

NOTES AND COMMENTS

NBFC REGULATION: MISTAKES OF THE PAST AND CHALLENGES OF THE FUTURE

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INTRODUCTION

After India has adopted the policy of economic liberalisation, the spotlight has been firmly focused on the financial markets and the regulatory system. 1997 will go down in history as the year of the 'CRB' scam. Chain Roop Bhansali, a Chartered Accountant from Sujangarh in Rajasthan, wove a web of financial deceit with a string of dummy companies he had floated over the last few years.

NBFCs - REGULATORY FRAMEWORK

a) Statutory Framework

The NBFCs come under the purview of Chapter III-B of the RBI Act, 1934 and directions issued thereunder. Section 45-I(e) specifies that a non-banking financial institution may be a company, corporation or a co-operative society.

b) Guidelines

There have been several directions issued under the various provisions in Chapter III-B which are quite exhaustive.¹ The Act and the Directions read together have had the effect of classifying the companies according to the business they carry on.² A point to be noted in this regard is that a company which carries on the business of agricultural operations, or industrial activity, or acquisition of immovable property is not an NBFC.³

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1 The relevant & important directions are:

- i) Non-Banking Financial Companies (Reserve Bank) Directions, 1977.
- ii) Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977.
- iii) Residuary Non-Banking Companies (Reserve Bank) Directions, 1987.

2 The NBFCs can be classified into:

- i) An equipment leasing company;
- ii) A hire purchase company;
- iii) A housing licence company;
- iv) An investment company;
- v) A loan company;
- vi) A mutual benefit financial company;
- vii) A miscellaneous NBFC (Chit Funds);
- viii) A residuary NBFC.

3 Section 45-I(c).

NBFCs - GROWTH AND REGULATION

From their inception in the mid 1970s, NBFCs have grown to occupy an important position in the financial markets. The Shah Committee Report noted that the number of NBFCs have grown from 7063 in 1981 to 24,009 in 1990, with an annual growth rate of 14%. The Deposits of NBFCs had grown ten-fold during this period. The deposits in NBFCs as a ratio of middle class savings, grew from 2% in 1981 to a staggering 7.9% in 1989-90.⁴ Their growth further accelerated in the 1990s, a fact reflected in the success of the CRB group. But, as the Shah Committee Report observed, the lack of regulation was one of the main reasons for this growth.

If one examines the history of NBFCs, it is not surprising that a scam occurred. In fact, the Supreme Court ten years ago speaking through Chinnappa Reddy, J. had observed,⁵ "We would also like to query what action the RBI and Union of India are taking or proposing to take against the mushroom growth of "finance and investment companies" offering staggeringly high rates of interest to depositors leading us to suspect whether these companies are not speculative ventures floated to attract unwary and credulous investors and capture their savings." He further observed,⁶ "While on the one hand these schemes encourage two vices affecting public economy, the desire to make quick and easy money and the habit of excessive and wasteful consumer spending, on the other hand the investors who generally belong to the gullible and less affluent classes have no security whatsoever. Action appears imperative."

Following this decision, the RBI came out with the RNBC Directions, 1987. But, the situation did not seem to improve. Five years later Ramaswamy J. observed "it is not uncommon that after collecting fabulous deposits, some unscrupulous people surreptitiously close the company and decamp with the collections keeping the depositor at bay. Therefore, the need to regulate the deposits, subscriptions, in particular, in private sector become imperative"⁷

Thus, it becomes fairly obvious that the NBFCs have acquired a dubious reputation over the years. They have shown a remarkable tendency to break rules and also exploit all the loopholes that an inefficient regulatory system seems to offer them.

THE CRB SCAM

Until January 1997, registration was not compulsory for NBFCs. This enabled CRB capital markets, an NBFC which collected deposits to operate in

4 *Id.*

5 *RBI v. Peerless General Life Insurance & Investment Co.*, AIR 1987 SC 1023 at p. 1043.

6 *Ibid.* at p. 1044.

7 *Peerless General Insurance & Investment Company v. RBI*, AIR 1992 SC 1033; This case came up because Peerless contested the application of RNBC Directions 1987 to one of their schemes. This decision has nothing in common with the 1987 decision.

the dark and indulge in malpractices. Bhansali started out with Rs. 4.58 crore as his deposit base, but by 1996 this had grown to an astounding Rs. 139.83 crores,⁸ largely due to the fact that he used to offer a relatively high interest rates of 7-10%. Under the existing NBFC (RBI) Directions, 1977, he could not offer an interest of more than 14%.⁹ But he circumvented this requirement by providing for staggered rates of interest i.e., higher the investment, the higher the interest rate, and those who could invest a lot of money (in violation of the law) were offered more than 14%.

Another significant development was the credit rating given to these deposits. CARE,¹⁰ a leading credit rating agency had always given the deposits of CRB capital markets an A+ rating. This, to the layman, meant that the deposit return was highly probable, both on the interest as well as the capital that had been invested. Though the credit rating came down after September 1996 as the irregularities came to the fore, during the boom time, the credit rating was the propeller drawing in the funds. Today, after the scam, the agency claims that it based its rating on the balance sheet as given by the auditors of CRB capital markets,¹¹ and repeated requests for more information were turned down. Thus based on information which was available, the deposit was given an A+ rating. This raises certain issues of regulation. Shouldn't non-disclosure of information, per se, be a ground of giving a below par rating? Shouldn't more care be exercised in giving such ratings? The crux of the issue is that in the mind of the investor a good rating makes up for the lack of reliability and safety which are there in bank deposits. If credit ratings are given in such a lax manner, it is obvious that the investor would be the one to suffer.

The NBFC (RBI) Directions, 1977, as a rule, do not permit any deposit which is repayable within twelve months. The maximum period ranges from sixty months to eighty four months.¹²

Even the nomenclature of business was misused by the CRB group. Loan or investment companies are not allowed to raise deposits which exceed, two times the 'Net Owned Funds' of such a company.¹³ An equipment leasing company is allowed to collect deposits which may be as high as ten times the net owned funds¹⁴ of the company.¹⁵ Although the main business of CRB capital markets was in disbursing loans and investing in companies it masqueraded as

8 See, Business India, June 2-15, 1997, No. 502 (Ashok H. Advani, Mumbai), at p. 67.

9 Para 10-A, NBFC (RBI) Direction, 1977.

10 Credit Analysis & Research a subsidiary of IDBI and a very respected credit rating agency.

11 The auditors vanished after the news of the scam broke out.

12 Paras Section 6 & 7.

13 Para 5(c) NBFC (RBI) Directions, 1977.

14 Net Owned Fund (hereinafter NOF) is defined in explanation to para 3 of the above Directions as the aggregate of the paid-up capital and free reserves reduced by loss and other charges.

15 Para 5(3).

an equipment leasing company and hence raised a large amount of money which it was not entitled to.¹⁶

This scam has also raised the issue of the legal status of deposits. It is astonishing to note that the Act and the Directions are absolutely silent on the point. Hence, the law which would be applicable is the Companies Act, 1956 under which secured creditors and secured debenture holders claim priority in the distribution of assets on liquidation. It is only after this that unsecured debenture holders' claim are met and it is in this category that the deposit holders are classified. Hence, a deposit is an unsecured instrument and if a company goes into liquidation, there is a good chance that the amount may not be repaid. This is what has occurred in the CRB scam.

Also it appears that the RBI itself was not aware of its regulatory power. Under Section 45-K the RBI has the power to call for any information "relating to or connected with deposits received". Under Section 45-K(4), any NBFC can be banned from accepting deposits on violations of directions issued under clause (3) of the same section. The RBI wielded this power in the CRB matter but it was too late. A lot of money by way of deposits had already been collected. S.P. Talwar, Deputy Governor of RBI has observed "we did not have the power to inspect the asset side of a NBFC till recently..."¹⁷ This only shows the ignorance about existing legal provisions. Section 45-L which is in an omnibus kind of provision clearly empowers the RBI to look into all matters of the NBFCs. It only takes on RBI order to be issued and the NBFC has to disclose all information.¹⁸

Lastly, the misdeeds came to light in September 1996 only because CRB capital markets on its own, applied for registration. It was prompted by the fact that if it was registered, it could promise more than 15% interest on deposits which non-registration would not give it. Thus, the scam came to light not because of any effort at regulating the company but because the company decided to avail itself of a benefit.

CHANGES BROUGHT IN UNDER THE RBI AMENDMENT ACT, 1997

The first point is about the time in which the amendment was brought into force. The amendment was independent of the scam and though it received Presidential assent on 28th March, 1997, it is deemed to have come into force on 9th January, 1997. One can only wish that the amendment was brought into force a bit earlier, because the amendment atleast addresses all the loopholes that the scam highlighted. There have been some far reaching changes in the law.

16 *Supra*, n. 12 at p. 6. The difference was to the tune of Rs. 88 crores which was nearly 2/3rds of the amount raised between 1994 and 1996.

17 *Supra*, n. 14 at p. 71.

18 Sections 45-L(1) gives this general power in sub-clause (2).

- (i) The first important change is to section 45-I which is the definition clause.¹⁹ A comprehensive definition of a NBFC has been adopted and the definition is very wide. It includes a "financial institution which is a company"²⁰ or "a non-banking institution which is a company and which has as its principal business the receiving of deposits".²¹ This is a consolidation of all definitions which were prescribed in the directions and is a step in the right direction.
- (ii) A new section called Section 45-IA has been introduced. Under clause (i) of this new provision every NBFC whose NOF exceeds 25 lakhs rupees, must register itself within six months, if it is less than 25 lakhs rupees it is given 3 years time to apply for registration.
- (iii) It is also interesting to note that when a NBFC applies for registration, the Act mentions several criteria²² which have to be satisfied before a certificate of registration is issued. Among the important ones are "public interest" and "interest of the depositors". In fact, throughout the amendment these are two prerequisites for the exercise of any power by the RBI. It is a far reaching provision which should give RBI complete control over NBFCs.
- (iv) The concept of NOF²³ has been completely changed and has been made more relevant and up-to-date.²⁴ The NOF is now defined as the aggregate of paid up equity capital and free reserves. From this aggregate, what is deducted is accumulated balance of loss. Also, investment of the NBFC in its subsidiaries, group companies and other NBFCs is also deducted. If in excess of 8% of the paid up capital and free reserves, loans, debentures, advances or bonds have been given to subsidiaries, or group companies even this amount has to be deducted. It is fairly obvious that this new method of calculating NOF, on whose basis ceilings on deposits and interest rates are based is far superior to the old model. In addition to this, it addresses the problems caused by the CRB scam where the NBFC invested nearly 50% of its money in subsidiaries and group companies. This is definitely a step in the right direction.
- (v) Other provisions relate to the kind of securities which a NBFC can invest in, which were already prescribed in the Directions.²⁵ A new section makes creation of a reserve fund from the net profit to the tune of 20% compulsory.²⁶

19 *Supra*, n. 25 at p. 62. Section 2(3) of the Amendment Act.

20 The New Section 45K(L)(i).

21 The New Section 45K(f)(ii).

22 Section 45IA(4). Some of the considerations are the company's ability to fulfil claims of depositors which will arise in due course.

23 *Supra*, n. 20.

24 Explanation to Section 45IA(5) 3rd proviso.

25 Section 45-IB.

26. Section 45-IC.

There are many provisions in the new amendment which confer extensive powers to the RBI to inspect books of accounts of NBFCs and no aspect is left out. The provisions are slightly harsh on NBFCs but are necessary.²⁷

- (vi) Now we come to the most important amendment. A new section now rests the power in the Company Law Board (CLB) to order repayment of desposits.²⁸ Every deposit shall, unless renewed, be repaid in accordance with the terms and conditions of such deposit and, if it is not repaid, the CLB on its own or on the basis of an application by the depositor, order that the deposit be repaid. The grounds of this order can be either "to safeguard the interests of the company" or "in the interest of the depositor" or "public interest".²⁹ An NBFC is to be given an opportunity to present its case before the CLB.³⁰ The order may be related either to the repayment of interest or the deposit amount or both. It should be noted that this provision does not create any charge on the assets but only makes the repayment of deposit legally binding. So, if there is a deposit which is still not mature and the company goes into liquidation, there is no charge on the assets.

CONCLUSION

At the present juncture NBFCs are in dire straits. The NBFCs do not know what other restrictions or limitations would be imposed on them. They have even approached commercial banks who are traditionally their competitors for funds and even the RBI wants to regulate the amount being lent to the NBFCs. The latest amendment which makes repayment of deposit legally binding is also very harsh. If an investor deposits with NBFC, he makes a conscious decision preferring it over a bank deposit. He has taken that risk already. What the amendment does is to take away that element of risk which upsets that balance. An investor has to take a risk. A proper solution would be to improve the way credit ratings are given to these deposits. That system should be made more accountable and transparent and then the decision should be left to the investor. One understands the RBI's rigid stand on NBFCs but this sector should not become the victim of over-regulation. It requires a fine balance and one can only hope that the RBI walks this tight rope.

27 Section 45-JA; Section 45-MB, Section 45-MC; Section 45-NA, 45-NB, which are all new provisions.

28 Section 45-QA.

29 Section 45-QA(2).

30 Section 45-QA Clause (u) proviso.