
March, 1997	The Reserve Bank of India (Amendment) Act was passed amending Chapters III-B, III-C and V of RBI Act, 1934.
April 30, 1997	Reserve Bank of India (Non-Banking Financial Companies) Returns Specifications 1997 was issued.
January 02, 1998	<p>New Regulatory Framework for NBFCs</p> <ul style="list-style-type: none"> • NBFCs were classified into 3 categories for purposes of regulation, viz, (i) those accepting public deposits; (ii) those which do not accept public deposits but are engaged in the financial business, and (iii) core investment companies which hold at least 90 per cent of their assets as investments in the securities of their group/holding/subsidiary companies. • New entry point norm of ₹25 lakh. • While NBFCs accepting public deposits were to be subjected to the entire gamut of regulations, those not accepting public deposits would be regulated in a limited manner. • In respect of new NBFCs (which are incorporated on or after April 20, 1999 and which seek registration with the Reserve Bank), the minimum NOF was raised to ₹2 crore.
January 31, 1998	<p>Directions were issued as under:</p> <ul style="list-style-type: none"> • Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 • Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 • Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1998

Month / Year	Particulars
August, 1998	Task Force on Non-Banking Finance Companies under the Chairmanship of Shri C M Vasudev, Special Secretary (Banking), Ministry of Finance to examine the adequacy of then legislative framework was set up.
October, 1998	<p>The Task Force submitted its Report to the Government. Recommendations included:</p> <ul style="list-style-type: none"> • higher CRAR for NBFCs than banks, • statutory powers to RBI to appoint depositors' grievance redressal authorities, • review of prudential norms, etc.
April 08, 1999	<p>Press Release issued by RBI defining principal business. A company will be treated as an NBFC:</p> <ul style="list-style-type: none"> • if its financial assets are more than 50 per cent of total assets (netted off against intangible assets), and • income from financial assets is more than 50 per cent of the gross income, • both these criteria are required to be fulfilled as the determinant factor for principal business of a company.
January 13, 2000	<p>On the lines of scheduled commercial banks, all NBFCs having asset size of ₹50 crore or above were advised to have compulsory internal audit system and also constitute an Audit Committee from among the members of their Board of Directors.</p> <p>Exemptions were granted to NBFCs (Section 25 Companies) engaged in micro financing activities, MBCs (Potential Nidhis) and Government companies (registration applicable) from Core provisions of RBI Act, 1934 and Directions, subject to eligibility criteria.</p>
June 09, 2000	Guidelines for entry of NBFCs into insurance business was issued.
December 13, 2000	Financial Companies Regulation Bill, FCRB was introduced in the Lok Sabha. The Standing Committee on Finance submitted its report in July 2003, making 21 recommendations for amendments in the FCRB. The Committee recommended that only deposit taking companies should be covered under the new legislation.
June 27, 2001	The concept of asset liability management was introduced in 2001 for all NBFCs with asset base of ₹100 crore or holding public deposits of ₹20 crore or more.

Month / Year	Particulars
November 28, 2002	Venture Capital Fund Companies registered with SEBI and not holding public deposits were exempted from core provisions of RBI Act and Directions.
January 08, 2003	Stock broking companies, registered with SEBI and not holding public deposit were exempted from core provisions of RBI Act and Directions.
March 29, 2003	As part of implementation of the recommendation of the Working Group on Redesigning of Financial Statements of NBFCs, additional schedule to Balance Sheet of NBFCs was stipulated for all NBFCs.
June 18, 2003	In terms of amended FEMA Notification No. 94, dated June 18, 2003, Foreign Direct Investments (FDI) was permitted under automatic route for 18 specified NBFC activities subject to minimum capitalisation norms.
2004	Several all India associations and State level associations formed a Self Regulatory Organisation named Finance Industry Development Council (FIDC).
June, 2004	Discussions were held with NBFCs regarding their plan of action for voluntarily phasing out of their acceptance of public in line with international practices. NBFCs-ND were advised that they would require ₹2 crore NoF before applying for permission to accept public deposits.
February, 2005	The Government of India (GOI) was advised by RBI that a separate legislation, viz., FCRB 2000, for financial companies was not necessary since the initiatives taken by RBI and the change in the composition of the sector, had addressed the issues to a great extent.
September 06, 2005	A system of monitoring the capital market exposure of NBFCs-ND-SI through monthly returns was brought in.
December, 2005	The concept of Corporate Governance was introduced in 2005 with directions to rotate partners of statutory auditors after three years and further elaborated in August 2007.
September 28, 2006	Guidelines on Fair Practices Code was issued to NBFCs.
December 06, 2006	A new category of NBFCs formed as Asset Finance Companies by combining the classes of Equipment Leasing and Hire Purchase Companies.

Month / Year	Particulars
December 12, 2006	<ul style="list-style-type: none"> • Systemic significance of the sector was recognized and NBFCs with asset size of ₹100 crore and above classified as systemically important companies. • Capital adequacy requirements and credit concentration norms introduced. • NBFCs allowed to issue co-branded credit cards with scheduled commercial banks without risk sharing and with prior approval of RBI subject to certain eligibility criteria.
February 22, 2007	The need for differential regulation was recognized for deposit taking and non- deposit taking companies and separate prudential norms were issued for them in February 2007.
April 27, 2007	Submission of an annual statement of capital funds, risk asset ratio, etc., as at end of March every year in Form NBS-7 was stipulated for NBFCs-ND-SI.
August 01, 2008	<ul style="list-style-type: none"> • Guidelines for NBFC-ND-SI as regards capital adequacy, liquidity and disclosure norms was issued. • Increase in Capital adequacy to 12% w.e.f. March 31, 2010 and 15% w.e.f. March 31, 2011. • Introduction of ALM reporting and disclosure norms for NBFC-ND-SI.
September 24, 2008	NBFCs with asset size of ₹50 crore and above but less than ₹100 crore were advised to submit online, a quarterly return on important financial parameters.
October 29, 2008	NBFCs-ND-SI were permitted to issue Perpetual Debt Instruments (PDIs) in accordance with the guidelines issued.
September 17, 2009	Instructions on takeover/acquisition of a deposit taking NBFC, would require prior permission of RBI were issued.
September 18, 2009	NBFCs were allowed to participate in Interest Rate Futures market subject to prescribed conditions.
February 12, 2010	New class of NBFCs viz; IFCs introduced and eligibility criteria stipulated.
July 09, 2010	Issue of guarantees by NBFCs-ND-SI treated as akin to access to public funds for considering applications for special dispensation from exposure norms.
August 09, 2010	NBFCs permitted to participate in currency futures only for hedging.

Month / Year	Particulars
August 11, 2010	NBFCs-ND-SI permitted to participate in repo of corporate debt securities.
August 12, 2010 & January 05, 2011	Guidelines and Notification on Core Investment Companies (CICs) issued.
September 16, 2010	NBFCs permitted to participate in currency options for hedging.
January 17, 2011	Provisioning requirement for standard assets - a general provision at 0.25 per cent of the outstanding standard assets introduced.
Feb. 02, 2011	Gold loans not to be treated as agricultural loans and the priority sector status for such bank lending was removed (RPCD circular).
Feb. 17, 2011	CRAR requirement of NBFCs-D raised to 15% from the extant 12% w.e.f. March 31, 2012.
March 30, 2011	NBFCs were prohibited from contributing capital to any partnership firm or to be partners in partnership firms.
May 27, 2011	Contribution made by the group entities in an insurance JV along with the NBFC brought within the ceiling of 'not more than 50% of the paid up equity capital of the insurance JV'. Group concept in this case has been revised on the lines of CICs.
February 6, 2013	Report of the Working Group to Study the Issues Related to Gold Imports and Gold Loans NBFCs in India
2016	<p>Various Master Directions were issued by the RBI:</p> <ul style="list-style-type: none"> • Mortgage Guarantee Companies (Reserve Bank) Directions, 2016 • Information Technology Framework for the NBFC Sector • Mortgage Guarantee Companies (Reserve Bank) Directions, 2016 • Monitoring of Frauds in NBFC (Reserve Bank) Directions, 2016 • Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016 • Non-Banking Financial Company-Account Aggregator (Reserve Bank) Directions, 2016 • Non-Banking Financial Company-Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 • Non-Banking Financial Company-Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016

Month / Year	Particulars
	<ul style="list-style-type: none"> • Residuary Non-Banking Financial Company (Reserve Bank) Directions, 2016 • Standalone Primary Dealers (Reserve Bank) Directions, 2016 • Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 2016 • Exemptions from the provisions of RBI Act, 1934 • Core Investment Companies (Reserve Bank) Directions, 2016 • Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016
February 23, 2018	Ombudsman Scheme for Non-Banking Financial Companies, 2018
July 27, 2018	Standalone Primary Dealers (SPDs) were permitted to offer foreign exchange products to their foreign portfolio investor (FPI) clients.
October 25, 2018	Directions on fit and proper criteria for sponsors of ARCs registered under the SARFAESI Act were issued.
November 29, 2018	Minimum holding period (MHP) requirement for securitisation transactions related to loans of original maturity above 5 years were relaxed for a period of six months.
February 22, 2019	<ul style="list-style-type: none"> • All systemically important non-deposit taking NBFCs were advised to take appropriate action as envisaged under Interest Subvention Scheme for micro, small and medium enterprises (MSMEs) announced by the Government of India. • Harmonisation of regulations governing AFCs, LCs and ICs were undertaken along with merging these into a new category called NBFC – Investment and Credit Company (NBFC – ICC).
February 22, 2019	In order to provide NBFCs with greater operational flexibility, harmonisation of different categories of NBFCs into fewer ones shall be carried out based on the principle of regulation by activity rather than regulation by entity. Accordingly, it has been decided to merge the three categories of NBFCs viz. Asset Finance Companies (AFC), Loan Companies (LCs) and Investment Companies (ICs) into a new category called NBFC - Investment and Credit Company (NBFC-ICC) .

Month / Year	Particulars
February 22, 2019	<p>Risk Weights for exposures to NBFCs:</p> <p>Exposures to all NBFCs, excluding Core Investment Companies (CICs), will be risk weighted as per the ratings assigned by the rating agencies registered with SEBI and accredited by the Reserve Bank of India, in a manner similar to that of corporates.</p>
April 16, 2019	<p>Systemically important non-deposit taking investment and credit companies were made eligible for Authorised Dealer – Category II (AD – Cat. II) license subject to meeting certain conditions.</p>
April 26, 2019	<p>Extension of Ombudsman Scheme for Non-Banking Financial Companies, 2018:</p> <p>RBI directed that the NBFCs Non-banking Financial Companies, as defined in Section 45-I(f) of the Reserve Bank of India Act, 1934 and registered with the RBI under Section 45-IA of the Reserve Bank of India Act, 1934 which (a) are authorised to accept deposits; (b) are Non-Deposit Taking Non-Banking Financial Companies having customer interface, with assets size of Rupees 100 crore or above, as on the date of the audited balance sheet of the previous financial year, or of any such asset size as the RBI may prescribe, will come within the ambit, and shall comply with the provisions of the Ombudsman Scheme for Non-Banking Financial Companies, 2018.</p>
May 8, 2019	<p>NBFCs registered with the Reserve Bank were advised to report cyber security related incidents in electronic format.</p>
May 16, 2019	<p>NBFCs with asset size of more than ₹50 billion were advised to appoint a chief risk officer (CRO) with clearly specified role and responsibilities.</p>
May 29, 2019	<p>Relaxations related to MHP requirement for securitisation transactions were extended till December 31, 2019.</p>
June 28, 2019	<p>ARCs were permitted to acquire financial assets from other ARCs subject to certain conditions</p>
May 16, 2019	<p>Risk Management System – Appointment of Chief Risk Officer (CRO) for NBFCs</p>
November 6, 2019	<p>Report of the working Group on Core Investment Companies</p>

4. Important Committees and their Recommendations on NBFCs Framework

4.1 *The Central Banking Enquiry Committee⁴ (1931)*

The Central Banking Enquiry Committee recognised the need to integrate the unorganised and organised sectors of money market. The committee suggested that the indigenous bankers should be linked with the RBI. The RBI prepared a scheme for direct linking with the various indigenous bankers on certain terms and conditions, which the indigenous bankers did not accept and thus the efforts made by the RBI to integrate them into the organised money market did not succeed.

4.2 *Banking Commission (1972)*

The Banking Commission under the Chairmanship of Shri R.G. Saraiya, recommended setting up of a Credit Intelligence Bureau as a statutory body which would furnish adequate and reliable credit information to banks and other financial institutions.

4.3 *James S. Raj Committee (1975)*

In early 1970s, Government of India asked Banking Commission to Study the Functioning of Chit Funds and examining activities of Non-Banking Financial Intermediaries. In 1972, Banking Commission recommended Uniform Chit Fund Legislation to whole country. Reserve Bank of India prepared Model Bill to regulate the conduct of chit funds and referred to study group under the Chairmanship of James S. Raj. In June 1974, study group recommended ban on Prize Chit and other Schemes and requested the Parliament to enact a bill which ensures uniformity in the provisions applicable to chit funds throughout the country. Parliament enacted two Acts. Prize Chits and Money Circulation Schemes (Banning) Act, 1978 and Chit Funds Act, 1982.

4.4 *Sukhamoy Chakravarty Committee (1984)*

In December 1982, Dr. Manmohan Singh, the then Governor of RBI appointed committee under the Chairmanship of 'Prof. Sukhamoy Chakravarty' to review functioning of monetary system in India.

The Committee recommended assessment of links among the Banking Sector, the Non-Banking Financial Institutions and the Un-organised sector to evaluate various instruments of Monetary and Credit policy in terms of their impact on the Credit System and the Economy.

The Committee recommended for the introduction of a system of licensing (based on the level of business) for NBFCs in order to protect the interests of depositors.

4.5 *Vaghul Committee⁵ (1987)*

The Vaghul Committee (1987) suggested that call money market should be purely an inter-bank market and therefore, the restrictions on entry into call market prevailing at that point of time should continue. The essential rationale for such recommendation was that freeing of entry into the call market coupled with allowing call money rates to be determined entirely by market forces at a time when deposit rates of banks were

4 <https://www.gr8ambitionz.com/2014/09/indigenous-bankers-rbi-and-banking.html>

5 Report of the Technical Group on Phasing Out of Non-banks from Call/Notice Money Market (March 2001), dated 29th March, 2001.

administered would lead to, it was apprehended, substantial diversion of funds from the bank deposit segment to the call money market segment which would raise the cost of funds to banks markedly. Therefore, while the Vaghul Committee decided in favour of making the call money market a pure inter-bank market, it felt that LIC and UTI which had been permitted in the market as lenders in 1971 would gradually come out of the market as other money market instruments develop with wider array of maturities.

4.6 Narasimham Committee (NC-I) (1991)

Narasimham Committee (1991) outlined a regulatory framework for streamlining the functioning of the NBFCs. Accordingly, the Committee recommended for the introduction of capital adequacy, debt-equity ratio, credit-concentration ratio, adherence to sound accounting practices, uniform disclosure requirements and assets valuation. Further, it also stressed that the supervision of these institutions should come within the purview of an agency to be set up for this purpose under the aegis of Reserve Bank of India.

4.7 A.C. Shah Committee (1992)

The Working Group headed by Shri A.C. Shah, in 1992, had observed that classifying NBFCs into various categories had become out of date and it was time to bring in uniform regulations as far as possible for all NBFCs.

Following the recommendations of the Working Group on Financial Companies constituted in April 1992 (Chairman: A.C. Shah), a system of registration was introduced in April 1993 for NBFCs with Net Owned Funds (NOF) of ₹50 lakh and above.

4.8 Khanna Committee⁶ (1995)

The Reserve Bank constituted an Expert Group in April 1995 for designing a supervisory framework for the NBFCs (Khanna Committee) to suggest the off-site surveillance and the on-site examination system based on their asset size and the nature of business conducted by them. Accordingly, an Ordinance was promulgated by the Government in January 1997 and subsequently, it was replaced by an Act in March 1997 by effecting comprehensive changes in the provisions contained in Chapter III-B and Chapter V of the Act by vesting more powers with the RBI.

The amended Act provided, *inter alia*, for:

- (i) Compulsory Registration of NBFCs and a minimum NOF of ₹25 lakh as entry point norm;
- (ii) Maintenance of liquid assets by NBFCs as a percentage of their deposits in unencumbered approved securities (Government securities/guaranteed bonds);
- (iii) Creation of a reserve fund and compulsory transfer of at least 20 per cent of the net profits to aforesaid fund;
- (iv) Authorising Company Law Board (CLB) to direct a defaulting NBFC to repay deposits; and
- (v) Vesting the Reserve Bank with the powers to:
 - (a) issue directions to NBFCs regarding compliance with the prudential norms;

⁶ RBI Working Paper Series No. 21 Inter-connectedness of Banks and NBFCs in India: Issues and Policy Implications, dated 2nd January, 2012.

- (b) issue directions to NBFCs and their Auditors on matters relating to balance sheet and undertake special audit as also to impose penalty on erring auditors;
- (c) prohibit NBFCs from accepting deposits for violation of the provisions of the RBI Act and direct NBFCs not to alienate their assets;
- (d) file winding up petition against NBFCs for violations of the provision of the Act/directions;
- (e) impose penalty directly on NBFCs for non-compliance with the provisions of the Act.

Thus, with the amended Act came into existence since January 1, 1998, the whole gamut of regulatory focus got redefined primarily to focus on NBFCs accepting public deposits. Accordingly, prudential norms pertaining to income recognition, asset classification and provisioning were prescribed in January 1998 and for the first time, assets of NBFCs were put under comprehensive regulatory regime (RBI, 1999).

4.9 *Narasimham Committee (NC-II) (1998)*⁷

- Mergers between banks and between banks and DFIs and NBFCs need to be based on synergies and locational and business specific complementarities of the concerned institutions and must obviously make sound commercial sense.
[A non-banking finance company has since been permitted to merge with a bank. Two banks in the private sector have also merged based on synergies and business specific complementarities.]
- All NBFCs are statutorily required to have a minimum net worth of ₹25 lakhs if they are to be registered. The Committee is of the view that this minimum figure should be progressively enhanced to ₹2 crores which is permissible now under the statute and that in the first instance it should be raised to ₹50 lakhs.
[In respect of new NBFCs, which seek registration with the RBI and commence the business on or after April 20, 1999 the criteria in regard to minimum net worth has been increased to ₹2 crore, vide the Monetary and Credit Policy for the year 1999-2000. (Circular MPD.BC.185/07.01.279/98-99, dated 20th April, 1999)]
- Deposit insurance for NBFCs could blur the distinction between banks, which are much more closely regulated, and the non-banks as far as safety of deposit is concerned and consequently lead to a serious moral hazard problem and adverse portfolio selection. The Committee would advise against any insurance of deposits with NBFCs.
[The recommendation on not providing insurance cover for deposits with NBFCs has been noted.]
- The Committee recommends that an integrated system of regulation and supervision be put in place to regulate and supervise the activities of banks, financial institutions and non-banking finance companies (NBFCs). The functions of regulation and supervision are organically linked and we propose that this agency be renamed as the Board for Financial Regulation and Supervision (BFRS) to make this combination of functions explicit. An

⁷ <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/24157.pdf>

independent regulatory supervisory system which provides for a closely coordinated monetary policy and banking supervision would be the ideal to work towards.

[BFS needs to be strengthened before regulatory functions are vested with it. It was, therefore, felt that while the Committee's recommendations to set up an agency named Board for Financial Regulation and Supervision (BFRS) to provide an integrated system of regulation and supervision over banks, FIs and NBFCs could be a long-term objective. For the time being, BFS may continue with its present mandate.]

4.10 C.M. Vasudev Committee (1998)

The deposit directions for NBFCs were issued by RBI in January 1998 which had introduced several new approaches to the regulation of acceptance of public deposits by NBFCs. It broadly segregates NBFCs into two categories viz. 'public deposit taking' and 'non-public deposit taking'. The companies although the deposit directions were well intended with main thrust at protecting the depositors, there was a perception in a section of the industry that the regulatory prescriptions were somewhat over-restrictive and stunted the growth of reasonably good and healthy NBFCs.

To look into the issues arising out of this feeling and other related issues, Government of India had appointed a Task Force under the Chairmanship of Shri C.M.Vasudev in pursuance of the recommendations of the Task Force, RBI, on December 18, 1998, has made certain relaxations, especially in respect of Equipment Leasing and Hire Purchase Finance Companies, with regard to ceilings on deposits and compulsory credit rating. RBI also accepted the other recommendations of the Task Force and implemented them including those which are structural in nature.

4.11 V.S.N. Murthy Committee (1999)

The Khanna Committee made some recommendations which impinged on the role of statutory auditors in regulation of NBFCs. The ICAI, while welcoming the recommendations had suggested that a study group may be constituted with members from both RBI and the ICAI to deliberate in detail about the various recommendations of the Khanna Committee.

Accordingly, a Committee was constituted under the Chairmanship of V.S.N.Murthy to go into the various aspects relating to the issue of bringing in more transparency in the financial statements of NBFCs.

The recommendations suggested by the V.S.N. Murthy Committee are appended below:

- As a consequence of the recommendations of the Expert Group on Designing a Supervisory Framework for NBFCs (Chairman: Shri P.R. Khanna) and amendments to RBI Act in 1997, it was decided, in consultation with The Institute of Chartered Accountants of India (ICAI), to design and prescribe separate formats of financial statements for the NBFCs.
- In the post-1997 period, the main thrust of the Reserve Bank's policy has primarily been to continue to provide indirect protection to the depositors through strengthening the financials of NBFCs and creating an environment where they function on healthy lines.

- The multifarious categories of companies with *inter se* classification based on the nature of their activity and deposit acceptance modalities have resulted in a somewhat diverse regulatory regime. The consolidation process has, however, begun with entry point barriers and putting in place comprehensive deposit regulation measures. This is expected to streamline the functioning of the sector and, over a period, enable the regulators to introduce the de-categorisation measures and bring in homogeneity in the sector.
- The formats of financial statements, specified in Schedule VI to the Companies Act, 1956 (presently used by the NBFCs for preparing their financial statements) have been principally designed in the context of non-banking non-financial companies and do not focus on capturing the type of activities specific to NBFCs. In view of this, the financial statements prepared by NBFCs in terms of the provisions of the Companies Act are considered to be inadequate.
- Section 45MA(1A) and 45Q of the RBI Act read with the proviso to sub-sections (1) and (2) of Section 211 of The Companies Act, 1956 gives sufficient powers to Reserve Bank to prescribe a separate set of financial statements to NBFCs.
- It is recommended that NBFCs should prepare their financial statements in the formats proposed in the Annexure to this Report. It has been suggested in the proposed formats that in case of composite companies, i.e., companies whose principal business is financial but which are also engaged in non-financial business, details relating to their non-financial business should be furnished additionally as per the requirements of Schedule VI to the Companies Act, 1956. The proposed formats which would be prescribed by Reserve Bank should only substitute Schedule VI and the other relevant provisions of the Companies Act would continue to apply *mutatis mutandis*.
- The proposed formats should be made applicable to all the NBFCs which are required to be registered with the Reserve Bank irrespective of their net owned fund or asset size. Consequently, it is recommended that prudential norms directions be also made applicable to all the NBFCs.
- The proposed formats of financial statements need not be made applicable to such NBFCs as are exempted (viz. Miscellaneous Non-Banking Companies, Nidhis, Housing Finance Companies) from registration with RBI and other core provisions of the RBI Act/Directions issued thereunder.
- There is a need to frame guidelines defining the term 'Principal Business' for the purpose of identifying an NBFC (especially in case of composite companies). Having regard to all the relevant aspects, the Committee feels that the 'Principal Business' of a company should be determined using solely the asset criteria and accordingly a company should be treated as an NBFC if it has financial assets to an extent of not less than 40 per cent of the total tangible assets. Once identified as an NBFC it should remain so classified till a period of three years or till such time it brings down its public deposits to the level prescribed under the Companies (Acceptance of Deposits) Rules, 1975, whichever is later.
- While the proposed formats of financial statements for NBFCs broadly follow the formats in Schedule VI to the Companies Act, 1956, there are some important additional disclosures that have been recommended; which are:

- (a) Maturity profile of assets and liabilities
 - (b) Concentration of assets and liabilities
 - (c) Classification of liabilities based on nature and source
 - (d) Overdue loans and other credits
 - (e) Amount of Non-Performing Assets under various asset type
 - (f) Details of valuation of investments
 - (g) Provisioning for NPAs and diminution in value of investments
 - (h) Cash flow statement
 - (i) Statement of Net Owned Fund (NOF) as per the RBI Act
 - (j) Statement of Capital Adequacy Ratio
 - (k) Details of SLR compliance
- It is recommended that the amount of provision to be made in respect of accounting for taxes on income should be made in accordance with the tax effect accounting methods as per the guidance note/accounting standard issued by ICAI, instead of the existing tax payable method.
 - For the sake of uniformity in the entire financial system, the Committee recommends that all NBFCs should prepare the audited financial statements as of March 31, every year (para 5.23).
 - It is recommended that NBFCs having assets size of ₹50 crore and above should constitute an Audit Committee of the Board.
 - As specific directions have been issued to the statutory auditors of NBFCs under the RBI Act, the Committee does not recommend any Long Form Audit Report (on the lines of banks) to be submitted by the auditors.

4.12 Usha Throat Committee (2011)⁸:

Key recommendations of the Working Group are:

- The minimum net owned fund (NOF) requirement for all new NBFCs wanting to register with the Reserve Bank could be retained at the present ₹2 crore till the Reserve Bank of India Act is amended. The Reserve Bank of India should, however, insist on a minimum asset size of more than ₹50 crore for registering any new NBFC. Existing NBFCs below this limit may deregister or be asked to seek a fresh certificate of registration at the end of two years;
- NBFCs not accessing public funds may be exempted from registration provided their assets are below ₹1000 crore;
- Any transfer of shareholding, direct or indirect, of 25 per cent and above, change in control, merger or acquisition of any registered NBFC should have prior approval of the Reserve Bank;
- The twin-criterion of assets and income for determining the principal business of an NBFC should be increased to 75 per cent of the total asset and 75 per cent of the total income, respectively. A time period of three years may be given to fulfil revised principal business criteria;

8 RBI Press Release: 2011-2012/319, dated 29th August, 2011

- Tier I capital for Capital to Risk Weighted Assets Ratio (CRAR) purposes may be specified at 12 per cent to be achieved in three years for all registered deposits taking and non-deposit taking NBFCs;
- Liquidity ratio may be introduced for all registered NBFCs such that cash, bank balances and holdings of Government securities fully cover the gaps, if any, between cumulative outflows and cumulative inflows for the first 30 days;
- Asset classification and provisioning norms similar to banks to be brought in phased manner for NBFCs. Suitable income-tax deduction akin to banks may be allowed for provisions made under the regulations. Accounting norms applicable to banks may be applied to NBFCs;
- NBFCs may be subject to regulations similar to banks while lending to stock brokers and merchant banks and similar to stock brokers, as specified by the Securities and Exchange Board of India (SEBI), while undertaking margin financing;
- Financial conglomerate approach may be adopted for supervision of larger NBFCs that have stock brokers and merchant bankers in the group;
- Government owned entities that qualify as NBFCs may comply with the regulatory framework applicable to NBFCs at the earliest.
- Board approved limits for bank's exposure to real estate may be made applicable for the bank group as a whole, where there is an NBFC in the group. The risk weights for NBFCs that are not sponsored by banks or that do not have any bank as part of the group may be raised to 150 per cent for capital market exposures and 125 per cent for Commercial Real Estate (CRE) exposures. In case of bank sponsored NBFCs, the risk weights for Capital Market Exposures (CME) and CRE may be the same as specified for banks;
- NBFCs may be given the benefit under Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002;
- Captive NBFCs, the business models of which focus mainly (90 per cent and above) on financing parent company's products, may maintain Tier I capital at 12 per cent from the time of registration. Supervisory risk assessment of such companies should take into account the risk of the parent company;
- For the purpose of applicability of registration and supervision, the total assets of all NBFCs in a group should be taken together to determine the cut off limit of ₹100 crore;
- All NBFCs with assets of ₹1000 crore and above, whether listed or not, should be required to comply with Clause 49 of SEBI Listing Agreements including mandatory disclosures;
- Disclosure for NBFCs with assets over Rs. 100 crore may include provision coverage ratio, liquidity ratio, asset liability profile, extent of financing of parent company products, movement of non-performing assets (NPAs), off-balance sheet exposures, structured products and securitisations/assignments.
- NBFCs with assets of ₹1000 crore and above should be inspected comprehensively on an annual basis with an annual stress test carried out to ascertain their vulnerability.

4.13 K.U.B. Rao Committee (2013)⁹:

The Committee was assigned with the task of studying whether large gold imports of India are a threat to external stability. The Working Group was also asked, among other things, to study the recent trends in gold loans extended by large gold loan NBFCs and see whether there are any systemic stability issues that arise out of the interconnectedness between banks and gold loans NBFCs.

The key recommendations given by the committee are as under:

- There is a need to moderate the demand for gold imports considering its impact on the current account deficit
- Fiscal measures to reduce the gold imports may be revisited
- Banks need to design innovative financial instruments that can provide real returns to investors
- Need to convert both rural and urban demand for gold into investment in gold-backed financial instruments through dematerialisation of gold
- Introduction of tax incentives on instruments that can impound idle gold may be considered
- There is a need to recycling of domestic scrap gold
- Limits on the volume and value of gold to be imported by banks may be considered, if required under extreme situation
- Consider imposing export obligation on bulk gold importers
- Banks may expand their gold jewellery loan portfolio to monetise the stocks of idle gold
- The debate on setting up of a gold bank may be revisited
- Banks may continue their role as nominated agencies in gold imports
- Differential pricing of banking services and finance for gold imports may be considered
- Bank finance to purchases of gold bullion may be prohibited
- There should not be any curb or limits on advances against gold jewellery and gold coins by individuals
- Banks may continue retailing of gold coins, given their small volume
- There is no strong case to exempt Metal Gold Loans from the base rate stipulations
- There is an imperative need to consider introducing new gold-backed financial products to unlock the hidden economic value in the idle gold in the economy
- Products like Gold Accumulation Plan, Gold Linked Account, modified Gold Deposit and Gold Pension Product may be considered for introduction
- Careful evaluation of each of the proposed gold-backed product is critical
- The rapid growth of the assets, borrowings and branch network of gold loan NBFCs need to be monitored continuously

9 RBI Press Release : 2012-2013/1120, dated 2nd January, 2013.

- Need to reduce the interconnectedness of gold loan NBFCs with the formal financial system gradually
- Declining capital adequacy ratio – Need to improve the capital of gold loan NBFCs
- Need to review the current stipulations pertaining to raising of resources through NCDs by gold loan NBFCs
- The exemption available to secured debentures from the definition of “deposit” may be reviewed
- There is a need for monitoring transactions between gold loan NBFCs and unincorporated bodies
- Though leverage of the gold loan NBFCs is not a cause for concern at the present juncture, going forward, there is a need for improving owned funds of the NBFCs
- There is a need to thoroughly review the operational practices followed by gold loans NBFCs
- There is a need to ensure transparent communication of loan terms by gold loans NBFCs
- Institution of a customer complaints and grievances redressal system by gold loans NBFCs is important
- Need to review the auction procedure by gold loans NBFCs
- Location of auctions should be same Taluka where the borrower is located
- Post-auction safeguards to be followed by gold loans NBFCs
- Better disclosure standards to be followed by gold loans NBFCs
- Monitoring the implementation of the Fair Practices Code
- Standard documentation to be followed by gold loans NBFCs
- Use of PAN Card for large gold loan transactions
- Payment through cheque for large gold loan transactions
- As of now, there is no case for conceding level playing field for the gold loan NBFCs with the banks
- There is a case for review of the extant ‘loan to value ratio’
- There is need for a clearly-defined and standardised concept of the term ‘Value’ for prescribing appropriate ‘Loan to Value Ratio’
- Unbridled growth of branches by large gold loan NBFCs needs to be moderated
- There is a need for an ombudsman to address the grievances of gold loan borrowers
- Rationalisation of interest rate structure by gold loans NBFCs

Major Conclusions

- Gold loans have a causal impact on gold imports substantiating the emergence of a liquidity motive for holding gold

- International gold prices and exchange rate significantly and positively affect the gold prices in India
- Increase in gold prices appears to be one factor that increase the gold loans outstanding
- Increase in gold loans extended by NBFCs and banks does not impact significantly the gold prices in India
- On the basis of empirical analysis of volatility in gold price, it is difficult to estimate future prices of gold
- Going by the past trends, a sharp sudden drop in gold price by 30 to 40 per cent is a remote possibility causing financial distress to the gold loan NBFCs
- The extant loan to value ratio (LTV) ratio should provide a reasonable risk cover in case the gold prices fall by 10 per cent
- Asset quality, NPAs as per cent of total credit exposure and Capital adequacy of gold loan NBFCs are not a cause for concern at present
- The sources of funds of gold loan NBFCs do not appear to be an immediate cause of concern giving rise to concentration credit risk
- The striking growth of gold loan NBFCs business warrant that their operations may be closely monitored
- Some gold loan NBFCs have been raising public deposits surreptitiously through unincorporated bodies raising concerns
- Banking sector's existing exposure in the form of their individual gold loans appears small and may not have any significant repercussions for the stability of the banking sector at present
- Probability of volatility in gold prices impacting the gold loan market is low
- Gold loans NBFCs are subjected to prudential regulations and reporting requirements
- Gold loans NBFCs are doing a socially useful function and that provides a strong rationale for a careful regulation of the activities of these NBFCs
- The recent slew of regulatory measures taken by RBI on the functioning of the gold loan NBFCs may be continued to ensure a healthy growth of the sector in the medium and long-term

4.14 Nachiket Mor Committee (2013-14)¹⁰:

Committee on Comprehensive Financial Services for Small Businesses and Low Income Households (commonly known as the Nachiket Mor Committee) was an expert committee formed by Raghuram Rajan on 23rd September, 2013, after he was appointed as the Governor of the Reserve Bank of India (RBI). It was headed by Nachiket Mor. The objective of the panel was to study various aspects of financial inclusion in India. The panel submitted its final report on 7th January, 2014.

The Committee recognises that a partial convergence of NBFC and Bank regulations may be desirable. It recommended the following:

¹⁰ Chapter 4.7. of Report on Comprehensive Financial Services for Small Business and Low Income Households