

Investigation into NBFCs

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A NBFC is a business entity whether incorporated under the Companies Act, 1956 or not which devotes its resources in providing to the society the financial services of various descriptions that are distinct from normal banking services.

Non Banking Finance companies are allowed to collect Deposits from General Public after complying with various provisions of the Companies Act and after filing all the requirements as per the guidelines issued by the Reserve Bank of India. It is to be noted that to raise deposits from the general public by giving an advertisement, the person soliciting deposits should file all the relevant documents with the Reserve Bank of India, obtain clearances and then only issue an advertisement.

Only those NBFCs who are registered with the Reserve Bank of India and who have complied with the requirements of credit rating satisfactory grade and prudential norms are given freedom to offer interest rate (with an upper ceiling of 11.00% prescribed) on deposits exceeding the period of one year and not exceeding the period of 5 years. The above rate is applicable to those deposits accepted or renewed by the NBFCs after 4th March 2003. NBFCs are free to offer lesser rate of interest also at their convenience. NBFCs raise deposits from the general public by issuing advertisements and thereafter invest the same in various businesses for which the companies are formed.

NBFCs comprise the business organizations carrying on activities like –

- Hire Purchase Finance
- Investment Activity
- Loan granting activity
- Mutual fund finance
- Equipment Lease finance
- Housing Finance
- Insurance Business

NBFCs not falling under the above categories are called RESIDUARY NBFCs

The following are the Books and Records normally maintained by a Non Banking Finance Company –

- Cash Book & Bank Book
- Depositors' Ledger
- Due Date & Renewal Register
- Interest Register
- Loan Ledger
- Investment Ledger
- General Ledger

PUBLIC DEPOSIT ACCEPTANCE NORMS

- An NBFC having Net Owned Funds of Rs. 200.00 lakhs and above only can accept Public Deposits
- It has obtained Minimum Stipulated Credit Rating from any one of the approved Credit Rating Agencies at least once in a year
- Copy of the Credit Rating should be sent to the RBI along with the Return on Prudential Norms.
- If the Credit Rating is either down graded or upgraded, the NBFC is required to report this fact to the RBI within 15 days from the date when it receives such information.
- It is to be noted that the deposits taken by the NBFCs are repayable on demand and the Minimum period for which Public Deposits can be accepted is not less than 12 months with a maximum period of 84 months.
- There is a ceiling provided for the quantum of deposits accepted by NBFCs.
 - Hire Purchase & Leasing Companies: 1.5 times of their Net Owned Funds or Rs. 10.00 Crores whichever is less. Such companies can accept or renew deposits up to 4.00 times of their Net Owned Funds provided they obtain minimum investment grade of credit rating.
 - Loan Companies and Investment Companies: 1.5 times of their Net Owned Funds.

Receipt to be issued to Depositor

NBFCs are required to issue a receipt to each depositor in respect of each deposit accepted. This receipt is required to be signed by the authorized official of the Company. The receipt should consist of the following particulars

- Date of Receipt
- Name of the Depositor
- Amount of Deposit in words and figures
- Rate of Interest
- Maturity Date

NBFCs are required to maintain a Register of Deposits consisting of the details of the depositor and the deposits along with all particulars.

Payment of Brokerage

NBFCs are not allowed to pay more than 2% of the deposit amount in the form of any brokerage to any broker on the public deposits collected by or through him and reimbursement of expenditure shall be given to a maximum extent of 0.5% of the deposits collected by or through him.

ADVERTISEMENT

NBFCs are required to issue an advertisement for acceptance of public deposits and this should be informed to the Reserve Bank of India.

Form and particulars of advertisement

- Every company intending to invite or allowing or causing any other person to invite or cause to be invited on its behalf, any deposits from the public, other than its directors, shareholders or employees shall issue an advertisement for the purpose in a leading English newspaper and one vernacular newspaper circulating in the State in which the registered office of the company is situate.
- No such company shall issue or allow any other person to issue or cause to be issued on its behalf, any advertisement inviting deposits unless such advertisement is issued on the authority and in the name of the board of directors of the company and contains a reference to the conditions subject to which deposits shall be accepted by the company, the date on which the said board of directors has approved the text of the advertisement and the following information, namely: -
 - The name of the company;
 - The date of incorporation of the company;
 - The business carried on by the company and its subsidiaries with details of branches or units, if any;
 - Brief particulars of the management of the company;
 - Names, addresses and occupations of the directors;
 - Profits of the company before and after making provisions for tax for the three financial years immediately preceding the date of advertisement;
 - Dividends declared by the company in respect of the said years;
 - A summarised financial position of the company as in the two audited balance sheets immediately preceding the date of advertisement.

VALIDITY OF THE ADVERTISEMENT

An advertisement issued in accordance with these rules shall be valid until the expiry of six months from the date of closure of the financial year in which it is issued or until the date on which the balance sheet is laid before the company in general meeting or where the annual general meeting for any year has not been held, the latest day on which that meeting should have been held in accordance with the provisions of the Companies Act, 1956 (1 of 1956), whichever is earlier, and a fresh advertisement shall be made in each succeeding financial year for invitation of deposits during that financial year.

Copy of the advertisement to be filed with the Reserve Bank

No advertisement shall be issued by or on behalf of company unless on or before the date of its issue, there has been delivered to the Regional Office of the 3[Department of Financial Companies] of the Reserve Bank of India within whose jurisdiction the registered office of such company is situate, a copy thereof signed by a majority of the directors constituting the board of directors which approved the advertisement or by their agents authorized in writing.

ACCEPTANCE OF DEPOSITS BY UNINCORPORATED BODIES

1. Individuals, Firms or an unincorporated Association of Individuals shall not accept any deposits if his or their business wholly or partly includes any of the activities mentioned in Section 45 I of the RBI Act.
2. Such people cannot accept deposits if his or its principal business is that of receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner.
3. Existing Registered Unincorporated Bodies and Individuals who carryout eligible business can accept deposits from a maximum of 25 depositors in the case of an Individual and 25 depositors per partner in the case of a Partnership Firm.

DEFAULTS MADE BY COMPANIES

Generally Companies commit frauds by receipt of deposits in contravention of Chapter IIIB and in issuance of advertisements / prospectus by violating provisions of Section 45NA. The penalty is Rs. 5.00 lakhs or double the amount of deposits received in contravention of the provisions, whichever is higher. In addition, various other penalties are provided for various offences, which were already provided elsewhere.

- **Leasing Company** – A leasing company enters in to arrangement, which provides an enterprise with the use and control over assets without receiving title to them. This arrangement could be oral or written allowing the use of assets for a specified period of time. The lessee does not get the final ownership. Leasing involves the use of an asset without assuming or intending to assume, ownership. **Frauds committed by Leasing Companies** –Leasing Companies follow dubious practices in providing lease assets to customers. They provide accommodation papers and furnish documents to various customers who require the same for obtaining loans from banks and financial institutions. The customers who obtain loans in such a fashion would in most of the cases be fraudulent and would not repay the monies. The Leasing Companies show losses in such peoples name and eat away the public deposits. Unless the investigating officer goes in to the details of the customers who obtained leased assets from the Leasing Company, it is impossible to trace out the frauds done by the Leasing Company from the documents maintained by it.
- **Investment Company etc.** – Investment companies assume different shapes and perform different activities although their sole objective is to invest the collected funds in securities on behalf of their clients. Generally, these companies do investment portfolio management and are licensed by SEBI as portfolio managers. These companies deal directly in both primary and secondary capital markets and invest collected funds in units of mutual funds and money market instruments. It may be noted that though they are licensed by SEBI it cannot be an accepted rule that these companies do not commit frauds.

The funds collected by the company are misappropriated by being invested in those shares or scrips, which do not carry the value at which the amounts are invested. This is done against gaining personal gains by the management of the investment company. Thus, after some time, the value of the shares or securities fall down resulting in reduction of the net asset value of the investment company raising the losses suffered. The ultimate effect is that the amounts collected from the general public are misappropriated and they are defrauded.

- **MUTUAL FUNDS** –Mutual Funds are corporations, which accept monies from savers and then use these monies to buy stocks, long-term bonds, short-term debt instruments issued by business units or government units, and these corporations pool funds and thus reduce risk by diversification.

Mutual funds, after collecting monies from the general public, to defraud with the monies accepted, invest the monies in non-government instruments and securities, at the prices, which are far more than the market prices or the real value of the securities. Making a tie-up with the management of the companies seeking funds does this. As the real value is far lesser than the investment, the funds are misappropriated and hence, the funds of the general public are utilised for making personal profits by the management of the Mutual Funds. It may be noted that the transactions of a Mutual Fund can be kept track of by observing the movements in the net asset value of the units of the Fund and the portfolios held by them and also from the areas of business in which the Funds have invested the monies of the general public.

- **Acceptance Credit and Bill Discounting** – One of the major activities taken up by various NBFCs is Acceptance Credit and Bill Discounting.

The activity can be explained by an example –A is a company supplying materials to B. i.e. A raises a bill against B and A has to get the monies of sale from B. A comes to an NBFC for discounting the bill and receiving the payments before B has actually paid the same. When B pays the monies, the NBFC receives the money and charges interest or services charges for discounting the Bill.

When an NBFC pools up funds from general public and wishes to misappropriate the same, bills from various companies, which are either non-existent, or duplicate bills are discounted without bothering about the credit worthiness of the company or person seeking funds. Thus, the funds of the general public are at stake.

- **RESIDUARY NBFCs** - A Residuary NBFC not falling in any of the 7 categories explained, on and from 01-04-2003, will have to pay to the depositors deposited amounts on and from the above date, the interest, premium, bonus or any other advantage whatever name may be given, a minimum of 5% p.a. on the amounts deposited in lump-sum or at monthly or longer intervals and 3.5% p.a. on the amounts deposited under daily deposit schemes. Whereas, the NBFCs does not account for the deposits in a proper fashion and show lesser rates of amounts payable to the depositors.

RNBFCs can charge an amount of Rs. 80/- fixed, for every deposit of more than Rs. 500/- and not exceeding the amount specified. For deposits less than Rs. 500/-, the amount of Rs. 80/- shall be reduced proportionately.

What the Investigator has to verify –

Verify the Loan Ledger and find out the customers to whom the loans were given or in which companies investments are made.

Ascertain whether proper documentation has been obtained before advancing the loan amounts.

Ascertain whether there is any collusion between the Company and the borrower or the beneficiary.

Asset-liability mismatch

Generally bad economic environment: Over past couple of years, the economy itself has done pretty badly. The demand for capital equipment has been at one of the lowest ebbs. Corporates have found themselves in a general cash crunch resulting into sticky loans. Poor and premature credit decisions in the past: Most NBFCs have learnt a very hard way to distinguish between a good credit prospect and a bad credit prospect. When a credit decision goes wrong, it is trite that in retrospect, it invariably seems to be the silliest mistake that ever could have been made, but what Indian leasing companies have suffered are certainly problems of infancy. Credit decisions were based on a pure financial view, with asset quality taking a back seat.

BRANCHES AND APPOINTMENT OF AGENTS TO COLLECT DEPOSITS

No NBFC shall open its branch or appoint agents to collect deposits except as provided hereunder:

1. A non-banking financial company having the certificate of registration issued under Section 45 – IA of the Reserve Bank of India Act, 1934 (2 of 1934) and otherwise entitled to accept public deposits as per Paragraph 4(4) of these Directions, may open its branch or appoint agents if its
 - a) NOF is up to Rs. 50 Crores Within the State where its Registered Office is situated;
 - b) NOF is more than Rs. 50 crores and
and its credit is AA or above. Anywhere in India
2. (a) for the purpose of opening a branch, a non-banking financial company shall notify to the Reserve Bank of its intention to open the proposed branch;
- (b) on receipt of such advice, the Reserve Bank may, on being satisfied that in the public interest or in the interest of the concerned non-banking financial company or for any other relevant reasons to be recorded, reject the proposal and communicate the same to the non-banking financial company;

If no advice of rejection of the proposal under (b) above is communicated by the Reserve Bank within 30 days from the receipt of such advice, the non-banking financial company may proceed with its proposal

FOLLOWING IS THE BRIEF READY CHECKLIST FOR INVESTIGATORS VERIFYING THE AUTHENTICITY OF AN NBFC

VERIFY WHETHER

- The Company is Registered with the Reserve Bank of India
- The Company has achieved the Net Owned Funds of Rs. 25.00 lakhs
- The Net Owned Funds have not fallen below Rs. 25.00 lakhs at any time
- The Company is eligible to accept Public Deposits
- The Company has accepted the Public Deposits within the applicable limits which depends on the following factors
 - Net Owned Funds
 - Credit Rating
 - Capital Adequacy
- Credit Rating obtained by the company is valid
- The Company has filed advertisements before acceptance of Public Deposits
- The Company has issued fresh advertisement every year before its expiry
- The Company has treated the Public Deposits as it is or has classified it as Non public Deposits
- The Company has not accepted any deposits which are not repayable on demand
- The Company has not accepted any deposits the tenure of which is less than 12 months
- The interest paid is within the ceiling prescribed (prescribed on time to time basis) by RBI.
- Brokerage paid is within the ceiling of 2% of the Public Deposits
- Reimbursement of expenditure to brokers is within the ceiling of 0.5% of the Public Deposits
- Application forms supplied by the company to the Depositors consist of all the data required by NBFC Act.
- The changes in credit rating have been informed to the RBI within a period of 15 days of the date on which the company comes to know about the change.
- The Company which holds excess Public Deposits than the regular ceiling have regularized the deposits
- The Company has paid interest on Public Deposits regularly
- The Company renews the Public Deposits to give benefit of higher rate of interest to the depositor
- In case of failure of delayed payment of deposits, the company has paid interest from the date of maturity of deposit to the date of actual payment
- The Company maintains a minimum liquidity of 10% or higher percentage as stipulated by RBI from time to time with a Scheduled Bank at any time during the currency of its operations.

- The Company debits the amount of loans given to a separate account and not to the Deposits Accounts
- The company has not granted an amount of loan on deposits exceeding 75 percent
- The Company issues a receipt for the deposits received
- The receipt issued consists of the information required by the relevant acts and rules
- The company maintains a Register of Public Deposits consisting of necessary particulars
- The company maintains prescribed percentage of liquid assets in approved securities in accordance with the requirements
- The Company has designated one branch of scheduled commercial bank for the custody of securities and informed RBI about the same
- The company lodges the securities with the designated branch as said above
- The Company has transferred at least 20% of the profit after tax to the Reserve Fund
- The Company has furnished the Balance Sheet, Profit & Loss Account to the RBI within 15 days from the date of Annual General Meeting
- The Company has not extended credit exceeding 15% of its owned funds to a single party
- The Company has not extended credit exceeding 25% of its owned funds to a single group of borrowers
- The Company has not made investments exceeding 25% of its owned funds in the shares of any single group of companies
- The Company has not granted any loans against its own shares.

If all the above requirements along with the other requirements of the RBI, SEBI guidelines and regulations are satisfied, then only the Company can be provisionally called to have accepted the deposits in a correct manner.

An officer dealing the case of acceptance of deposits and the utilization of monies accepted as deposits, has to first verify the Books & Records (elsewhere mentioned in this material) and see that the provisions and regulations as stipulated by the Reserve Bank of India and the Securities Exchange Board of India as mentioned in the checklist and other applicable provisions are satisfied.

According to the recent guidelines issued by RBI, it has been provided that any complaint filed with the Police has to be registered and informed to the RBI and in turn RBI shall provide information in relation to the Group against which complaint has been filed, which will enable the Department to speed up the process of investigation or inquiry.

The role of NBFCs in our economy needs to be emphasized. They have supplemented the role played by the Banks. While functioning as financial intermediaries between the savers and the users, they cater to the different segments of the society. RBI allowed them to have a high gearing of ten times. This led to the promotion of finance companies by people who had nothing to do with finance business. They only want to collect money under the grab of NBFC for diversion. The directions governing the finance companies

are not comprehensive enough. So, something was bound to happen and what happened was not pleasing. Some companies promise unrealistic things. Some unscrupulous elements dupe the gullible people of their hard earned money. Hence, the reaction by the regulators becomes inevitable. Until the reaction comes in to effect and the NBFCs and finance companies are regulated properly, it is everybody's duty to take precautions and go further in matters relating to dealings with NBFCs.