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Financial Reporting for Financial Institutions

UNIT 1: MUTUAL FUNDS

Note: This chapter is also discussed in Paper 2: Strategic Financial Management of Final Course Study Material. In Financial Reporting Paper, students should emphasise upon accounting aspects of net present value and valuation only. Strategic Financial Management Paper deals with return aspect of mutual funds.

1.1 Definition

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realized is shared by its unit holders in proportion to the number of units owned by them.

Different investment avenues are available to investors. Mutual funds also offer good investment opportunities to the investors. Like all investments, they also carry certain risks. The investors should compare the risks and expected yields after adjustment of tax on various instruments while taking investment decisions.

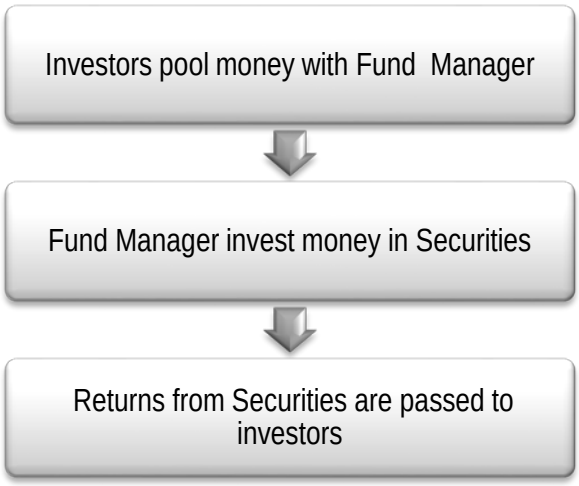
Investments in securities are spread across a wide cross-section of industries and sectors and thus the risk is reduced. Diversification reduces the risk because all stocks may not move in the same direction in the same proportion at the same time. Mutual fund issues units to the investors in accordance with quantum of money invested by them. Investors of mutual funds are known as unitholders.

The profits or losses are shared by the investors in proportion to their investments. The mutual funds normally come out with a number of schemes with different investment objectives which are launched from time to time. A mutual fund is required to be registered with Securities and Exchange Board of India (SEBI) which regulates securities markets before it can collect funds from the public.

As per section 2(q) of Securities and Exchange Board of India (SEBI) (Mutual Funds) Regulations, 1996, "Mutual Fund" means a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments or gold or gold related instruments

or real estate assets.

The following flow chart describes broadly the working of a mutual fund:



1.2 History of Mutual Funds in India and Role of SEBI in Mutual Funds Industry

Unit Trust of India was the first mutual fund set up in India in the year 1963. In early 1990s, Government allowed public sector banks and institutions to set up mutual funds. In the year 1992, Securities and exchange Board of India (SEBI) Act was passed. The objectives of SEBI are – to protect the interest of investors in securities and to promote the development of and to regulate the securities market.

As far as mutual funds are concerned, SEBI formulates policies and regulates the mutual funds to protect the interest of the investors. SEBI notified regulations for the mutual funds in 1993. Thereafter, mutual funds sponsored by private sector entities were allowed to enter the capital market. The regulations were fully revised in 1996 and have been amended thereafter from time to time. SEBI has also issued guidelines to the mutual funds from time to time to protect the interests of investors.

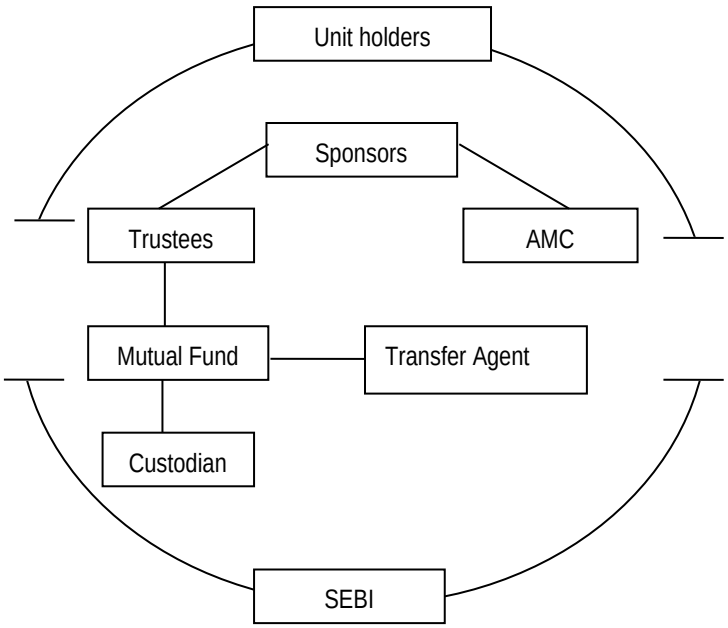
All mutual funds whether promoted by public sector or private sector entities including those promoted by foreign entities are governed by the same set of Regulations. There is no distinction in regulatory requirements for these mutual funds and all are subject to monitoring and inspections by SEBI. The risks associated with the schemes launched by the mutual funds sponsored by these entities are of similar type.

1.3 Organisation of Mutual Funds

In India, mutual funds are regulated by SEBI (Mutual Funds) Regulations, 1996. A mutual fund is set up in the form of a trust, which has sponsor, trustees, asset management company (AMC) and custodian. The trust is established by a sponsor or more than one sponsor who is like

promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unitholders. Asset Management Company (AMC) approved by SEBI manages the funds by making investments in various types of securities. Custodian, who is registered with SEBI, holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of SEBI Regulations by the mutual fund.

SEBI Regulations require that at least two thirds of the directors of trustee company or board of trustees must be independent i.e. they should not be associated with the sponsors. Also, 50% of the directors of AMC must be independent. All mutual funds are required to be registered with SEBI before they launch any scheme.



Here, "Asset management company" means a company formed and registered under the Companies Act, 1956 or 2013 and approved as such by the Securities and Exchange Board of India to manage the funds of a mutual fund.

"Unit" means the interest of the unit holders in a scheme, which consists of each unit representing one undivided share in the assets of a scheme;

Money market instruments provide for borrowers' short-term needs and gives needed liquidity to lenders. Money market instruments includes commercial papers, commercial bills, treasury bills, Government securities having an unexpired maturity up to one year, call or notice money, certificate of deposit, usance bills, and any other like instruments as specified by the Reserve Bank of India from time to time.

1.4 Net Asset Value (NAV) of a Scheme

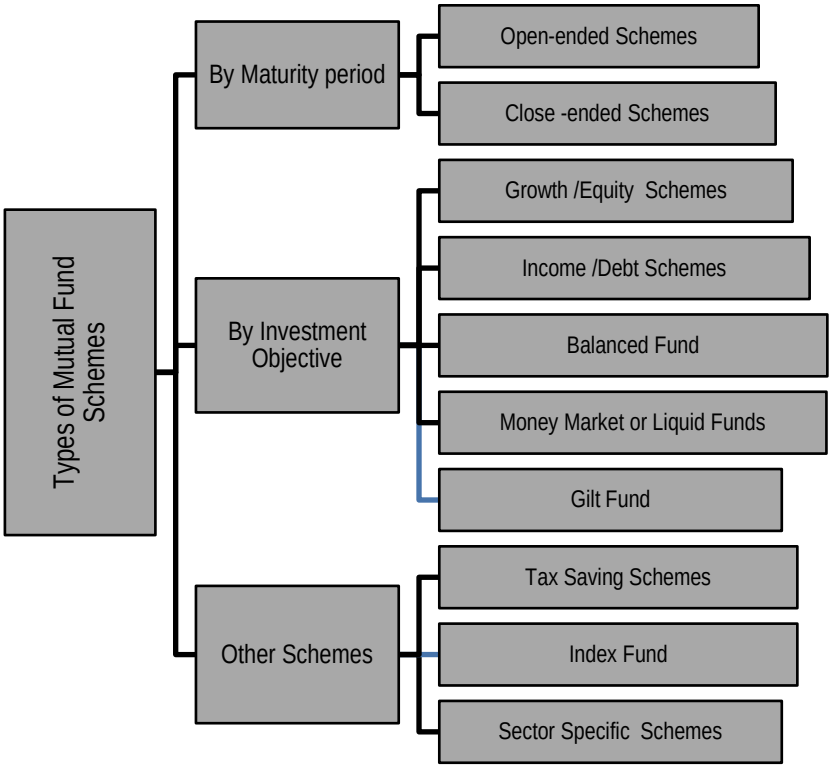
The performance of a particular scheme of a mutual fund is denoted by Net Asset Value (NAV).

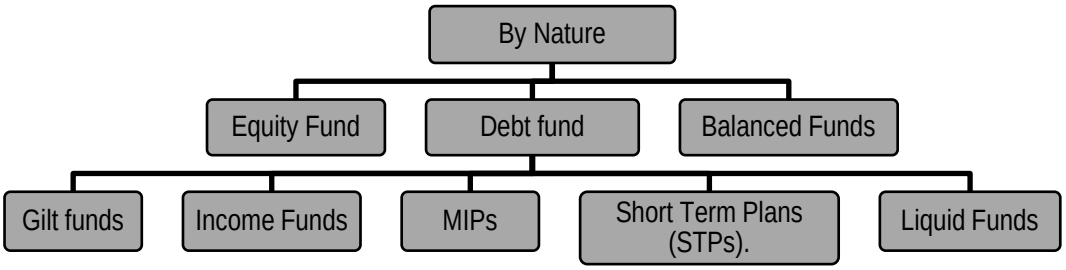
Mutual funds invest the money collected from the investors in securities markets. In simple words, Net Asset Value is the market value of the securities held by the scheme. Since market value of securities changes every day, NAV of a scheme also varies on day to day basis. The NAV per unit is the market value of securities of a scheme divided by the total number of units of the scheme on any particular date.

For example, if the market value of securities of a mutual fund scheme is Rs. 200 lakhs and the mutual fund has issued 10 lakhs units of Rs. 10 each to the investors, then the NAV per unit of the fund is Rs.20. NAV is required to be disclosed by the mutual funds on a regular basis - daily or weekly - depending on the type of scheme.

1.5 Types of Mutual Fund Schemes

Wide variety of Mutual Fund Schemes exists to cater to the needs of the investors. There are over hundreds of mutual funds scheme to choose from. The charts given below will give an overview of existing types of schemes:





All the above mentioned schemes have been discussed in brief in the succeeding paragraphs.

By Maturity Period

A mutual fund scheme can be classified into open-ended scheme or close-ended scheme depending on its maturity period.

1. Open - Ended Schemes: An open-end fund is one that is available for subscription and repurchase all through the year. These do not have a fixed maturity. Investors can conveniently buy and sell units at Net Asset Value ("NAV") related prices which are declared on a daily basis. The key feature of open-end schemes is liquidity.

2 Close - Ended Schemes: These schemes have a pre-specified maturity period. One can invest directly in the scheme at the time of the initial issue. Depending on the structure of the scheme there are two exit options available to an investor after the initial offer period closes. Investors can transact (buy or sell) the units of the scheme on the stock exchanges where they are listed. The market price at the stock exchanges could vary from the net asset value (NAV) of the scheme on account of demand and supply situation, expectations of unit holder and other market factors. Alternatively some close-ended schemes provide an additional option of selling the units directly to the Mutual Fund through periodic repurchase at the schemes NAV; however one cannot buy units and can only sell units during the liquidity window. SEBI Regulations ensure that at least one of the two exit routes is provided to the investor.

3. Interval Schemes: Interval Schemes are that scheme, which combines the features of open-ended and close-ended schemes. The units may be traded on the stock exchange or may be open for sale or redemption during pre-determined intervals at NAV related prices.

By Investment Objective

A scheme can also be classified as growth scheme, income scheme, or balanced scheme considering its investment objective. Such schemes may be open-ended or close-ended schemes as described earlier. Such schemes may be classified mainly as follows:

1. Equity fund: The aim of growth funds is to provide capital appreciation over the medium to long- term. Such schemes normally invest a major part of their corpus in equities. Such funds have comparatively high risks. These schemes provide different options to the investors like dividend option, capital appreciation, etc. and the investors may choose an option depending on their preferences. The investors must indicate the option in the application form. The mutual funds also allow the investors to change the options at a later date. Growth schemes are good for investors having a long-term outlook seeking appreciation over a period of time.

The Equity Funds are sub-classified depending upon their investment objective, as follows:

- Diversified Equity Funds
- Mid-Cap Funds
- Sector Specific Funds
- Tax Savings Funds (ELSS)

Equity investments are meant for a longer time horizon, thus Equity funds rank high on the risk-return matrix. Growth Schemes are also known as equity schemes. The aim of these schemes is to provide capital appreciation over medium to long term. These schemes normally invest a major part of their fund in equities and are willing to bear short-term decline in value for possible future appreciation.

- Income Schemes: Income Schemes are also known as debt schemes. The aim of these schemes is to provide regular and steady income to investors. These schemes generally invest in fixed income securities such as bonds and corporate debentures. Capital appreciation in such schemes may be limited.
- Balanced Schemes: Balanced Schemes aim to provide both growth and income by periodically distributing a part of the income and capital gains they earn. These schemes invest in both shares and fixed income securities, in the proportion indicated in their offer documents (normally 50:50).
- Money Market Schemes: Money Market Schemes aim to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer, short-term instruments, such as treasury bills, certificates of deposit, commercial paper and inter-bank call money.

2. Debt funds: The objective of these Funds is to invest in debt papers. Government authorities, private companies, banks and financial institutions are some of the major issuers of debt papers. By investing in debt instruments, these funds ensure low risk and provide stable income to the investors. These funds are not affected because of fluctuations in equity markets. However, opportunities of capital appreciation are also limited in such funds. The NAVs of such funds are affected because of change in interest rates in the country. If the interest rates fall, NAVs of such funds are likely to increase in the short run and vice versa. However, long term investors may not bother about these fluctuations. Debt funds are further classified as:

- Income Funds: Invest a major portion into various debt instruments such as bonds, corporate debentures and Government securities.
- Monthly Income Plans (MIPs): Invests maximum of their total corpus in debt instruments while they take minimum exposure in equities. It gets benefit of both equity and debt market. These scheme ranks slightly high on the risk-return matrix when compared with other debt schemes.
- Short Term Plans (STPs): Meant for investment horizon for three to six months. These funds primarily invest in short term papers like Certificate of Deposits (CDs) and Commercial Papers (CPs). Some portion of the corpus is also invested in corporate debentures.

- Liquid Funds: Also known as Money Market Schemes, These funds provides easy liquidity and preservation of capital. These schemes invest in short-term instruments like Treasury Bills, inter-bank call money market, CPs and CDs. These funds are meant for short-term cash management of corporate houses and are meant for an investment horizon of 1 day to 3 months. These schemes rank low on risk-return matrix and are considered to be the safest amongst all categories of mutual funds.

3. Balanced funds: As the name suggest they, are a mix of both equity and debt funds. They invest in both equities and fixed income securities, which are in line with pre-defined investment objective of the scheme. These schemes aim to provide investors with the best of both the worlds. Equity part provides growth and the debt part provides stability in returns. They generally invest 40-60% in equity and debt instruments. These funds are also affected because of fluctuations in share prices in the stock markets. However, NAVs of such funds are likely to be less volatile compared to pure equity funds.

4. Money Market or Liquid Fund: These funds are also income funds and their aim is to provide easy liquidity, preservation of capital and moderate income. These schemes invest exclusively in safer short-term instruments such as treasury bills, certificates of deposit, commercial paper and inter-bank call money, government securities, etc. Returns on these schemes fluctuate much less compared to other funds. These funds are appropriate for corporate and individual investors as a means to park their surplus funds for short periods.

5. Gilt Funds: These funds invest exclusively in government securities. Government securities have no default risk. NAVs of these schemes also fluctuate due to change in interest rates and other economic factors as is the case with income or debt oriented schemes.

By Other Schemes

1. Tax Saving Schemes: Tax-saving schemes offer tax rebates to the investors under tax laws prescribed from time to time. Under Sec. 80C (2) of the Income Tax Act, contributions made to any notified Equity Linked Savings Scheme (ELSS) are eligible for rebate. Pension schemes launched by the mutual funds also offer tax benefits. These schemes are growth oriented and invest pre-dominantly in equities. Their growth opportunities and risks associated are like any equity-oriented scheme.

2. Index Schemes: Index schemes attempt to replicate the performance of a particular index such as the BSE Sensex or the NSE 50. The portfolio of these schemes will consist of only those stocks that constitute the index. The percentage of each stock to the total holding will be identical to the stocks index weightage. And hence, the returns from such schemes would be more or less equivalent to those of the Index.

3. Sector Specific Schemes: These are the funds/schemes which invest in the securities of only those sectors or industries as specified in the offer documents. e.g. Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks, etc. The returns in these funds are dependent on the performance of the respective sectors/industries. While these funds may give higher returns, they are riskier compared to diversified funds. Investors need to keep a watch on the performance of those sectors/industries and must exit at an appropriate time.

1.6 Fund of Funds (FoF) scheme

A scheme that invests primarily in other schemes of the same mutual fund or other mutual funds is known as a FoF scheme. An FoF scheme enables the investors to achieve greater diversification through one scheme. It spreads risks across a greater universe.

1.7 Load or No-load Fund

A Load Fund is one that charges a percentage of NAV for entry or exit. That is, each time one buys or sells units in the fund, a charge will be payable. This charge is used by the mutual fund for marketing and distribution expenses. Suppose the NAV per unit is Rs.10. If the entry as well as exit load charged is 1%, then the investors who buy would be required to pay Rs.10.10 and those who offer their units for repurchase to the mutual fund will get only Rs.9.90 per unit. The investors should take the loads into consideration while making investment as these affect their yields/returns. However, the investors should also consider the performance track record and service standards of the mutual fund which are more important. Efficient funds may give higher returns in spite of loads.

A no-load fund is one that does not charge for entry or exit. It means the investors can enter the fund/scheme at NAV and no additional charges are payable on purchase or sale of units.

1.8 Frequently Used Terms

Net Asset Value (NAV): Net asset value is the market value of the assets of the scheme minus its liabilities. The per unit NAV is the net asset value of the scheme divided by the number of units outstanding on the valuation date.

Sale Price (SP): It is the price you pay when you invest in a scheme; also called offer price. It may include a sales load.

Repurchase Price: It is the price at which units under open-ended schemes are repurchased by the Mutual Fund. Such prices are NAV related.

Redemption Price: It is the price at which close-ended schemes redeem their units on maturity. Such prices are NAV related.

Sales Load: It is a charge collected by a scheme when it sells the units. Also called 'Front-end' load. Schemes that do not charge a load are called 'No Load' schemes.

Repurchase or 'Back-end' Load: It is a charge collected by a scheme when it buys back the units from the unit holders.

The Association of Mutual Funds in India (AMFI): The Association is dedicated to developing the Indian Mutual Fund Industry on professional, healthy and ethical lines and to enhance and maintain standards in all areas with a view to protecting and promoting the interests of mutual funds and their unit holders.

1.9 SEBI Guidelines for Mutual Funds in India

Application for registration An application for registration of a mutual fund shall be made to the Board in Form A by the sponsor.

Furnishing information

The Board may require the sponsor to furnish such further information or clarification as may be required by it.

Eligibility criteria

(a) For the purpose of grant of a certificate of registration, the applicant has to fulfill the following, namely, the sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions;

Explanation: For the purposes of this clause "sound track record" shall mean the sponsor should,-

(i) be carrying on business in financial services for a period of not less than five years; and the net worth is positive in all the immediately preceding five years; and the net worth in the immediately preceding year is more than the capital contribution of the sponsor in the asset management company; and

(ii) the sponsor has profits after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year.

(b) applicant is a fit and proper person.

(c) in the case of an existing mutual fund, such fund is in the form of a trust and the trust deed has been approved by the Board;

(d) the sponsor has contributed or contributes at least 40% to the net worth of the asset management company;

Provided that any person who holds 40% or more of the net worth of an asset management company shall be deemed to be a sponsor and will be required to fulfill the eligibility criteria specified in these regulations;

(e) the sponsor or any of its directors or the principal officer to be employed by the mutual fund should not have been guilty of fraud or has not been convicted of an offense involving moral turpitude or has not been found guilty of any economic offence.

(f) appointment of trustees to act as trustees for the mutual fund in accordance with the provisions of the regulations;

(g) appointment of asset management company to manage the mutual fund and operate the scheme of such funds in accordance with the provisions of these regulations;

(h) Appointment of a custodian in order to keep custody of the securities and carry out the custodian activities as may be authorized by the trustees.

The Board may register the mutual fund and grant a certificate in Form B on the applicant paying the registration fee as specified in Second Schedule.

Trust Deed to be registered under the Registration Act

A mutual fund shall be constituted in the form of a trust and the instrument of trust shall be in the form of a deed, duly registered under the provisions of the Indian Registration Act, 1908 (16 of 1908) executed by the sponsor in favour of the trustees named in such an instrument.

Approval of the Board for appointment of trustee

No trustee shall initially or any time thereafter be appointed without prior approval of the Board. The existing trustees of any mutual fund may form a trustee company to act as a trustee with the prior approval of the Board.

Rights and obligations of the trustees

The trustees and the asset management company shall with the prior approval of the Board enter into an investment management agreement. The trustees shall ensure before the launch of any scheme that the asset management company has;-

(a) systems in place for its back office, dealing room and accounting;

(b) appointed all key personnel including fund manager(s) for the scheme(s) and submitted their bio-data which shall contain the educational qualifications, past experience in the securities market with the trustees, within 15 days of their appointment;

(c) appointed auditors to audit its accounts;

(d) appointed a compliance officer to comply with regulatory requirement and to redress investor grievances;

(e) appointed registrars and laid down parameters for their supervision;

(f) prepared a compliance manual and designed internal control mechanisms including internal audit systems;

(g) specified norms for empanelment of brokers and marketing agents.

The trustees shall ensure that an asset management company has been diligent in empanelling the brokers, in monitoring securities transactions with brokers and avoiding undue concentration of business with any broker.

Each trustee shall file the details of his transactions of dealing in securities with the Mutual Fund on a quarterly basis.

The trustees shall be accountable for, and be the custodian of, the funds and Trustees shall exercise due diligence as under:

1. The Trustees shall be discerning in the appointment of the directors on the Board of the asset management company.
2. The trustee shall ensure that the trust property is properly protected, held and administered by proper persons and by a proper number of such persons.
3. The trustee shall ensure that all service providers are holding appropriate registrations from the Board or concerned regulatory authority.

4. The Trustees shall arrange for test checks of service contracts.
5. Trustees shall immediately report to Board of any special developments in the mutual fund.
6. The Trustees shall: obtain internal audit reports at regular intervals from independent auditors appointed by the Trustees.
7. Obtain compliance certificates at regular intervals from the asset management company.
8. Hold meeting of trustees more frequently to review the operation of the AMC function and auditor's report in order to take appropriate action.

1.10 Annual Report

Every mutual fund or the asset management company is required to prepare in respect of each financial year an annual report and annual statement of accounts of the schemes and the fund as specified in Eleventh Schedule.

As per Regulation 51, the financial year, for all the schemes, shall end as of March 31st of each year.

The scheme wise Annual Report of a mutual fund or an abridged summary thereof shall be mailed to all the unit holders as soon as may be but not later than four months from the date of closure of the relevant accounts year.

According to Eleventh Schedule, the annual report shall contain –

(i) Report of the board of Trustees on the operations of the various schemes of the fund and the fund as a whole during the year and the future outlook of the fund;

(ii) Balance Sheet and Revenue Account in accordance with paras 2, 3 and 4, respectively of this Schedule;

(iii) Auditor's Report in accordance with paragraph 5 of this Schedule;

(iv) Brief statement of the Board of Trustees on the following aspects, namely:-

   (a) Liabilities and responsibilities of the Trustees and the Settlor;

   (b) Investment objective of each scheme;

   (c) Basis and policy of investment underlying the scheme;

   (d) If the scheme permits investment partly or wholly in shares, bonds, debentures and other scrips or securities whose value can fluctuate, a statement on the following lines:

   "The price and redemption value of the units, and income from them, can go up as well as down with the fluctuations in the market value of its underlying investments in securities or fair value in underlying real estate asset, as the case may be."

   (e) Comments of the Trustees on the performance of the scheme, with full justification.

(v) Statement giving relevant perspective historical 'per unit' statistics in accordance with paragraph 6 of this Schedule;

(vi) Statement on the following lines:

"On written request, present and prospective unit holders /investors can obtain copy of the trust deed, the annual report [at a price] and the text of the relevant scheme."

1.11 Restriction on Investments

As per Seventh Schedule, a mutual fund scheme shall not invest more than *10%* of its NAV in debt instruments issued by a single issuer which are rated not below investment grade by a credit rating agency authorised to carry out such activity under the Act. Such investment limit may be extended to *12%* of the NAV of the scheme with the prior approval of the Board of Trustees and the Board of asset management company. Provided that such limit shall not be applicable for investments in government securities and money market instruments.

1. A mutual fund scheme shall not invest more than 10% of its NAV in unrated debt instruments issued by a single issuer and the total investment in such instruments shall not exceed 25% of the NAV of the scheme. All such investments shall be made with the prior approval of the Board of Trustees and the Board of asset management company.
2. No mutual fund under all its schemes should own more than ten per cent of any company's paid up capital carrying voting rights.
3. Transfers of investments from one scheme to another scheme in the same mutual fund shall be allowed only if, -
   (a) such transfers are done at the prevailing market price for quoted instruments on spot basis.

   [Explanation - "spot basis" shall have same meaning as specified by stock exchange for spot transactions.]

   (b) the securities so transferred shall be in conformity with the investment objective of the scheme to which such transfer has been made.
4. A scheme may invest in another scheme under the same asset management company or any other mutual fund without charging any fees, provided that aggregate inter scheme investment made by all schemes under the same management or in schemes under the management of any other asset management company shall not exceed 5% of the net asset value of the mutual fund.
5. Every mutual fund shall buy and sell securities on the basis of deliveries and shall in all cases of purchases, take delivery of relevant securities and in all cases of sale, deliver the securities.

   Provided that a mutual fund may engage in short selling of securities in accordance with the framework relating to short selling and securities lending and borrowing specified by the Board. Provided further that a mutual fund may enter into derivatives transactions in a recognized stock exchange, subject to the framework specified by the Board. Provided further that sale of government security already contracted for purchase shall be permitted in accordance with the guidelines issued by the Reserve Bank of India in this regard.

6. Every mutual fund shall, get the securities purchased or transferred in the name of the mutual fund on account of the concerned scheme, wherever investments are intended to be of long term nature.
7. Pending deployment of funds of a scheme in securities in terms of investment objectives of the scheme a mutual fund may invest them in short term deposits of scheduled commercial banks.
8. No mutual fund [scheme] shall make any investment in;
   (a) any unlisted security of an associate or group company of the sponsor; or
   (b) any security issued by way of private placement by an associate or group company of the sponsor; or
   (c) the listed securities of group companies of the sponsor which is in excess of 25% of the net assets.
9. No mutual fund scheme shall invest more than 10 per cent of its NAV in the equity shares or equity related instruments of any company.

   Provided that, the limit of 10 per cent shall not be applicable for investments [in case of] index fund or sector or industry specific scheme.
10. A mutual fund scheme shall not invest more than 5% of its NAV in the unlisted equity shares or equity related instruments in case of open ended scheme and 10% of its NAV in case of close ended scheme.
11. A fund of funds scheme shall be subject to the following investment restrictions:
    a. A fund of funds scheme shall not invest in any other fund or funds scheme;
    b. A fund of funds scheme shall not invest its assets other than in schemes of mutual funds, except to the extent of funds required for meeting the liquidity requirements for the purpose of repurchases or redemptions, as disclosed in the offer document of fund of funds scheme.

1.12 Cost of Investments

According to Ninth Schedule of SEBI (Mutual Fund) Regulations, 1996, cost of investments acquired or purchased should include brokerage, stamp charges and any charge customarily included in the broker's bought note. In respect of privately placed debt instruments any front – end discount offered should be deducted from the cost of the investment.

As per the Eleventh Schedule of the SEBI Regulations, in respect of all interest – bearing investments, income must be accrued on a day-to-day basis as it is earned. Therefore, when such investments are purchased, interest paid for the period from the last interest due date upto the date of purchase must not be treated as a cost of purchase but must be debited to Interest Recoverable Account. Similarly, interest received at the time of sale for the period from the last interest due date upto the date of sale must not be treated as an addition to sale value but must be credited to Interest Recoverable Account.

In determining the holding cost of investments and the gains or loss on sale of investments, the "average cost" method must be followed. As per Regulation 51A, the exit load charged, if any, shall be credited to the scheme.

1.13 Investment Valuation Norms

Eight Schedule of the SEBI (Mutual Fund) Regulations, 1996 states the Investment Valuation Norms. NAV of a scheme as determined by dividing the net assets of the scheme by the number of outstanding units on the valuation date.

1. Traded Securities:-

(i) The securities shall be valued at the last quoted closing price on the stock exchange.

(ii) When the securities are traded on more than one recognised stock exchange, the securities shall be valued at the last quoted closing price on the stock exchange where the security is principally traded. It would be left to the asset management company to select the appropriate stock exchange, but the reasons for the selection should be recorded in writing. There should however be no objection for all scrips being valued at the prices quoted on the stock exchange where a majority in value of the investments is principally traded.

(iii) Once a stock exchange has been selected for valuation of a particular security, reasons for change of the exchange shall be recorded in writing by the asset management company.

(iv) When on a particular valuation day, a security has not been traded on the selected stock exchange, the value at which it is traded on another stock exchange may be used.

(v) When a security is not traded on any stock exchange on a particular valuation day, the value at which it was traded on the selected stock exchange or any other stock exchange, as the case may be, on the earliest previous day may be used provided such date is not more than sixty days prior to the valuation date.

2. `Non-traded Securities':-

(i) When a security is not traded on any stock exchange for a period of thirty days prior to the valuation date, the scrip must be treated as a 'non-traded' scrip.

(ii) Non-traded securities shall be valued "in-good faith" by the asset management company on the basis of appropriate valuation methods based on the principles approved by the Board of the asset management company. [For example, non-traded debt and money market securities of short term maturities, as may be specified by the Board from time to time, may be valued on amortization basis provided that such valuation shall be reflective of the fair value of the securities and all investors are treated fairly.] Such decision of the Board must be documented in the Board minute and the supporting data in respect of each security so valued must be preserved. The methods used to arrive at values "in-good faith" shall be periodically reviewed by the trustees and reported upon by the auditors as "fair and reasonable" in their report on the annual accounts of the fund. For the purpose of valuation of non-traded securities, the following principles should be adopted:-

(a) Equity instruments shall generally be valued on the basis of capitalization of earnings solely or in combination with the net asset value, using for the purposes of capitalization, the price or earning ratios of comparable traded securities and with an appropriate discount for lower liquidity;

(b) Debt instruments shall generally be valued on a yield to maturity basis, the capitalization factor being determined for comparable traded securities and with an appropriate discount for lower liquidity;

(c) Investments in call money, bills purchased under rediscounting scheme and short term deposits with banks shall be valued at cost plus accrual; other money market instruments shall be valued at the yield at which they are currently traded. For this purpose, non-traded instruments that is instruments not traded for a period of seven days will be valued at cost plus interest accrued till the beginning of the day plus the difference between the redemption value and the cost spread uniformly over the remaining maturity period of the instruments; Government securities will be valued at yield to maturity based on the prevailing market rate.

(d) In respect of convertible debentures and bonds, the non-convertible and convertible components shall be valued separately. The non-convertible component should be valued on the same basis as would be applicable to a debt instrument. The convertible component should be valued on the same basis as would be applicable to an equity instrument. If, after conversion the resultant equity instrument would be traded pari passu with an existing instrument which is traded, the value of the latter instrument can be adopted after an appropriate discount for the non-tradability of the instrument during the period preceding the conversion. While valuing such instruments, the fact whether the conversion is optional should also be factored in;

(e) In respect of warrants to subscribe for shares attached to instruments, the warrants can be valued at the value of the share which would be obtained on exercise of the warrant as reduced by the amount which would be payable on exercise of the warrant. A discount similar to the discount to be determined in respect of convertible debentures (as referred to in sub-paragraph (d) above) must be deducted to account for the period which must elapse before the warrant can be exercised;

(f) Where instruments have been bought on `repo' basis, the instrument must be valued at the resale price after deduction of applicable interest upto date of resale. Where an instrument has been sold on a `repo' basis, adjustment must be made for the difference between the repurchase price (after deduction of applicable interest upto date of repurchase) and the value of the instrument. If the repurchase price exceeds the value, the depreciation must be provided for and if the repurchase price is lower than the value, credit must be taken for the appreciation.

3. Until they are traded, the value of the "rights" shares should be calculated as:

$$Vr = \frac{n}{m} \times (Pex - Pof)$$

Where	Vr	=	Value of rights
	n	=	no. of rights offered
	m	=	no.of original shares held
	Pex	=	Ex-rights price
	Pof	=	Rights Offer Price

Where the rights are not treated pari passu with the existing shares, suitable adjustment should be made to the value of rights. Where it is decided not to subscribe for the rights but to renounce them and renunciations are being traded, the rights can be valued at the renunciation value.

Value of Gold:

The gold held by a gold exchange traded fund scheme shall be valued at the AM fixing price of London Bullion Market Association (LBMA) in US dollars per troy ounce for gold having a fineness of 995.0 parts per thousand, subject to the following:

(a) adjustment for conversion to metric measure as per standard conversion rates;

(b) adjustment for conversion of US dollars into Indian rupees as per the RBI reference rate declared by the Foreign Exchange Dealers Association of India (FEDAI); and

(c) Addition of-

(i) transportation and other charges that may be normally incurred in bringing such gold from London to the place where it is actually stored on behalf of the mutual fund; and

(ii) notional customs duty and other applicable taxes and levies that may be normally incurred to bring the gold from the London to the place where it is actually stored on behalf of the mutual fund. Provided that the adjustment under clause (c) above may be made on the basis of a notional premium that is usually charged for delivery of gold to the place where it is stored on behalf of the mutual fund. Provided further that where the gold held by a gold exchange traded fund scheme has a greater fineness, the relevant LBMA prices of AM fixing shall be taken as the reference price under this sub-paragraph.

If the gold acquired by the gold exchange traded fund scheme is not in the form of standard bars, it shall be assayed and converted into standard bars which comply with the good delivery norms of the LBMA and thereafter valued in terms of sub-paragraph (1).

All expenses and incomes accrued upto the valuation date shall be considered for computation of net asset value. For this purpose, while major expenses like management fees and other periodic expenses should be accrued on a day to day basis, other minor expenses and income need not be so accrued, provided the non-accrual does not affect the NAV calculations by more than 1%.

Any changes in securities and in the number of units be recorded in the books not later than the first valuation date following the date of transaction. If this is not possible given the frequency of the Net Asset Value disclosure, the recording may be delayed upto a period of seven days

following the date of the transaction, provided that as a result of the non-recording, the Net Asset Value calculations shall not be affected by more than *1%*.

In case the Net Asset Value of a scheme differs by more than 1%, due to non-recording of the transactions, the investors or scheme/s as the case may be, shall be paid the difference in amount as follows:

(i) If the investors are allotted units at a price higher than Net Asset Value or are given a price lower than Net Asset Value at the time of sale of their units, they shall be paid the difference in amount by the scheme.

(ii) If the investors are charged lower Net Asset Value at the time of purchase of their units or are given higher Net Asset Value at the time of sale of their units, asset management company shall pay the difference in amount to the scheme. The asset management company may recover the difference from the investors.

Thinly traded securities as defined in the guidelines shall be valued in the manner as specified in the guidelines issued by the Board.

The aggregate value of illiquid securities as defined in the guidelines shall not exceed 15 per cent of the total assets of the scheme and any illiquid securities held above 15 per cent of the total assets shall be valued in the manner as specified in the guidelines issued by Board.

1.14 Marking Investments to Market

For the purposes of the financial statements, mutual funds shall mark all investments to market and carry investments in the balance sheet at market value. However, since the unrealized gain arising out of appreciation on investments cannot be distributed, provision has to be made for exclusion of this item when arriving at distributable income.

1.15 Pricing of Units

As per Regulation 49 of the Securities and Exchange Board of India Mutual Funds Regulations, 1996:

(1) The price at which the units may be subscribed or sold and the price at which such units may at any time be repurchased by the mutual fund shall be made available to the investors.

(2) The mutual fund, in case of open ended scheme, shall at least once a week publish in a daily newspaper of all India circulation, the sale and repurchase price of units.

(3) While determining the prices of the units, the mutual fund shall ensure that the repurchase price is not lower than 93% of the Net Asset Value and the sale price is not higher than 107% of the Net Asset Value.

Provided that the repurchase price of the units of a close ended scheme shall not be lower than 95% of the Net Asset Value:

Provided further that the difference between the repurchase price and the sale price of the unit shall not exceed 7% calculated on the sale price.

(3A) Where a mutual fund repurchases units in a close ended scheme launched prior to the commencement of the Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2009 which fulfils the conditions mentioned in sub-regulation (3B), it shall deduct an amount representing proportionate initial issue expenses or part thereof remaining unamortized, from the repurchase proceeds.

Explanation:

The term —proportionate initial issue expenses or part thereof remaining unamortised refers to such proportion of the expenses of the scheme as are attributable to the units being repurchased.

(3B) The conditions referred to in sub-regulation (3A) are the following:

(a) the scheme is launched after the commencement of the Securities and Exchange Board of India (Mutual Funds) (Second Amendment) Regulations, 2006 and prior to commencement of the Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2008;

(b) initial issue expenses in respect of the scheme are accounted in the books of accounts of the scheme in accordance with Tenth Schedule.

(3C) The amount recovered under sub-regulation (3A) shall be credited to the unamortized initial issue expenses of the scheme.

(4) The price of units shall be determined with reference to the last determined Net Asset Value as mentioned in sub-regulation (3) unless,

(a) the scheme announces the Net Asset Value on a daily basis; and

(b) the sale price is determined with or without a fixed premium added to the future net asset value which is declared in advance.

1.16 Limitation on Fees and Expenses on Issue of Schemes

As per Regulation 52, all expenses should be clearly identified and appropriated in the individual schemes. The asset management company may charge the scheme with investment and advisory fees which shall be fully disclosed in the offer document.

In addition to the above, the asset management company may charge the scheme with recurring expenses as mentioned in sub regulation 4.

Any other expense shall be borne by the asset management company or trustee or sponsors.

The total expenses of the scheme excluding issue or redemption expenses, whether initially borne by the mutual fund or by the asset management company, but including the investment management and advisory fee shall be subject to the following limits:—

(a) in case of a fund of funds scheme, the total expenses of the scheme including weighted average of charges levied by the underlying schemes shall not exceed 2.50 per cent of the daily net assets of the scheme.

(b) in case of an index fund scheme or exchange traded fund, the total expenses of the scheme

including the investment and advisory fees shall not exceed one and one half percent (1.5%) of the daily net assets;

(c) in case of any other scheme-

(i) on the first ₹ 100 crores of the daily net assets 2.5%;

(ii) on the next ₹ 300 crores of the daily net assets 2.25%;

(iii) on the next ₹ 300 crores of the daily net assets 2.0%;

(iv) on the balance of the assets 1.75%:

In addition to the limits specified above, the following costs or expenses may be charged to the scheme, namely-

(a) brokerage and transaction costs which are incurred for the purpose of execution of trade and is included in the cost of investment, not exceeding 0.12 per cent in case of cash market transactions and 0.05 per cent in case of derivatives transactions;

(b) expenses not exceeding of 0.30 per cent of daily net assets, if the new inflows from such cities as specified by the Board from time to time are at least -

(i) 30 per cent of gross new inflows in the scheme, or;

(ii) 15 per cent of the average assets under management (year to date) of the scheme,

whichever is higher:

(c) additional expenses, incurred towards different heads mentioned under sub regulations (2) and (4), not exceeding 0.20 per cent of daily net assets of the scheme

Any expenditure in excess of the limits specified shall be borne by the asset management company or by the trustee or sponsors.

1.17 Accounting Policies For Investment in Securities

As per regulation 50(3) of SEBI (Mutual Funds) Regulations, 1996, the Asset Management Companies are required to follow the accounting policies and standards specified in the Ninth Schedule of the Regulations so as to provide appropriate details of the scheme-wise disposition of the assets of the fund at the relevant accounting date and the performance during that period together with information regarding distribution or accumulation of income accruing to the unitholder in a fair and true manner.

Following accounting policies shall be followed by Mutual Funds for the preparation of accounts:

a. For the purposes of the financial statements, mutual fund shall mark all investments to market and carry investments in the balance sheet at market value. However, since the unrealised gain arising out of appreciation on investments cannot be distributed, provision has to be made for exclusion of this item when arriving at distributable income.

b. Dividend income earned by a scheme should be recognised, not on the date the dividend is declared, but on the date the share is quoted on an ex-dividend basis. For investments

which are not quoted on the stock exchange, dividend income must be recognised on the date of declaration.

c. In respect of all interest-bearing investments, income must be accrued on a day to day basis as it is earned. Therefore when such investments are purchased, interest paid for the period from the last interest due date up to the date of purchase must not be treated as a cost of purchase but must be debited to Interest Recoverable Account. Similarly, interest received at the time of sale for the period from the last interest due date up to the date of sale must not be treated as an addition to sale value but must be credited to Interest Recoverable Account.

d. In determining the holding cost of investments and the gains or loss on sale of investments, the "average cost" method must be followed.

e. Transactions for purchase or sale of investments should be recognised as of the trade date and not as of the settlement date, so that the effect of all investments traded during a financial year are recorded and reflected in the financial statements for that year. Where investment transactions take place outside the stock market, for example, acquisitions through private placement or purchases or sales through private treaty, the transaction should be recorded, in the event of a purchase, as of the date on which the scheme obtains in enforceable obligation to pay the price or, in the event of a sale, when the scheme obtains an enforceable right to collect the proceeds of sale or an enforceable obligation to deliver the instruments sold.

f. Bonus shares to which the scheme becomes entitled should be recognised only when the original shares on which the bonus entitlement accrues are traded on the stock exchange on an ex-bonus basis. Similarly, rights entitlements should be recognised only when the original shares on which the right entitlement accrues are traded on the stock exchange on an ex-rights basis.

g. Where income receivable on investments has accrued but has not been received for the period specified in the guidelines issued by the Board, provision shall be made by debiting to the revenue account the income so accrued in the manner specified by guidelines issued by the Board.

h. When in the case of an open-ended scheme units are sold, the difference between the sale price and the face value of the unit, if positive, should be credited to reserves and if negative is debited to reserve, the face value being credited to Capital Account. Similarly, when in respect of such a scheme, units are repurchased the difference between the purchase price and face value of the unit, if positive should be debited to reserves and, if negative, should be credited to reserves, the face value being debited to the capital account.

i. In the case of an open-ended scheme, when units are sold an appropriate part of the sale proceeds should be credited to an Equalization Account and when units are repurchased an appropriate amount should be debited to Equalization Account. The net balance on this account should be credited or debited to the Revenue Account. The balance on the Equalization Account debited or credited to the Revenue Account should not decrease or

increase the net income of the fund but is only an adjustment to the distributable surplus. It should therefore be reflected in the Revenue Account only after the net income of the fund is determined.

j. In a close-ended scheme which provide to the unit holders the option for an early redemption or repurchase their own units, the par value of the unit has to be debited to Capital Account and the difference between the purchase price and the par value, if positive, should be credited to reserves and, if negative, should be debited to reserves. A proportionate part of the unamortized initial issue expenses should also be transferred to the reserves so that the balance carried forward on that account is proportional to the number of units remaining outstanding.

k. The cost of investments acquired or purchased should include brokerage, stamp charges and any charge customarily included in the broker's bought note. In respect of privately placed debt instruments any front-end discount offered should be reduced from the cost of the investment.

l. Underwriting commission should be recognised as revenue only when there is no devolvement on the scheme. Where there is devolvement on the scheme, the full underwriting commission received and not merely the portion applicable to the devolvement should be reduced from the cost of the investment.

m. In case of real estate mutual fund scheme, investments in unlisted equity shares shall be valued as per the norms specified in this regard.

1.18 Accounting Policies For Direct Investment in Real Estate Asset

A real estate asset that is held by a real estate mutual fund scheme shall be valued at fair value. Where a portion of the real estate asset is held to earn rentals or for capital appreciation and if the portions can be sold or leased separately, the real estate mutual fund scheme shall account for the portions separately.

Initial Recognition

A real estate mutual fund scheme shall recognise a real estate asset if (a) it is probable that the future economic benefits that are associated with the real estate asset will flow to the real estate mutual fund scheme; and (b) the cost of the asset can be measured reliably.

A real estate mutual fund scheme shall evaluate all its real estate asset costs including those incurred initially to acquire a real estate asset and those incurred subsequently to add to, replace part of, or service a real estate asset, at the time they are incurred. Provided that a real estate mutual fund scheme shall not recognise in the carrying amount of a real estate asset the costs of the day-to-day servicing of such an asset and such costs shall be recognised in the revenue account as incurred.

A real estate mutual fund scheme may acquire parts of real estate assets through replacement. For example, the interior walls may be replacements of original walls. Under the recognition principle, a real estate mutual fund scheme shall recognise in the carrying amount of a real estate asset, the cost of replacing part of an existing real estate asset at the time that cost is

incurred if the recognition criteria are met. The carrying amount of those parts that are replaced shall be derecognised.

The real estate asset shall be recognized on the date of completion of the process of transfer of ownership i.e. the date on which the real estate mutual fund scheme obtains an enforceable right including all significant risks and rewards of ownership.

Measurement at Initial Recognition

A real estate asset shall be measured initially at cost. Such cost shall comprise purchase price and any other directly attributable expenditure such as professional fees for legal services, registration expenses and asset transfer taxes.

If the payment for a real estate asset is deferred, its cost is the cash price equivalent. A real estate mutual fund scheme shall recognise the difference between this amount and the total payments as interest expense over the period of credit.

A real estate mutual fund scheme may acquire one or more real estate assets in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The cost of such a real estate asset shall be measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired real estate asset shall be measured in this manner even if a real estate mutual fund scheme cannot immediately derecognize the asset given up. If the acquired real estate asset cannot be measured at fair value, its cost shall be measured at the carrying amount of the asset given up.

A real estate mutual fund scheme determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction.

For the purpose of determining whether an exchange transaction has commercial substance, the real estate mutual fund scheme-specific value of the portion of the real estate mutual fund scheme's operations affected by the transaction should reflect post-tax cash flows.

If the real estate mutual fund scheme is able to determine reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

Subsequent Measurement

After initial recognition, a real estate asset held by a real estate mutual fund scheme shall be measured at its fair value. A gain or loss arising from a change in the fair value of the real estate asset shall be recognised in the Revenue Account for the period in which it arises. The gain that arises from the appreciation in the value of real estate asset is an unrealised gain and thus the same cannot be distributed.

Where the fair value of the asset is not reliably determinable on a continuing basis, a real estate mutual fund scheme shall measure that real estate asset at cost as per AS 10. The residual value of the real estate asset shall be assumed to be zero. The real estate mutual fund scheme

shall apply AS 10 until disposal of the investment asset. In determining the fair value of the real estate asset, it shall be ensured that there is no double-counting of assets or liabilities.

Explanation:

(a) equipment such as lifts or air-conditioning is often an integral part of a building and is generally included in the fair value of the real estate asset, rather than recognised separately as asset, plant and equipment.

(b) if an office is leased on a furnished basis, the fair value of the office generally includes the fair value of the furniture, because the rental income relates to the furnished office. When furniture is included in the fair value of real estate asset, a real estate mutual fund scheme shall not recognise that furniture as a separate asset.

(c) the fair value of real estate asset shall exclude prepaid or accrued operating lease income, because the real estate mutual fund scheme would recognise it as a separate liability or asset.

(d) The fair value of real estate asset held under a lease reflects expected cash flows (including contingent rent that is expected to become payable). Accordingly, if a valuation obtained for an asset is net of all payments expected to be made, it will be necessary to add back any recognised lease liability, to arrive at the fair value of the real estate asset for accounting purposes.

Where a real estate mutual fund scheme expects that the present value of its payments relating to a real estate asset (other than payments relating to recognised liabilities) will exceed the present value of the related cash receipts it shall apply AS 29, Provisions, Contingent Liabilities and Contingent Assets to determine whether to recognise a liability and, if so, how to measure it.

To determine the fair value of a real estate asset in accordance with the above-mentioned paragraphs, a real estate mutual fund scheme is required to use the services of two independent and approved valuers having recent experience in category of the real estate asset being valued and use the lower of the two valuations.

For accounting for rental income on real estate asset, AS 19, Leases, shall be followed. Such income shall be accrued on a daily basis, till the currency of the lease agreements.

Where the rental income receivable by a real estate mutual fund scheme in respect of real estate asset, has accrued but has not been received for the period specified by the Board. Further, provision shall be made by debiting to the revenue account the income so accrued in the manner as may be specified by the Board.

Derecognition of Real Estate Asset

A real estate mutual fund scheme shall derecognise a real estate asset on disposal or when the asset is permanently withdrawn from use and no future economic benefits are expected from its disposal.

In determining the date of disposal for real estate asset by way of sale, a real estate mutual fund scheme shall apply the criteria in AS 9, Revenue Recognition, for recognising revenue from the sale of goods and considers the related guidance in the Appendix to AS 9.

Gains or losses arising from the disposal or retirement of real estate asset shall be determined as the difference between the net disposal proceeds and the carrying amount of the real estate asset and shall be recognised in the Revenue Account in the period of the disposal or retirement.

The consideration receivable on disposal of a real estate asset is to be recognised initially at fair value. In particular, if payment for a real estate asset is deferred, the consideration received is recognized initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent should be recognised as interest revenue over the period of credit.

1.19 Contents of Balance Sheet and Revenue Account

The annual report of a mutual fund consists of (a) Balance Sheet (b) Revenue Account (c) Report of the Board of Trustees (d) Auditor's Report and (e) Statement of the Board of Trustees on specified matters.

Contents of Balance Sheet

(i) The Balance Sheet shall give scheme wise particulars of its assets and liabilities. It shall also disclose, *inter alia*, accounting policies relating to valuation of investments and other important areas.

(ii) If investments are carried at costs or written down cost, their aggregate market value shall be stated separately in respect of each type of investment, such as equity shares, preference shares, convertible debentures listed on recognized stock exchange, non-convertible debentures or bonds further differentiating between those listed on recognised stock exchange and those privately placed.

(iii) The Balance Sheet shall disclose under each type of investment the aggregate carrying value and market value of non-performing investments. An investment shall be regarded as non-performing if it has provided no returns in the form of dividend or interest for a period specified in the Guidelines issued by the Board.

(iv) The Balance Sheet shall indicate the extent of provision made in the Revenue Account for the depreciation/loss in the value of non-performing investments. However, if the investments are valued at marked to market, provisions for depreciation shall not be necessary.

(v) The Balance Sheet shall disclose the per-unit net asset value (NAV) as at the end of the accounting year.

(vi) As in case of companies, the Balance Sheet shall give against each item, the corresponding figures as at the end of the preceding accounting year.

(vii) The notes to the balance sheet should disclose the following information regarding investments:-

(a) all investments shall be grouped under the major classification given in the balance sheet;

(b) under each major classification, the total value of investments falling under each major industry group (which constitutes not less than 5% of the total investment in the major classification) shall be disclosed together with the percentage thereof in relation to the total investment within the classification;

(c) a full list of investments of the scheme shall be made available for inspection with the Asset Management Company;

(d) the basis on which management fees have been paid to the Asset Management Company and the computation thereof;

(e) if brokerage, custodial fees or any other payment for services are paid to or payable to any entity in which the Asset Management Company or its major shareholders have a substantial interest (being not less than 10% of the equity capital), the amounts debited to the revenue account or amounts treated as cost of investments in respect of such services shall be separately disclosed together with details of the interest of the Asset Management Company or its major shareholders;

(f) aggregate value of purchases and sales of investments during the year and expressed as a percentage of average weekly net asset value;

(g) where the non-traded investments which have been valued "in good faith" exceed 5% of the NAV at the end of the year, the aggregate value of such investments; and

(h) movement in unit capital should be stated.

An example of the manner in which the movement in unit capital may be disclosed is given below:

	No. of units	(₹ in lakhs)
Balance as on 1st April, 2016	1250,00,000	12,500.00
Units sold during the year	127,50,000	1,275.00
Units repurchased during the year	(15,40,000)	(154.00)
	1362,10,000	13,621.00

(i) the name of the company including the amount of investment made in each company of the group by each scheme and the aggregate investments made by all schemes in the group companies of the sponsor;

(j) if the investments are marked to market, the total income of the scheme shall include unrealised depreciation or appreciation on investment. There should be disclosure and unrealised appreciation deducted before arriving at the distributable income in the following manner, e.g.

	₹ in lakh	*₹ in lakh*
Net income as per Revenue Account	100	
Add: Balance of undistributed income		

as at 1st April, 2016 brought forward	20	120
Less: Unrealised appreciation on investments		
As on 31st March, 2017	30	
As on 1st April, 2016	15	(15)
		105
Less: Distributed to unit holders	80	
Transfer to reserve	5	(85)
		20

(viii) Provisions for doubtful deposits, doubtful debts and for doubtful outstandings and accrued income shall not be included under provisions on the liability side of the balance sheet, but shall be shown as a deduction from the aggregate value of the relevant asset.

(ix) Disclosure shall be made of all contingent liabilities showing separately underwriting commitments, uncalled liability on partly paid shares and other commitments with specifying details.

Contents of Revenue Account

(i) The Revenue Account shall give scheme wise particulars of the income, expenditure and surplus of the mutual fund. These particulars shall contain information enumerated in Annexure 2 of this Schedule.

(ii) If profit on sale of investments shown in the Revenue Account includes profit/loss on inter-scheme transfer of investments within the same mutual fund the aggregate of such profit recognised as realised, shall be disclosed separately without being clubbed with the profit/loss on sale of investments to third parties.

(iii) Unprovided depreciation in value of investments representing the difference between their aggregate market value and their carrying cost shall be disclosed by way of a note forming part of the Revenue Account. Conversely, unrealised profit on investment representing the difference between their aggregate market value and carrying cost, shall be disclosed by way of note to accounts. The Revenue Account shall indicate the appropriation of surplus by way of transfer to reserves and dividend distributed. However, if investments are marked to market, depreciation may not be provided.

(iv) The Revenue Account shall indicate the appropriation of surplus by way of transfer to reserves and dividend distributed.

(v) The following disclosures shall also be made in the revenue accounts:

(a) provision for aggregate value of doubtful deposits, debts and outstanding and accrued income;

(b) profit or loss in sale and redemption of investment may be shown on a net basis;

(c) custodian and registrar fees;

(d) total income and expenditure expressed as a percentage of average net assets, calculated on a weekly basis.

1.20 Evaluation of Mutual Funds

Mutual funds sell their shares to public and redeem them at current Net Assets Value (NAV) which is calculated as under –

$$\frac{\text{Total market value of all MF holdings - All MF liabilities}}{\text{Unit size}}$$

The net asset value of a mutual fund scheme is basically the per unit market value of all the assets of the scheme. To illustrate this better, a simple example will help.

Scheme name	:	XYZ
Scheme size	:	₹ 50,00,00,000 (Rupees Fifty crores)
Face value of units	:	₹ 10
No. of units	:	5,00,00,000
		$\frac{\text{Scheme size}}{\text{Face value of units}}$
Investments	:	In shares
Market value of shares	:	₹ 75,00,00,000 (Rupees seventy five crores)
	=	$\frac{\text{Market value of investments}}{\text{No. of units}} = \frac{₹\ 75,00,00,000}{5,00,00,000} = ₹\ 15$

Thus, each unit of ₹ 10 is worth ₹ 15.

Simply stated, NAV is the value of the assets of each unit of the scheme, or even simpler value of one unit of the scheme. Thus, if the NAV is more than the face value (₹ 10), it means your money has appreciated and *vice versa*.

NAV also includes dividends, interest accruals and reduction of liabilities and expenses, besides market value of investments. The Net Asset Value (NAV) is the value of net assets under a mutual fund scheme. The NAV per unit is NAV of the scheme divided by number of units outstanding. NAV of a scheme keep on changing with change in market value of portfolio under the scheme. The day of valuation of NAV is called the valuation day.

As per SEBI (Mutual Funds) Regulations, Regulation 48(2) states that the Net Asset Value of the scheme shall be calculated on daily basis.

Illustration 1

Sparrow Holdings is a SEBI Registered Mutual Fund which made its maiden N.F.O (New Fund Offer) on 10th April, 2016 ₹ 10 face value per unit. Subscription was received for 90 lakhs units. An underwriting arrangement was also entered into with Affinity Capital Markets Ltd., that agreed to underwrite the entire NFO of 100 lakh units on a commission of 1.5%.

Out of the monies received ₹ 892.50 lakhs was invested in various capital market instruments. The marketing expenses for the N.F.O amounted to ₹ 11.25 lakhs. During the financial year ended March

2013 the Fund sold securities having cost of ₹127.25 lakh (FV ₹ 54.36 lakhs) for ₹ 141.25 lakhs. The fund in turn purchased securities for ₹ 130 lakhs. The management expenses of the fund are regulated by SEBI stipulations which state that the same shall not exceed 0.25% of the average funds invested during the year. The actual amount spent towards management expenses was ₹ 2.47 lakhs of which ₹ 47,000 was in arrear. The dividends earned on the investments held amounted to ₹ 2.51 lakhs of which a sum of ₹ 25,000 is yet to be collected. The fund distributed 80% of realized earnings. The closing market value of the portfolio was ₹ 1120.23 lakhs.

You are required to determine the closing per unit NAV of the fund.

Solution

Calculation of Closing per unit of NAV of the fund

	₹ in lakhs
Net Assets of Sparrow holding	
Closing cash balance (W.N.2)	79.99
Closing Market Value of Investments	1,120.23
Accrued Dividends (collectable)	0.25
	1,200.47
Less: Current Liabilities	
Outstanding Management Fee (payable)	(0.47)
Closing Net Assets (A)	1,200.00
Units outstanding (in lakhs) (B)	100.00
NAV per unit (A/B)	12.00

Working Notes:

			₹ in lakhs
1.	Computation of opening cash balance		
	Proceeds of NFO in full including underwriters commitment		1000.00
	Less: Initial Purchase of Securities		(892.50)
			107.50
	Less: Underwriting Commission	15.00	
	Marketing Expenses	11.25	(26.25)
	Opening Cash Balance		81.25
2.	Computation of Closing cash balance		
	Opening bank balance (W.N.1)		81.25
	Add: Proceeds from sale of securities	141.25	
	Dividends received on investment	2.26	143.51
			224.76
	Less: Cost of Securities purchased	130.00	

Management Expenses (W.N.3)	1.76	
Capital Gains Distributed ₹ (141.25 - 127.25 x 80%)	11.20	
Dividends Distributed ₹ (2.26 x 80%)	1.81	(144.77)
Closing cash balance		79.99
3. Computation of Management Expenses Chargeable		
Actual Expense Incurred [A]		2.47
Opening Investment Made	892.50	
Closing Funds Invested (892.50 - 127.25 + 130)	895.25	
Total	1,787.75	
Average Funds Invested (1,787.75/2)	893.875	
0.25% of Average Funds Invested [B]		2.23
Lower of A or B		2.23
Less: Amount unpaid		(0.47)
Management expenses paid		1.76

Illustration 2

Calculate the year-end NAV of the Mutual Fund scheme on the basis of the information given below:

(i) UTI launched a new Fund scheme for ₹6,000 crore.

(ii) Underwriting Commission is 1% of the fund shared equally by SBI, PNB, Syndicate Bank and UTI Bank.

(iii) The Fund was launched on 1.4.2016 with a face value of ₹1000 per unit.

(iv) Underwriting Commission was paid in full.

(vi) Management Expense was allowed by SEBI @ 1% of the Fund raised. However, during the year management expense was of ₹45 crore only. The management decided to defer the payment of ₹5 crore to the next financial year.

(vii) On 1.5.2016, the total fund received was invested after deduction of underwriting commission and ₹100 crore to meet the day to day management expenses. The investment fund received yielded 10% interest per annum. The interest was received for 3 quarters and the interest of last quarter is yet to receive. The interest realized in cash has been distributed to the unit holders @ 80%. The financial year runs from April to March. The quarter starts from the date of investment i.e. 1.5.2016.

Solution

Calculation of Net Asset Value of a fund

		₹ in crores
Total Assets:		
Investment (6,000 - 60 -100)	5,840.00	
Add: Closing Cash Balance (Refer W.N.)	147.60	
Add: Interest for two months due to be received	97.33	6,084.93

$\left(5,840 \times 10\% \times \frac{2}{12}\right)$)		
Less: Outstanding Management Expenses		(5.00)
Total value of the fund		6,079.93

No. of Units = $\frac{₹\ 6,000\ \text{crore}}{1,000} = 6\ \text{crore units}$

NAV per unit = $\frac{₹\ 6079.93\ \text{crore}}{6\ \text{crore}}$ = ₹ 1,013.32 per unit

Working Note:

Calculation of year-end cash/bank balance of the fund

		₹ in crores
Cash received during the year for the fund		
Sale of units		6,000
Add: Interest for 3 quarters on investment $\left(5,840 \times 10\% \times \frac{9}{12}\right)$		438
		6,438
Less: Underwriting commission	60	
Management expenses paid in cash	40	
Investment	5,840	
Dividend paid (438 x 80%)	350.40	(6,290.40)
		147.60

1.21 Disposal of Investments

The profit/loss arising on the disposal of investment is the difference between the selling price and the cost. The profit arising on disposal of investment is recognised fully in the Revenue Account.

The loss on disposal of investment is recognised fully in the revenue account, if the investments are sold in the same year in which they are purchased. However, if an investment is sold in any year subsequent to year of purchase, loss on disposal is charged first against provision for depreciation to the extent of balance available, and the balance of loss, if any, should be charged directly to the Revenue Account.

Illustration 3

The investment portfolio for a mutual fund scheme includes 10,000 shares of A Ltd. and 8,000 shares of B Ltd. acquired on 30/10/2016. The cost of A Ltd. shares is ₹ 20 while that of B Ltd. shares is ₹ 30. The market values of these shares at the end of 2016-17 were ₹ 19 and ₹ 32 respectively. Show important accounting entries in books of the fund in the accounting year 2016-17.

Solution

			₹ 000	₹ 000
31.10.16	Investment in A Ltd. Shares	Dr.	200	
	Investment in B Ltd. Shares	Dr.	240	
	To Bank			440
	(Being purchase of A Ltd., 10,000 shares @ ₹ 20 and 8000 shares of B Ltd., @ ₹ 30 each)			
31.3.17	Revenue A/c	Dr.	10	
	To Provision for Depreciation			10
	(Being market value of A Ltd depreciated for ₹ 1 each for 10,000 shares)			
31.3.17	Investment in B Ltd. Shares	Dr.	16	
	To Unrealised Appreciation Reserve			16
	(Being 8000 shares of B Ltd., appreciated @ ₹ 2 each per share on the closing date)			

Illustration 4

In the previous example, suppose that shares of both of the companies were disposed off on 31/05/16 realizing ₹ 18.50 per A Ltd. shares and ₹ 33.50 per B Ltd. shares. Show important accounting entries in books of the fund in the accounting year 2016-17.

Solution

Date	*Particulars*		*₹ 000*	*₹ 000*
1.4.16	Unrealised Appreciation Reserve	Dr.	16	
	To Investment in B Ltd. Shares			16
	(Being 8,000 shares of B Ltd., appreciated @ ₹ 2 each per share on the closing date has been reversed at the beginning of the next year)			
31-5-16	Bank Account	Dr.	185	
	Loss on disposal of Investment	Dr.	15	
	To Investment in A Ltd. Shares			200
	(Being ₹ 2,00,000 of A Ltd., shares sold for ₹ 1,85,000 and Loss incurred ₹ 15,000)			
	Provision for Depreciation	Dr.	10	
	Revenue A/c	Dr.	5	
	To Loss on disposal of Investment			15
	(Earlier depreciation provision provided being reversed on disposal of total shares of A Ltd., and the balance amount debited to Revenue Account.)			

	Bank Account Dr.	268	
	To Investment in B Ltd. shares		256
	To Revenue A/c		12
	(Being 8,000 shares of B Ltd., sold @ ₹ 33.50 accounted on the trade date as per AS 30 since this is a regular transaction in the business)		

Illustration 5

A fund purchased 10,000 debentures of a company on June 1, 2016 for 10.7 lakh and further 5,000 debentures on November 1, 2016 for ₹ 5.45 lakh. The debentures carry fixed annual coupon of 12%, payable on every 31 March and 30 September. On February 28, 2017 the fund sold 6,000 of these debentures for ₹ 6.78 lakh. Nominal value per debenture is ₹ 100.

Show Investment in Debentures A/c in books of the fund.

Solution

Investment in Debentures A/c

		₹ *Lakh*			₹ *Lakh*
June 1, 2016	To Bank	10.70	June 1, 2016	By Interest Recoverable (Note 1)	0.20
Nov. 1, 2016	To Bank	5.45	Nov. 1, 2016	By Interest Recoverable (Note 2)	0.05
Feb. 28, 2017	To Interest Recoverable (Note 3)	0.30	Feb. 28, 2017	By Bank	6.78
Feb. 28, 2017	To Profit on disposal (Note 4)	0.12	March 31, 2017	By Balance c/d	9.54
		16.57			16.57

Working Notes:

Note 1: 10,000 x 100 x 12/100 x 2/12 = ₹ 0.20 Lakhs

Note 2: 5,000 x 100 x 12/100 x 1/12 = ₹ 0.05 Lakhs

Note 3: 6,000 x 100 x 12/100 x 5/12 = ₹ 0.30 Lakhs

Note 4: Cost of investments (per unit) = [(10,70,000 -20,000)+(5,45,000– 5,000)]/15,000 units

= [10,50,000+ 5,40,000]/15,000 = ₹ 106

Cost of investments sold = ₹ 106 x 6,000 = ₹ 6,36,000

Sale proceeds = ₹ 6,78,000 - ₹ 30,000(interest) = ₹ 6,48,000

Profit = ₹ 6,48,000 - ₹ 6,36,000 = ₹ 12,000

1.22 Recognition of Dividend Income

Dividend income earned by a scheme should be recognized, not on the date the dividend is declared, but on the date the share is quoted on an ex-dividend basis. For investments, which are not quoted on the stock exchange, dividend income must be recognized on the date of declaration.

Where income receivable on investments has accrued but has not been received for the period specified in the SEBI guidelines, the income accrued should be debited to Revenue A/c as provision.

Bonus shares to which the scheme becomes entitled should be recognized only when the original shares on which the bonus the bonus entitlement accrues are traded on the stock exchange on an ex-bonus basis. Similarly, rights entitlements should be recognized only when the original shares on which the right entitlement accrues are traded on the stock exchange on an ex-rights basis.

1.23 Date of Recognition of Transactions

For investments in securities

Transaction for purchase or sale of investments should be recognized as of the trade date and not as of the settlement date, so that the effect of all investments traded during a financial year are recorded and reflected in the financial statements for that year. Where investment transactions take place outside the stock market, for example, acquisitions through private placement or purchases or sales through private treaty, the transaction should be recorded in the event of a purchase, as of the date on which the scheme obtains in enforceable obligation to pay the price or, in the event of a sale, when the scheme obtains an enforceable right to collect the proceeds of sale or an enforceable obligation to deliver the instruments sold.

(a) When in the case of an open – ended scheme units are sold, the difference between the sale price and the face value of the unit, if positive, should be credited to reserves and if negative be debited to reserves, the face value being credited to Capital Account. Similarly, when in respect of such a scheme, units are repurchased, the difference between the purchase price and face value of the unit, if positive should be debited to reserves and, if negative, should be credited to reserves, the face value being debited to the capital account.

(b) In the case of an open – ended scheme, when units are sold an appropriate part of the sale proceeds should be credited to an Equalisation Account and when units are repurchased an appropriate amount should be debited to Equalisation Account. The net balance on this account should be credited or debited to the Revenue Account. The balance on the Equalisation Account debited or credited to the Revenue Account should not decrease or increase the net income of the fund but is only an adjustment to the distributable surplus. It should, therefore, be reflected in the Revenue Account only after the net income of the fund is determined.

(c) In a close – ended scheme which provide to the unit holders the option for an early redemption or repurchase their own units, the par value of the unit has to be debited to Capital Account and the difference between the purchase price and the par value, if positive, should be credited to reserves and, if negative, should be debited to reserves. A proportionate part of the unamortized initial issue expenses should also be transferred to the reserves so that the balance carried forward on that account is proportional to the number of units remaining outstanding.

(d) Underwriting commission should be recognized as revenue only when there is no devolvement on the scheme. Where there is devolvement on the scheme, the full underwriting commission received and not merely the portion applicable to the devolvement should be reduced from the cost of the investment.

For investments in real estate assets

In a real estate mutual fund scheme which provides to the unit holders the option for an early redemption or repurchase their own units the par value of the unit shall be debited to Capital Account and the difference between the purchase price and the par value, if positive, should be debited to reserves and, if negative, shall be credited to reserves.

1.24 Dividend Equalisation

New investors are not entitled to any share of the income of a mutual fund scheme which arose before they bought their units. However, at the end of each distribution period the fund management allocates the same amount from the income of the fund to each unit. To compensate for this an equalisation payment is added to the cost of new units. This is the amount of income that has arisen up to the date of purchase of the unit. Because these payments are included in the amount available for distribution they are effectively repaid to the purchaser. The purchaser's dividend voucher at the end of the first distribution period should show the amount of the returned equalisation payment. This payment is not income. It should not be treated as capital distribution. It is a return of the initial price paid and it should therefore be deducted from the price paid when computing the chargeable gain on eventual disposal.

Illustration 6

On April 1, 2016 a mutual fund scheme had 9 lakh units of face value ₹ 10 outstanding. The scheme earned ₹ 81 lakh in 2016-17, out of which ₹ 45 lakh was earned in first half-year. 1 lakh units were sold on 30.09.16 at NAV ₹ 60. Show important accounting entries for sale of units and distribution of dividend at the end of 2016-17.

Solution

Allocation of earnings

	Old unit holders (9 lakh units) (₹ Lakh)	*New unit holders (1 lakh units) (₹ lakh)*	*Total earning (₹ Lakh)*
First half-year (₹ 5.00 per unit)	45.0	Nil	45.0

Second half-year (₹ 3.60 per unit)	32.4	3.6	36.0
	77.4	3.6	81.0
Add: Equalisation payment recovered			5.0
Total available for distribution			86.0

Note: Equalisation payment = ₹ 45 lakh / 9 lakh = ₹ 5 per unit.

Distribution of earning per unit

	Old unit holders ₹	*New unit holders* ₹
Dividend distributed	8.60	8.60
Less: Equalisation payment		(5.00)
Net distributed income	8.60	3.60

Journal Entries

Date			*₹ lakh*	*₹ lakh*	
30/09/16	Bank	Dr.	65		1 lakh x ₹ 65
	To Unit Capital			10	1 lakh x ₹ 10
	To Reserves			50	1 lakh x ₹ 50
	To Dividend Equalisation			5	1 lakh x ₹ 5
31/03/17	Dividend Equalisation	Dr.	5		
	To Revenue A/c			5	
31/03/17	Revenue A/c	Dr.	86		
	To Bank			86	10 lakh x ₹ 8.60

UNIT 2: NON-BANKING FINANCE COMPANY

2.1 Introduction

Non Banking Financial Companies (NBFC) play a crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector. They are increasingly being recognised as complementary to the banking system, capable of absorbing shocks and spreading risks at times of financial distress. Simplified sanction procedures, orientation towards customers, attractive rates of return on deposits and flexibility and timeliness in meeting the credit needs of specified sectors (like equipment leasing and hire purchase), are some of the factors that enhanced the attractiveness of NBFCs.

2.2 Definition of NBFC

Section 45 I(f) of Reserve Bank of India (Amendment) Act, 1997 defines a non-banking financial company as:

(i) A financial institution which is a company;

(ii) A non-banking institution which is a company with principal business of 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 Reserve Bank with the previous approval of the Central Government may specify by notification in the Official Gazette.

For purposes of RBI Directions relating to Acceptance of Public Deposits, non-banking financial company means only the non-banking institution which is a – "Loan company", "Investment company", "Hire purchase finance company", "Equipment leasing company" and "Mutual benefit financial company".

In a simple language, an Non-Banking Financial Company (NBFC)

- is a company registered under the Companies Act, 1956 or 2013
- is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business
- does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.

Residuary non-banking company - A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or any other manner, or lending in any manner is also a non-banking financial company.

What does conducting financial activity as "principal business" mean?

Financial activity as principal business is when a company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria will be registered as NBFC by RBI. The term 'principal business' is not defined by the Reserve Bank of India Act. The Reserve Bank has defined it so as to ensure that only companies predominantly engaged in financial activity get registered with it and are regulated and supervised by it. Hence if there are companies engaged in agricultural operations, industrial activity, purchase and sale of goods, providing services or purchase, sale or construction of immovable property as their principal business and are doing some financial business in a small way, they will not be regulated by the Reserve Bank. Interestingly, this test is popularly known as 50-50 test and is applied to determine whether or not a company is into financial business.

2.3 Registration of Every NBFC with RBI

In terms of Section 45-IA of the RBI Act, 1934, no Non-banking Financial company can commence or carry on business of a non-banking financial institution without a) obtaining a certificate of registration from the Bank and without having a Net Owned Funds of ₹ 25 lakhs (₹ Two crore since April 1999). However, in terms of the powers given to the Bank, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock broking companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi companies as notified under Section 620A of the Companies Act, 1956, Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982,Housing Finance Companies regulated by National Housing Bank, Stock Exchange or a Mutual Benefit company.

2.4 Distinction between an NBFC and a Bank

NBFCs perform functions similar to that of banks. However there are following few differences:

S.No.	NBFC	Bank
1.	An NBFC cannot accept demand deposits	A Bank can accept demand deposits
2.	An NBFC is not a part of the payment and settlement system	A Bank is a part of the payment and settlement system
3.	An NBFC cannot issue cheques drawn on itself	A Bank can issue cheques drawn on itself
4.	Deposit insurance facility of the Deposit Insurance and Credit Guarantee Corporation (DICGC) is not available for NBFC depositors, unlike banks	Deposit insurance facility of the Deposit Insurance and Credit Guarantee Corporation (DICGC) is available for banks

2.5 Classification of NBFC

Does the Reserve Bank regulate all financial companies? No.

A. Companies exempted from registration under RBI

Housing Finance Companies, Merchant Banking Companies, Stock Exchanges, Companies engaged in the business of stock-broking/sub-broking, Venture Capital Fund Companies, Nidhi Companies, Insurance companies and Chit Fund Companies are NBFCs but they have been exempted from the requirement of registration under Section 45-IA of the RBI Act, 1934 subject to certain conditions.

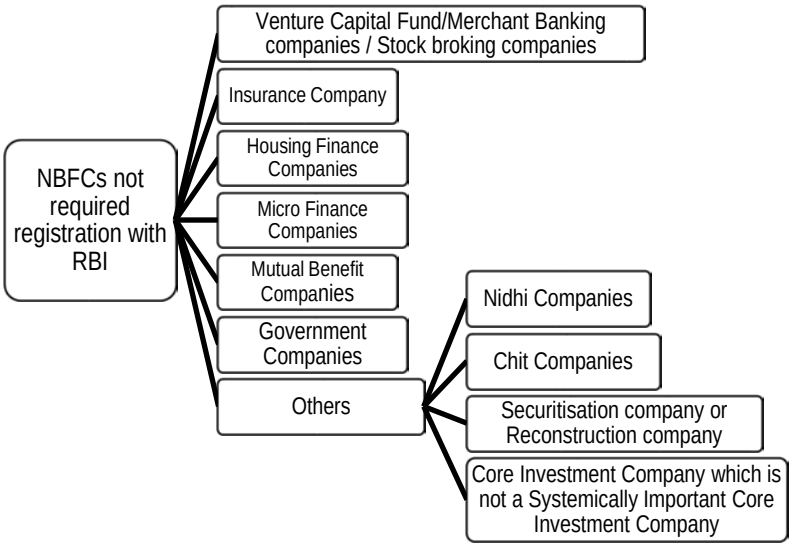
Housing Finance Companies are regulated by National Housing Bank, Merchant Banker/Venture Capital Fund Company/stock-exchanges/stock brokers/sub-brokers are regulated by Securities and Exchange Board of India, and Insurance companies are regulated by Insurance Regulatory and Development Authority. Similarly, Chit Fund Companies are regulated by the respective State Governments and Nidhi Companies are regulated by Ministry of Corporate Affairs, Government of India.

Companies that do financial business but are regulated by other regulators are given specific exemption by the Reserve Bank from its regulatory requirements for avoiding duality of regulation.

It may also be mentioned that Mortgage Guarantee Companies have been notified as Non-Banking Financial Companies under Section 45 I(f)(iii) of the RBI Act, 1934.

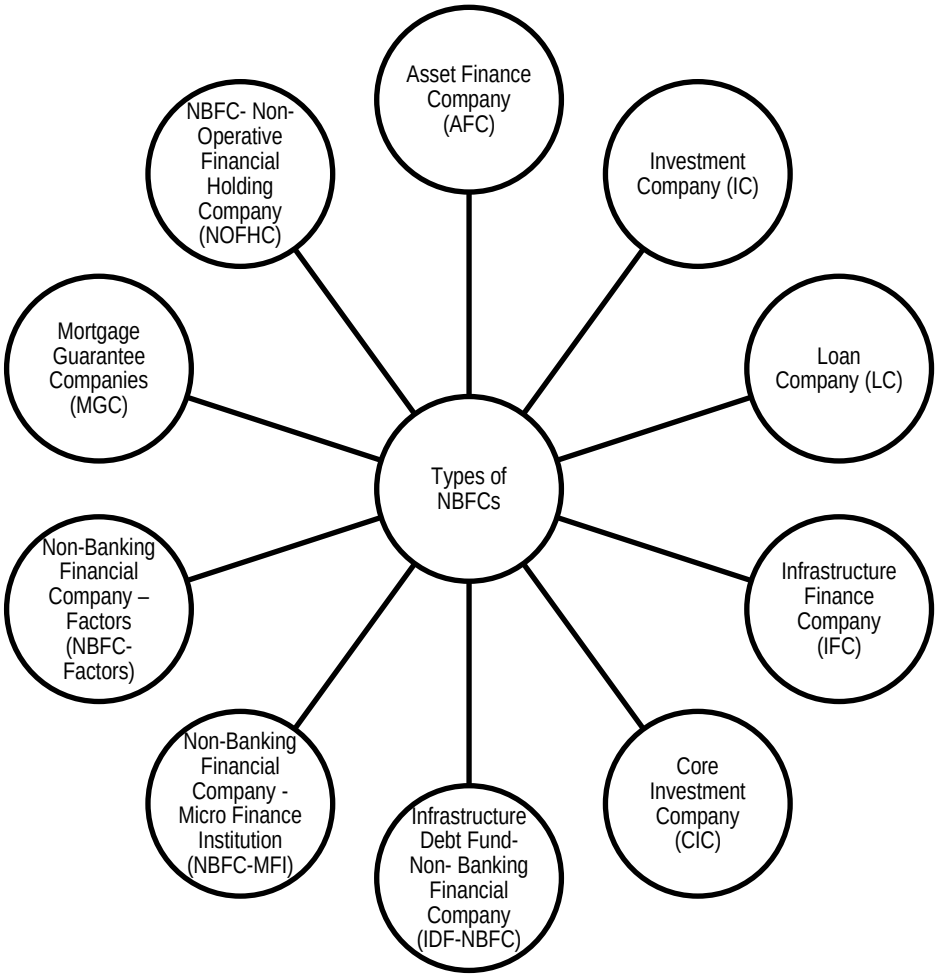
Core Investment Companies with asset size of less than ₹ 100 crore, and those with asset size of ₹ 100 crore and above but not accessing public funds are exempted from registration with the RBI.

NBFCs not registered with RBI are classified under following categories:



B. NBFCs mandated to register under RBI

NBFCs registered with RBI are classified under following categories:



NBFCs are categorized a) in terms of the type of liabilities into Deposit and Non-Deposit accepting NBFCs, b) non deposit taking NBFCs by their size into systemically important and other non-deposit holding companies (NBFC-NDSI and NBFC-ND) and c) by the kind of activity they conduct. Within this broad categorization the different types of NBFCs are as follows:

1. Asset Finance Company (AFC)

(i) AFC would be defined as any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines.

(ii) Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising there from is not less than 60% of its total assets and total income respectively.

2. Investment Company (IC): It means a company which is a financial institution carrying on as its main business of the acquisition of securities.

3. Loan Company (LC): It means any company which is a financial institution carrying on as its main business by providing finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

4. Infrastructure Finance Company: An IFC is defined as non deposit taking NBFC that fulfills the criteria mentioned below:

(i) have a minimum of 75 per cent of its total assets should be deployed in infrastructure loans as defined in Para 2(viii) of the Non Banking Financial (Non Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

(ii) have a net owned funds of ₹ 300 crore or above;

(iii) have obtained a minimum credit rating 'A' or equivalent of CRISIL, FITCH, CARE, ICRA, Brickwork Ratings India Pvt. Ltd. or equivalent rating by any other crediting rating agency accredited by RBI;

(iv) have a Capital to Risk Asset Ratio (CRAR) of 15 percent (with a minimum Tier I capital of 10 percent).

5. Core Investment Companies: Core Investment Company means a NBFC carrying on the business of acquisition of shares and securities which satisfies the following conditions:

- it holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;
- its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its Total Assets;
- it does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;
- it does not carry on any other financial activity referred to in section 45-I(*c*) and 45-I(*f*) of the RBI Act, 1934 except investment in bank deposits, money market instruments, government securities, loans and investments in debt issuances of group companies or guarantees issued on behalf of group companies.

Core Investment Companies (CIC) with an asset size of less than ₹ 100 crores will not be required to register themselves with RBI.

Core Investment Companies (CIC) with total assets size of ₹ 100 crores or more either individually or in aggregate alongwith other Core Investment Companies in the groups and raises or holds public funds will be regarded as Systemically Important Core Investment Companies (CICs-ND-SI). NBFCs whose asset size is of ₹ 500 cr or more as per last audited

balance sheet are considered as systemically important NBFCs. Systemically Important Core Investment Companies will be required to get themselves registered with Reserve Bank of India.

A CIC-ND-SI which fulfills the following conditions, will not be required to meet the requirement for maintaining Net Owned Funds & capital adequacy and exposure norms as required under Non-Banking Financial (Non-Deposit Accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2007:

- Maintenance of minimum Capital Ratio where Adjusted Net Worth shall not be less than 30% of its Aggregate Risk Weighted Assets on Balance Sheet and risk adjusted value off-balance sheet items as on the date of the last audited Balance Sheet at the end of the financial year.
- Ensuring that it's outside liabilities at all times doesn't not exceed 2.5 times of the Adjusted Net Worth as on last audited Balance Sheet date.

The above mentioned categories may further have the following sub-categories depending upon their business functions:

(i) Equipment leasing company engaged in equipment leasing or financing of such activity.

(ii) Hire purchase finance company engaged in hire purchase transaction or financing of such transactions.

(iii) Investment company engaged in acquisition of securities and trading in such securities to earn a profit.

(iv) Loan company engaged in providing finance by making loans or advances, or otherwise for any activity other than its own; excludes EL/HP/Housing finance Companies (HFCs).

6. Infrastructure Debt Fund- Non- Banking Financial Company (IDF-NBFC): "Infrastructure Finance Company" means a non-deposit taking NBFC that fulfills the following criteria :

(a) a minimum of 75 per cent of its total assets deployed in "infrastructure loans";

(b) Net owned funds of ` 300 crore or above;

(c) minimum credit rating 'A' or equivalent of CRISIL, FITCH, CARE, ICRA, Brickwork Rating India Pvt. Ltd. (Brickwork) or equivalent rating by any other credit rating agency accredited by the Bank;

(d) CRAR of 15 percent (with a minimum Tier I capital of 10 percent).

It invests only in Public Private Partnerships (PPP) and post commencement operations date (COD) infrastructure projects which have completed at least one year of satisfactory commercial operation and becomes a party to a Tripartite Agreement.

Infrastructure Debt Funds (IDFs) facilitate the flow of long-term debt into infrastructure projects. The IDF will be set up either as trust or as a company. A trust based IDF would normally be a mutual fund while a company based IDF would normally be a NBFC i.e. IDF-NBFC. IDF- NBFC would raise resources through issue of either Rupee or Dollar denominated bonds of minimum

5 year maturity. The investors would be primarily domestic and off-shore institutional investors, especially insurance and pension funds which would have long term resources. IDF-NBFC would be regulated by the Reserve Bank.

7. Non-Banking Financial Company–Micro Finance Institution (NBFC-MFI): The Reserve Bank of India having considered it necessary in the public interest and being satisfied that for the purpose of enabling the Bank to regulate the credit system to the advantage of the country, gave the directions for the Non-Banking Financial Company -Micro Finance Institutions (Reserve Bank) Directions, 2011.

An NBFC-MFI is defined as a non-deposit taking NBFC (other than a company licensed under Section 25 of the Indian Companies Act, 1956 or Section 8 of the Companies Act, 2013) having not less than 85% of its assets in the nature of qualifying assets which satisfy the following criteria:

i. Minimum Net Owned Funds of ₹ 5 crore. (For NBFC-MFIs registered in the North Eastern Region of the country, the minimum NOF requirement shall stand at ₹ 2 crore).

ii. Not less than 85% of its net assets are in the nature of "qualifying assets."

For the purpose of ii above,

"Net assets" are defined as total assets other than cash and bank balances and money market instruments.

"Qualifying asset" shall mean a loan which satisfies the following criteria:-

a. loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding ₹ 1,00,000 or urban and semi-urban household income not exceeding ₹ 1,60,000;

b. loan amount does not exceed ₹ 50,000 in the first cycle and ₹ 1,00,000 in subsequent cycles;

c. total indebtedness of the borrower does not exceed ₹ 1,00,000;

d. tenure of the loan not to be less than 24 months for loan amount in excess of ₹ 15,000 with prepayment without penalty;

e. loan to be extended without collateral;

f. aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs;

g. loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower

8. Non-Banking Financial Company – Factors (NBFC-Factors): NBFC-Factor is a non-deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring business should constitute at least 50 percent of its total assets and its income derived from factoring business should not be less than 50 percent of its gross income.

9. Mortgage Guarantee Companies (MGC): MGC are financial institutions for which at least 90% of the business turnover is mortgage guarantee business or at least 90% of the gross income is from mortgage guarantee business and net owned fund is ₹ 100 crore.

10. NBFC- Non-Operative Financial Holding Company (NOFHC) is financial institution through which promoter / promoter groups will be permitted to set up a new bank. It's a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators, to the extent permissible under the applicable regulatory prescriptions.

2.6 Registration and Regulation of NBFC

Under Section 45–IA of the Reserve Bank of India (Amendment) Act, 1997, no non-banking financial company is allowed to commence or carry on the business of a non-banking financial institution without obtaining a certificate of registration issued by the Reserve Bank of India.

A company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934 should comply with the following:

i. it should be a company registered under Section 3 of the companies Act, 1956

ii. It should have a minimum net owned fund of ₹ 200 lakh. (The minimum net owned fund (NOF) required for specialized NBFCs like NBFC-MFIs, NBFC-Factors, CICs is indicated separately in the FAQs on specialized NBFCs)

They can apply to Reserve Bank of India in prescribed form along with necessary documents for registration. The RBI issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

However, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI

The Reserve Bank of India has issued directions to non-banking financial companies on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs. Directions were also issued to auditors to report non-compliance with the RBI Act and regulations to the Reserve Bank, Board of Directors and shareholders. RBI has also issued Fair Practices Code to be adopted by all NBFCs while doing lending business. The guidelines inter alia, covered general principles on adequate disclosures on the terms and conditions of a loan and also adopting a non-coercive recovery method.

2.7 Residuary Non-Banking Companies (RNBCs)

Residuary Non-Banking Company is a class of NBFC which is a company and has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner and not being Investment, Asset Financing, Loan Company. These companies are required to maintain investments as per directions of RBI, in addition to liquid assets. The functioning of these companies is different from those of NBFCs in terms of method of mobilization of deposits and requirement of deployment of depositors' funds as per Directions. Besides, Prudential Norms Directions are applicable to these companies also.

The minimum interest an RNBC should pay on deposits should be 5% (to be compounded annually) on the amount deposited in lump sum or at monthly or longer intervals; and 3.5% (to be compounded annually) on the amount deposited under daily deposit scheme. Interest here includes premium, bonus or any other advantage, that an RNBC promises to the depositor by way of return. An RNBC can accept deposits for a minimum period of 12 months and maximum period of 84 months from the date of receipt of such deposit. They cannot accept deposits repayable on demand. However, at present, the only RNBCs in existence (Peerless) has been directed by the Reserve Bank to stop collecting deposits, repay the deposits to the depositor and wind up their RNBC business as their business model is inherently unviable.

2.8 Minimum Net Owned Fund

On registration of NBFC with RBI, all NBFCs have to comply with certain requirements like maintenance of the minimum Net Owned Fund (NOF), creation of reserve fund, compulsory transfer of certain percentage of net profit etc.

NOF requirement for new companies applying for grant of CoR to commence business of an NBFC is stipulated at ₹200 lakh.

As per the definition:

Owned Fund = Aggregate of the paid-up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, after deducting therefrom accumulated balance of loss, deferred revenue expenditure and other intangible assets.

Net Owned Fund = Owned Fund – Investments in shares of subsidiaries/ companies in same group/Other NBFC – Book value of debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group (to the extent such sum exceeds 10% of owned fund)

In terms of Section 45-IC of the RBI Act, NBFCs are required to create a reserve fund and transfer therein a sum not less than twenty per cent of its net profit every year.

2.9 Liquid Asset Requirements

In terms of Section 45-IB of the RBI Act, 1934 the minimum level of liquid asset to be maintained by NBFCs is 15 per cent of public deposits outstanding as on the last working day of the second preceding quarter.

Of the 15%, NBFCs are required to invest not less than 10% in approved securities and the remaining 5% can be in unencumbered term deposits with any scheduled commercial bank. Thus, the liquid assets may consist of government securities, government guaranteed bonds and term deposits with any scheduled commercial bank.

The investment in government securities should be in dematerialised form which can be maintained in Constituents' Subsidiary General Ledger (CSGL) Account with a scheduled

commercial bank (SCB) / Stock Holding Corporation of India Limited (SHICL). In case of Government guaranteed bonds the same may be kept in dematerialised form with SCB/SHCIL or in a dematerialised account with depositories [National Securities Depository Ltd. (NSDL)/Central Depository Services (India) Ltd. (CDSL)] through a depository participant registered with Securities & Exchange Board of India (SEBI). However in case there are Government bonds which are in physical form the same may be kept in safe custody of SCB/SHCIL.

NBFCs have been directed to maintain the mandated liquid asset securities in a dematerialised form with the entities stated above at a place where the registered office of the company is situated. However, if a NBFC intends to entrust the securities at a place other than the place at which its registered office is located, it may do so after obtaining in writing the permission of RBI. It may be noted that the liquid assets in approved securities will have to be maintained in dematerialised form only.

The liquid assets maintained as above are to be utilised for payment of claims of depositors. However, deposit being unsecured in nature depositors do not have direct claim on liquid assets.

2.10 Categories of NBFCs

The Non-Banking Finance Company sector has evolved considerably in terms of its size, operations, technological sophistication, and entry into newer areas of financial services and products. NBFCs are now deeply interconnected with the entities in the financial sector, on both sides of their balance sheets. Being financial entities, they are as exposed to risks arising out of counterparty failures, funding and asset concentration, interest rate movement and risks pertaining to liquidity and solvency, as any other financial sector player. At the same time there are segments within the sector that do not pose any significant risks to the system.

Accordingly, NBFCs are categorized into following three groups for the purpose of administering prudential regulations:

1. Deposits taking NBFCs (NBFCs-D);
2. Non-deposit taking NBFCs (NBFCs-ND) (those with assets of less than ₹ 500 crore); and
3. Non–deposit taking systemically important NBFCs (NBFCs-ND-SI) (those with assets of ₹ 500 crore and above),

2.11 Prudential Accounting Norms

In order to ensure that NBFCs function on sound and healthy lines and make adequate disclosures in their financial reports, the Reserve Bank has issued prudential norms for all the Non-banking Financial Companies. The current prudential regulation mainly comprises the following elements:

a) Norms relating to Income Recognition, Asset Classification and Provisioning norms;

b) Capital to Risk Weighted Assets Ratio (CRAR); and

c) Credit Concentration Norms

Note: [norms at b) and c) are applicable to only NBFCs–D and NBFCs-ND-SI].

Currently, there are following two sets of Directions for prudential norms:

1. "Non-Banking Financial Company–Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016"

   The provisions of "Non-Banking Financial Company –Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016", shall apply to

   (i) every non-banking financial company not accepting / holding public deposits which is not systemically important (as defined in paragraph 3 (xxviii) of the Directions;

   (ii) every NBFC-Factor registered with the Bank under section 3 of the Factoring Regulation Act, 2011 and having an asset size of below ` 500 crore;

   (iii) every Non-Banking Finance Company – Micro Finance Institution (NBFC-MFI) registered with the Bank under the provisions of RBI Act, 1934 and having an asset size of below ` 500 crore;

   (iv) every Non-Banking Finance Company - Infrastructure Finance Company (NBFC-IFC) registered with the Bank under the provisions of RBI Act, 1934 and having an asset size of below ` 500 crore.

2. "Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016"

   The provisions of "Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016" shall apply to:

   (i) every Systemically Important Non-Deposit taking Non-Banking Financial Company (NBFC-ND-SI) registered with the Bank under the provisions of RBI Act, 1934;

   (ii) every Deposit taking Non-Banking Financial Company (NBFC-D) registered with the Bank under the provisions of RBI Act, 1934;

   (iii) every NBFC-Factor registered with the Bank under section 3 of the Factoring Regulation Act, 2011 and having an asset size of ` 500 crore and above;

   (iv) every Infrastructure Debt Fund –Non-Banking Finance Company(IDF-NBFC) registered with the Bank under the provisions of RBI Act, 1934;

   (v) every Non-Banking Finance Company –Micro Finance Institutions (NBFC-MFIs) registered with the Bank under the provisions of RBI Act, 1934 and having an asset size of ` 500 crore and above;

   (vi) every Non-Banking Finance Company - Infrastructure Finance Company (NBFC-IFC) registered with the Bank under the provisions of RBI Act, 1934 and having an asset size of ` 500 crore and above.

2.12 Important Definitions

Break up value means the equity capital and reserves as reduced by intangible assets and revaluation reserves, divided by the number of equity shares of the investee company.

Carrying cost means book value of the assets and interest accrued thereon but not received.

Earning value means the value of an equity share computed by taking the average of profits after tax as reduced by the preference dividend and adjusted for extra-ordinary and non-recurring items, for the immediately preceding three years and further divided by the number of equity shares of the investee company and capitalised at the following rate:

(a) in case of predominantly manufacturing company, eight per cent;

(b) in case of predominantly trading company, ten per cent; and

(c) in case of any other company, including non-banking financial company, twelve per cent;

Note: If an investee company is a loss making company the earning value will be taken at zero.

Fair value means the mean of the earning value and the break up value.

Net book value means:

(a) in the case of hire purchase asset, the aggregate of overdue and future instalments receivable as reduced by the balance of unmatured finance charges and further reduced by the provisions made as per paragraph 9(2)(i) of these Directions;

(b) in the case of leased asset, aggregate of capital portion of overdue lease rentals accounted as receivable and depreciated book value of the lease asset as adjusted by the balance of lease adjustment account.

Infrastructure Finance Company means a non-banking finance company which deploys at least 75 per cent of its total assets in infrastructure loans"

Subordinated debt means an instrument, which is fully paid up, is unsecured and is subordinated to the claims of other creditors and is free from restrictive clauses and is not redeemable at the instance of the holder or without the consent of the supervisory authority of the non-banking financial company. The book value of such instrument shall be subjected to discounting as provided hereunder:

Remaining Maturity of the instruments	*Rate of discount*
(a) Upto one year	100%
(b) More than one year but upto two years	80%
(c) More than two years but upto three years	60%
(d) More than three years but upto four years	40%
(e) More than four years but upto five years	20%

to the extent such discounted value does not exceed fifty per cent of Tier capital.

Substantial interest means holding of a beneficial interest by an individual or his spouse or minor child, whether singly or taken together in the shares of a company, the amount paid up

on which exceeds ten per cent of the paid up capital of the company; or the capital subscribed by all the partners of a partnership firm.

Systemically important non-deposit taking non-banking financial company means a non-banking financial company not accepting / holding public deposits and having total assets of ₹ 500 crore and above as shown in the last audited balance sheet.

2.13 Income Recognition

(1) The income recognition shall be based on recognised accounting principles.

(2) Income including interest/ discount/ hire charges/ lease rentals or any other charges on NPA shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed.

2.14 Income from Investment

(1) Income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis. Provided that the income from dividend on shares of corporate bodies shall be taken into account on accrual basis when such dividend has been declared by the corporate body in its annual general meeting and the applicable NBFC's right to receive payment is established.

(2) Income from bonds and debentures of corporate bodies and from Government securities/bonds shall be taken into account on accrual basis. Provided that the interest rate on these instruments is pre-determined and interest is serviced regularly and is not in arrears.

(3) Income on securities of corporate bodies or public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government shall be taken into account on accrual basis.

2.15 Accounting for Investments

1. (a) The Board of Directors of every non-banking financial company shall frame investment policy for the company and implement the same;

   (b) The criteria to classify the investments into current and long term investments shall be spelt out by the Board of the company in the investment policy;

   (c) Investments in securities shall be classified into current and long term, at the time of making each investment;

   (d) (i) There shall be no inter-class transfer on ad-hoc basis;

   (ii) The inter-class transfer, if warranted, shall be effected only at the beginning of each half year, on April 1 or October 1, with the approval of the Board;

   (iii) The investments shall be transferred scrip-wise, from current to long-term or vice-versa, at book value or market value, whichever is lower;

(iv) The depreciation, if any, in each scrip shall be fully provided for and appreciation, if any, shall be ignored;

(v) The depreciation in one scrip shall not be set off against appreciation in another scrip, at the time of such inter-class transfer, even in respect of the scrips of the same category.

2. Quoted current investments shall, for the purposes of valuation, be grouped into the following categories, viz.,

   (a) equity shares,

   (b) preference shares,

   (c) debentures and bonds,

   (d) Government securities including treasury bills,

   (e) units of mutual fund, and

   (f) others.

   Quoted current investments for each category shall be valued at cost or market value whichever is lower. For this purpose, the investments in each category shall be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored. Depreciation in one category of investments shall not be set off against appreciation in another category.

3. Unquoted equity shares in the nature of current investments shall be valued at cost or break up value, whichever is lower. However, non-banking financial companies may substitute fair value for the break up value of the shares, if considered necessary. Where the balance sheet of the investee company is not available for two years, such shares shall be valued at one Rupee only.

4. Unquoted preference shares in the nature of current investments shall be valued at cost or face value, whichever is lower.

5. Investments in unquoted Government securities or Government guaranteed bonds shall be valued at carrying cost.

6. Unquoted investments in the units of mutual funds in the nature of current investments shall be valued at the net asset value declared by the mutual fund in respect of each particular scheme.

7. Commercial papers shall be valued at carrying cost.

8. A long term investment shall be valued in accordance with the Accounting Standard issued by ICAI.

Note: Unquoted debentures shall be treated as term loans or other type of credit facilities depending upon the tenure of such debentures for the purpose of income recognition and asset classification.

2.16 Applicability of Prudential Norms

One of the main objectives of prudential regulation is to address systemic risks. The systemic risks posed by NBFCs functioning exclusively out of their own funds and NBFCs accessing public funds cannot be equated and hence cannot be subjected to the same level of regulation. Hence, as a principle, enhanced prudential regulations has been made applicable to NBFCs wherever public funds are accepted and conduct of business regulations are made applicable wherever customer interface is involved.

Accordingly, the regulatory approach in respect of NBFCs-ND with an asset size of less than ₹ 500 crore is as under:

(i) They shall not be subjected to any regulation either prudential or conduct of business regulations viz., Fair Practices Code (FPC), KYC, etc., if they have not accessed any public funds and do not have a customer interface.

(ii) Those having customer interface will be subjected only to conduct of business regulations including FPC, KYC etc., if they are not accessing public funds.

(iii) Those accepting public funds will be subjected to limited prudential regulations but not conduct of business regulations if they have no customer interface.

(iv) Where both public funds are accepted and customer interface exist, such companies will be subjected both to limited prudential regulations and conduct of business regulations.

All NBFCs-ND with assets of ₹ 500 crore and above, irrespective of whether they have accessed public funds or not, has to comply with prudential regulations as applicable to NBFCs-ND-SI. They has to also comply with conduct of business regulations if customer interface exists.

Note: For this purpose, the term 'public funds' includes "funds raised directly or indirectly through public deposits, commercial papers, debentures, inter-corporate deposits and bank finance, but excludes funds raised by issue of instruments compulsorily convertible into equity shares within a period not exceeding 5 years from the date of issue".

2.17 Asset Classification

Every NBFC shall, after taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realisation, classify its lease/hire purchase assets, loans and advances and any other forms of credit into the following classes namely, -

(a) Standard assets;

(b) Sub-standard assets;

(c) Doubtful assets; and

(d) Loss assets.

(a) *Standard asset* means an asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem nor carry

more than normal risk attached to the business.

(b) *Sub-standard asset* : As per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, sub-standard asset means (a) an asset which has been classified as non-performing asset for a period not exceeding 14 months for the financial year ending March 31, 2017; (b) an asset where the terms of the agreement regarding interest and / or principal have been renegotiated or rescheduled or restructured after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled or restructured terms.

For the existing loans, a one-time adjustment of the repayment schedule, which shall not amount to restructuring will, however, be permitted.

Note: The above *14 months* criteria for classification of sub-standard asset is till the financial year ending March 31, *2017*. However, in future, for all loan and hire-purchase and lease assets, sub-standard asset would mean an asset that has been classified as NPA for a period not exceeding 12 months for the financial year ending March 31, 2018 and thereafter.

However, as per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, sub-standard asset shall mean:

(a) an asset which has been classified as non-performing asset for a period not exceeding 18 months;

(b) an asset where the terms of the agreement regarding interest and / or principal have been renegotiated or rescheduled or restructured after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled or restructured terms

(c) *Doubtful asset* : As per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, doubtful asset means (a) a term loan, or (b) a lease asset, or (c) a hire purchase asset, or (d) any other asset, which remains a sub-standard asset for a period exceeding *14 months* for the financial year ending *March 31, 2017*;

Note: The above *14 months* criteria for classification of doubtful asset is till the financial year ending *March 31, 2017*. However, in future, for all loan and hire-purchase and lease assets, doubtful asset would mean an asset that has remained sub-standard for a period exceeding 12 months for the financial year ending March 31, 2018 and thereafter.

However, as per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, "doubtful asset" shall mean (a) a term loan, or (b) a lease asset, or (c) a hire purchase asset, or (d) any other asset, which remains a sub-standard asset for a period exceeding 18 months.

(d) *Loss asset* means (i) an asset which has been identified as loss asset by the NBFC or its internal or external auditor or by the Reserve Bank during the inspection of the NBFC, to the extent it is not written off by the NBFC; and (ii) an asset which is adversely affected by

a potential threat of non-recoverability due to either erosion in the value of security or non-availability of security or due to any fraudulent act or omission on the part of the borrower.

The class of assets referred to above shall not be upgraded merely as a result of rescheduling, unless it satisfies the conditions required for the up gradation.

2.18 Non-Performing Asset (NPA)

'Non-performing asset' means:

(a) an asset, in respect of which, interest has remained overdue for a period of six months or more;

(b) a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more;

(c) a demand or call loan, which remained overdue for a period of six months or more from the date of demand or call or on which interest amount remained overdue for a period of six months or more;

(d) a bill which remains overdue for a period of six months or more;

(e) the interest in respect of a debt or the income on receivables under the head other current assets' in the nature of short term loans/advances, which facility remained overdue for a period of six months or more;

(f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months or more;

Note : As per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, the above six months criteria for the assets covered under (a) to (f) is 4 months for the financial year ending March 31, 2017; and from next year ending March 31, 2018 and thereafter it will be 3 months.

It implies that as per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, the criteria is 6 months only.

(g) the lease rental and hire purchase instalment, which has become overdue for a period of twelve months or more;

Note: The above twelve months criteria for the assets covered under (g) is 6 months for the financial year ending March 31, 2017 and from next year ending March 31, 2018 and thereafter it will be 3 months.

(h) in respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes non-performing asset:

Provided that in the case of lease and hire purchase transactions, a non-banking financial company may classify each such account on the basis of its record of recovery;

2.19 Provisioning Requirements

Every NBFC shall, after taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make provision against sub-standard assets, doubtful assets and loss assets as provided hereunder:

A. Loans, advances and other credit facilities including bills purchased and discounted

The provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted shall be as under:

1. Loss Assets

   The entire asset shall be written off. If the assets are permitted to remain in the books for any reason, 100% of the outstanding should be provided for.

2. Doubtful Assets

   (a) 100% provision to the extent to which the advance is not covered by the realisable value of the security to which the NBFC has a valid recourse shall be made. The realisable value is to be estimated on a realistic basis.

   (b) In addition to item (a) above, depending upon the period for which the asset has remained doubtful, provision to the provision to the extent of 20% to 50% of the secured portion (i.e. estimated realisable value of the outstanding) shall be made on the following basis: -

Period for which the asset has been considered as doubtful	*% of provision*
Upto one year	20
One to three years	30
More than three years	50

3. Sub-standard asset

   A general provision of 10% of total outstanding shall be made.

4. Standard asset

   A general provision at *0.35* per cent of the outstanding standard assets shall be made by the end of March 2017. The provision for standard assets as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, is being increased to 0.40% by the end of March 2018.

Note: As per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, every applicable NBFC shall make provision for standard assets at 0.25 percent of the outstanding amount.

The provisions on standard assets should not be reckoned for arriving at net NPAs. The provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' in the balance sheet.

B. Lease and hire purchase assets

The provisioning requirements in respect of hire purchase and leased assets shall be as under:

Hire purchase assets

(i) In respect of hire purchase assets, the total dues (overdue and future instalments taken together) as reduced by

(a) the finance charges not credited to the profit and loss account and carried forward as unmatured finance charges; and

(b) the depreciated value of the underlying asset,

shall be provided for.

Explanation:

For the purpose of this paragraph,

(1) the depreciated value of the asset shall be notionally computed as the original cost of the asset to be reduced by depreciation at the rate of twenty per cent per annum on a straight line method; and

(2) in the case of second hand asset, the original cost shall be the actual cost incurred for acquisition of such second hand asset.

Additional provision for hire purchase and leased assets

(ii) In respect of hire purchase and leased assets, additional provision shall be made as under:

(a) Where hire charges or lease rentals are overdue upto 12 months	Nil
(b) where hire charges or lease rentals are overdue for more than 12 months but upto 24 months	10% of the net book value
(c) where hire charges or lease rentals are overdue for more than 24 months but upto 36 months	40 percent of the net book value
(d) where hire charges or lease rentals are overdue for more than 36 months but upto 48 months	70 percent of the net book value
(e) where hire charges or lease rentals are overdue for more than 48 months	100 percent of the net book value

(iii) On expiry of a period of 12 months after the due date of the last instalment of hire purchase/leased asset, the entire net book value shall be fully provided for.

Here, 'Net book value' means

(a) in the case of hire purchase asset, the aggregate of overdue and future instalments receivable as reduced by the balance of unmatured finance charges and further reduced by the provisions made as per paragraph 9(2)(i) of these Directions;

(b) in the case of leased asset, aggregate of capital portion of overdue lease rentals accounted as receivable and depreciated book value of the lease asset as adjusted by the balance of lease adjustment account.

Notes:

(1) The amount of caution money/margin money or security deposits kept by the borrower with the non-banking financial company in pursuance of the hire purchase agreement may be deducted against the provisions stipulated under clause (i) above, if not already taken into account while arriving at the equated monthly instalments under the agreement. The value of any other security available in pursuance to the hire purchase agreement may be deducted only against the provisions stipulated under clause (ii) above.

(2) The amount of security deposits kept by the borrower with the non-banking financial company in pursuance to the lease agreement together with the value of any other security available in pursuance to the lease agreement may be deducted only against the provisions stipulated under clause (ii) above.

(3) It is clarified that income recognition on and provisioning against NPAs are two different aspects of prudential norms and provisions as per the norms are required to be made on NPAs on total outstanding balances including the depreciated book value of the leased asset under reference after adjusting the balance, if any, in the lease adjustment account. The fact that income on an NPA has not been recognised cannot be taken as reason for not making provision.

(4) An asset which has been renegotiated or rescheduled as referred to in paragraph (2) (1) (xvi) (b) of these Directions shall be a sub-standard asset or continue to remain in the same category in which it was prior to its renegotiation or reschedulement as a doubtful asset or a loss asset as the case may be. Necessary provision is required to be made as applicable to such asset till it is upgraded.

(5) The balance sheet to be prepared by the non-banking financial company may be in accordance with the provisions contained in sub-paragraph (2) of paragraph 10.

(6) All financial leases written on or after April 1, 2001 attract the provisioning requirements as applicable to hire purchase assets.

(7) In case of NBFC-MFIs, if the advance covered by Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH) guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances.

2.20 Disclosure in the Balance Sheet

Every non-banking financial company shall finalize its balance sheet within a period of 3 months from the date to which it pertains.

(a) Every NBFC shall, separately disclose in its balance sheet the provisions made as per requirements without netting them from the income or against the value of assets.

(b) The provisions shall be distinctly indicated under separate heads of accounts as provisions for bad and doubtful debts and provisions for depreciation in investments.

(c) Such provisions shall not be appropriated from the general provisions and loss reserves held, if any, by the NBFC.

(d) Such provisions for each year shall be debited to the profit and loss account. The excess of provisions, if any, held under the heads general Provisions and loss reserves may be written back without making adjustment against them.

2.21 Accounting Year

Every non-banking financial company shall prepare its balance sheet and profit and loss account as on March 31 every year. Whenever a non-banking financial company intends to extend the date of its balance sheet as per provisions of the Companies Act, it should take prior approval of the Reserve Bank of India before approaching the Registrar of Companies for this purpose.

Further, even in cases where the Bank and the Registrar of Companies grant extension of time, the non-banking financial company shall furnish to the Bank a proforma balance sheet (unaudited) as on March 31 of the year and the statutory returns due on the said date. Every non-banking financial company shall finalise its balance sheet within a period of 3 months from the date to which it pertains.

2.22 Preparation of Financial Statements of NBFCs

All NBFCs should comply with the Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India, so far as these are not inconsistent with the prudential norms directions of the Reserve Bank of India.

On 30th March, 2016 the Ministry of Corporate Affairs of India (MCA) has issued the roadmap for implementation of Ind AS by Non-Banking Financial Companies;

As per the notification

(a) The following NBFCs shall comply with the Indian Accounting Standards (Ind AS) for accounting periods beginning on or after the 1st April, 2018, with comparatives for the periods ending on 31st March, 2018, or thereafter—

   (A) NBFCs having net worth of rupees five hundred crore or more;

   (B) holding, subsidiary, joint venture or associate companies of companies covered under item (A),

(b) The following NBFCs shall comply with the Indian Accounting Standards (Ind AS) for accounting periods beginning on or after the 1st April, 2019, with comparatives for the periods ending on 31st March, 2019, or thereafter—

(A) NBFCs whose equity or debt securities are listed or in the process of listing on any stock exchange in India or outside India and having net worth less than rupees five hundred crore;

(B) NBFCs, that are unlisted companies, having net worth of rupees two-hundred and fifty crore or more but less than rupees five hundred crore; and

(C) holding, subsidiary, joint venture or associate companies of companies covered under item (A) or item (B) of sub-clause (b),

Other NBFCs shall prepare their financial statements based on the Companies (Accounting Standards) Rules, 2006.

2.23 Requirement as to Capital Adequacy

NBFCs-ND with asset size of less than ₹500 crore, are exempted from the requirement of maintaining CRAR and complying with Credit Concentration Norms.

A leverage ratio of 7 is being introduced for all such NBFCs-ND to link their asset growth with the capital they hold. For this purpose, leverage ratio is defined as Total Outside Liabilities / Owned Funds.

At present, all NBFCs-D and NBFCs-ND-SI are required to have minimum CRAR of 15%. Consequently, Tier 1 capital cannot be less than *10%*. For Infrastructure Finance Companies (IFCs), however, Tier 1 capital cannot be less than 10%. Similarly, NBFCs primarily engaged in lending against gold jewellery have to maintain a minimum Tier 1 capital of 12% w.e.f. April 01, 2014.

The minimum Tier 1 capital requirement for NBFCs primarily engaged in lending against gold jewellery remains unchanged for the present.

The total of Tier II capital, at any point of time, shall not exceed one hundred percent of Tier I capital.

"Tier I Capital" means owned fund as reduced by investment in shares of other non-banking financial companies and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten per cent of the owned fund;

"Tier II capital" includes the following:

(a) preference shares other than those which are compulsorily convertible into equity;

(b) revaluation reserves at discounted rate of fifty five percent;

(c) general provisions and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to

meet unexpected losses, to the extent of one and one fourth percent of risk weighted assets;

(d) hybrid debt capital instruments; and

(e) subordinated debt to the extent the aggregate does not exceed Tier I capital.

"*Subordinated debt*" means an instrument, which is fully paid up and is unsecured and is subordinated to the claims of other creditors and is free from restrictive clauses and is not redeemable at the instance of the holder or without the consent of the supervisory authority of non-banking financial company. The book value of such instrument shall be subjected to discounting as provided hereunder:

	Remaining Maturity of the instruments	*Rate of discount*
(a)	Upto one year	100%
(b)	More than one year but upto two years	80%
(c)	More than two years but upto three years	60%
(d)	More than three years but upto four years	40%
(e)	More than four years but upto five years	20%

to the extent such discounted value does not exceed fifty per cent of Tier I capital.

The Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, require the NBFCs to maintain a minimum CRAR based on risk weights assigned to both on and off balance sheet items.

On balance sheet assets - Degrees of credit risk expressed as percentage weightages have been assigned to balance sheet assets. Hence, the value of each asset/item requires to be multiplied by the relevant risk weights to arrive at risk adjusted value of assets. The aggregate shall be taken into account for reckoning the minimum capital ratio. The risk weighted asset shall be calculated as the weighted aggregate of funded items as detailed hereunder:

Weighted risk assets – On-Balance Sheet items	*Percentage weight*
(i) Cash and bank balances including fixed deposits and certificates of deposits with banks	0
(ii) Investments	
(a) Approved securities [Except at (c) below]	0
(b) Bonds of public sector banks	20
(c) Fixed deposits/certificates of deposits/bonds of public financial institutions	100

	(d) Shares of all companies and debentures/bonds/commercial papers of all companies and units of all mutual funds	100
	(e) All assets covering PPP and post commercial operations date (COD) infrastructure projects in existence over a year of commercial operation	50
(iii)	Current assets	
	(a) Stock on hire (net book value)	100
	(b) Inter-corporate loans/deposits	100
	(c) Loans and advances fully secured against deposits held by the company itself	0
	(d) Loans to staff	0
	(e) Other secured loans and advances considered good	100
	(f) Bills purchased/discounted	100
	(g) Others (To be specified)	100
(iv)	Fixed Assets (net of depreciation)	
	(a) Assets leased out (net book value)	100
	(b) Premises	100
	(c) Furniture & Fixtures	100
(v)	Other assets	
	(a) Income tax deducted at source (net of provision)	0
	(b) Advance tax paid (net of provision)	0
	(c) Interest due on Government securities	0
	(d) Others (to be specified)	100
(vi)	Domestic Sovereign	
	(a) fund based claims on the Central Government	0
	(b) Direct loan / credit / overdraft exposure and investment in State Government securities	0
	(c) Central Government guaranteed claims	0
	(d) State Government guaranteed claims, which have not remained in default/ which are in default for a period not more than 90 days	20
	(e) State Government guaranteed claims, which have remained in default for a period of more than 90 days	100

Notes:

(1) Netting may be done only in respect of assets where provisions for depreciation or for bad and doubtful debts have been made.

(2) Assets which have been deducted from owned fund to arrive at net owned fund shall have a weightage of `zero'.

(3) While calculating the aggregate of funded exposure of a borrower for the purpose of assignment of risk weight, non-banking financial companies may net off the amount of cash margin / caution money/security deposits (against which right to set-off is available) held as collateral against the advances out of the total outstanding exposure of the borrower.

(4) The counterparty credit risk, arising out of exposure of NBFCs to CCIL on account of securities financing transactions (CBLOs) will carry a risk weight of zero, as it is presumed that the CCP's exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures. The deposits / collaterals kept by NBFCs with CCIL will attract a risk weight of 20 per cent

(5) For loans guaranteed by Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH) NBFC-MFIs may assign zero risk weight for the guaranteed portion. The balance outstanding in excess of the guaranteed portion would attract a risk-weight as per extant guidelines.

On Off-Balance Sheet Items - It has been considered necessary to expand the off-balance sheet regulatory framework to introduce greater granularity in the risk weights and credit conversion factors for different types of off balance sheet items. For this purpose, NBFCs will need to calculate the total risk weighted off-balance sheet credit exposure as the sum of the risk-weighted amount of the market related and non-market related off-balance sheet items. The risk-weighted amount of an off-balance sheet item that gives rise to credit exposure will be calculated by means of a two-step process:

(a) the notional amount of the transaction is converted into a credit equivalent amount, by multiplying the amount by the specified credit conversion factor or by applying the current exposure method; and

(b) the resulting credit equivalent amount is multiplied by the risk weight applicable viz; zero percent for exposure to Central Government/State Governments, 20 percent for exposure to banks and 100 percent for others.

(1) Non-market-related off- balance sheet items

i. The credit equivalent amount in relation to a non-market related off-balance sheet item will be determined by multiplying the contracted amount of that particular transaction by the relevant credit conversion factor (CCF).

Sr. No.	*Instruments*	*Credit Conversion Factor*
i.	Financial & other guarantees	100
ii.	Share/debenture underwriting obligations	50
iii.	Partly-paid shares/debentures	100
iv.	Bills discounted/rediscounted	100
v.	Lease contracts entered into but yet to be executed	100

vi.	Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the NBFC.	100
vii.	Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain draw down.	100
viii.	Lending of NBFC securities or posting of securities as collateral by NBFC, including instances where these arise out of repo style transactions	100
ix.	Other commitments (e.g., formal standby facilities and credit lines) with an original maturity of	
	up to one year	20
	over one year	50
x.	Similar commitments that are unconditionally cancellable at any time by the NBFC without prior notice or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness'.	0
xi.	Take-out Finance in the books of taking-over institution	
	(i) Unconditional take-out finance	100
	(ii) Conditional take-out finance	50
	Note: As the counter-party exposure will determine the risk weight, it will be 100 percent in respect of all borrowers or zero percent if covered by Government guarantee.	
xii.	Commitment to provide liquidity facility for securitization of standard asset transactions	100
xiii.	Second loss credit enhancement for securitization of standard asset transactions provided by third party	100
xiv.	Other contingent liabilities (To be specified)	50
xv	Non-fund based claims on the Central Government	0

Note:

i. Cash margins/deposits shall be deducted before applying the conversion factor

ii. Where the non-market related off-balance sheet item is an undrawn or partially undrawn fund-based facility, the amount of undrawn commitment to be included in calculating the off-balance sheet non-market related credit exposures is the maximum unused portion of the commitment that could be drawn during the remaining period to maturity. Any drawn portion of a commitment forms a part of NBFC's on-balance sheet credit exposure'.

For example:

A term loan of ₹ 700 cr is sanctioned for a large project which can be drawn down in stages over a three year period. The terms of sanction allow draw down in three stages – ₹ 150 cr in Stage I, ₹ 200 cr in Stage II and ₹ 350 cr in Stage III, where the borrower needs the

NBFC's explicit approval for draw downunder Stages II and III after completion of certain formalities. If the borrower has drawn already ₹ 50 cr under Stage I, then the undrawn portion would be computed with reference to Stage I alone i.e., it will be ₹ 100 cr. If Stage I is scheduled to be completed within one year, the CCF will be 20 per cent and if it is more than one year then the applicable CCF will be 50 per cent'.

(2) Market Related Off-Balance Sheet Items

i. NBFCs should take into account all market related off-balance sheet items (OTC derivatives and Securities Financing Transactions such as repo / reverse repo/ CBLO etc.) while calculating the risk weighted off-balance sheet credit exposures.

ii. The credit risk on market related off-balance sheet items is the cost to an NBFC of replacing the cash flow specified by the contract in the event of counterparty default. This would depend, among other things, upon the maturity of the contract and on the volatility of rates underlying the type of instrument.

iii. Market related off-balance sheet items would include:

   a. interest rate contracts - including single currency interest rate swaps, basis swaps, forward rate agreements, and interest rate futures;

   b. foreign exchange contracts, including contracts involving gold, - includes cross currency swaps (including cross currency interest rate swaps), forward foreign exchange contracts, currency futures, currency options;

   c. Credit Default Swaps; and

   d. any other market related contracts specifically allowed by the Reserve Bank which give rise to credit risk.

iv. Exemption from capital requirements is permitted for -

   a. foreign exchange (except gold) contracts which have an original maturity of 14 calendar days or less; and

   b. instruments traded on futures and options exchanges which are subject to daily mark-to-market and margin payments.

v. The exposures to Central Counter Parties (CCPs), on account of derivatives trading and securities financing transactions (e.g. Collateralised Borrowing and Lending Obligations – CBLOs, Repos) outstanding against them will be assigned zero exposure value for counterparty credit risk, as it is presumed that the CCPs' exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures.

vi. A CCF of 100 per cent will be applied to the corporate securities posted as collaterals with CCPs and the resultant off-balance sheet exposure will be assigned risk weights appropriate to the nature of the CCPs. In the case of Clearing Corporation of India Limited (CCIL), the risk weight will be 20 per cent and for other CCPs, the risk weight will be 50 percent.

vii. The total credit exposure to counterparty in respect of derivative transactions should be calculated according to the current exposure method as explained below:

Current Exposure Method:

The credit equivalent amount of a market related off-balance sheet transaction calculated using the current exposure method is the sum of a) current credit exposure and b) potential future credit exposure of the contract.

a) Current credit exposure is defined as the sum of the gross positive mark-to-market value of all contracts with respect to a single counterparty (positive and negative marked-to-market values of various contracts with the same counterparty should not be netted). The Current Exposure Method requires periodical calculation of the current credit exposure by marking these contracts to market.

b) Potential future credit exposure is determined by multiplying the notional principal amount of each of these contracts, irrespective of whether the contract has a zero, positive or negative mark-to-market value by the relevant add-on factor indicated below according to the nature and residual maturity of the instrument.

Credit Conversion Factors for interest rate related, exchange rate related and gold related derivatives		
Credit Conversion Factors (%)		
	Interest Rate Contracts	*Exchange Rate Contracts & Gold*
One year or less	0.50	2.00
Over one year to five years	1.00	10.00
Over five years	3.00	15.00

i. For contracts with multiple exchanges of principal, the add-on factors are to be multiplied by the number of remaining payments in the contract.

ii. For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. However, in the case of interest rate contracts which have residual maturities of more than one year and meet the above criteria, the CCF or add-on factor is subject to a floor of 1.0 per cent.

iii. No potential future credit exposure would be calculated for single currency floating / floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

iv. Potential future exposures should be based on 'effective' rather than 'apparent notional amounts'. In the event that the 'stated notional amount' is leveraged or enhanced by the structure of the transaction, the 'effective notional amount' must be used for determining potential future exposure. For example, a stated notional amount

of USD 1 million with payments based on an internal rate of two times the lending rate of the NBFC would have an effective notional amount of USD 2 million.

Credit conversion factors for Credit Default Swaps(CDS):

NBFCs are only permitted to buy credit protection to hedge their credit risk on corporate bonds they hold. The bonds may be held in current category or permanent category. The capital charge for these exposures will be as under:

(i) For corporate bonds held in current category and hedged by CDS where there is no mismatch between the CDS and the hedged bond, the credit protection will be permitted to be recognised to a maximum of 80% of the exposure hedged. Therefore, the NBFC will continue to maintain capital charge for the corporate bond to the extent of 20% of the applicable capital charge. This can be achieved by taking the exposure value at 20% of the market value of the bond and then multiplying that with the risk weight of the issuing entity. In addition to this, the bought CDS position will attract a capital charge for counterparty risk which will be calculated by applying a credit conversion factor of 100 percent and a risk weight as applicable to the protection seller i.e. 20 per cent for banks and 100 per cent for others.

(ii) For corporate bonds held in permanent category and hedged by CDS where there is no mismatch between the CDS and the hedged bond, NBFCs can recognise full credit protection for the underlying asset and no capital will be required to be maintained thereon. The exposure will stand fully substituted by the exposure to the protection seller and attract risk weight as applicable to the protection seller i.e. 20 per cent for banks and 100 per cent for others.

2.24 Asset-Liability Management (ALM)

ALM is a risk management tool that helps a bank/NBFC to manage its liquidity risk and interest rate risk. This is a powerful tool that helps banks/NBFCs plan long term financial, funding, and capital strategy using present value analysis. With ALM, a bank/NBFC can model interest income and expenses for analysis and re-price assets and liabilities. Based on ALM position, banks/NBFCs can also model effect of competitive pricing to create innovative and imaginative new banking products. ALM also helps regulatory compliance for banks/NBFCs by through appropriate investment / disinvestment decisions to maintain the required statutory liquidity ratio (SLR), credit reserve ratio (CRR) and other ratios as per Reserve Bank of India (RBI) guidelines. ALM involves the analysis of Structural Liquidity Gap Analysis, Interest Rate Gap Analysis, Net Interest Income (NII) Analysis, Net Interest Margin (NIM) Analysis, Tolerance Analysis, Cost to Close Analysis, Duration Gap Analysis, Trend Analysis, Comparative Analysis, Present Value Analysis, Forward Analysis and Scenario Analysis The Reserve Bank of India has announced its ALM guidelines for NBFCs for effective risk management. The NBFCs covered under the system are required to submit ALM returns comprising of statements on structural liquidity, short-term dynamic liquidity and interest rate sensitivity, to the Reserve Bank of India.

Miscellaneous Illustrations

Illustration 1

Templeton Finance Ltd. is a non-banking finance company. The extracts of its balance sheet are given below:

Liabilities	*Amount*	*Assets*	*Amount*
	₹ in 000		*₹ in 000*
Paid-up equity capital	*100*	*Leased out assets*	*800*
Free reserves	*500*	*Investment:*	
Loans	*400*	*In shares of subsidiaries and*	
Deposits	*400*	*group companies*	*100*
		In debentures of subsidiaries and group Companies	*100*
		Cash and bank balances	*200*
		Deferred expenditure	*200*
	1,400		*1,400*

You are required to compute 'Net owned Fund' of Templeton Finance Ltd. as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Solution

Statement showing computation of 'Net Owned Fund'

		₹ in 000
Paid up Equity Capital		100
Free Reserves		500
		600
Less: Deferred expenditure		(200)
	A	400
Investments		
In shares of subsidiaries and group companies		100
In debentures of subsidiaries and group companies		100
	B	200
10% of A		40
Excess of Investment over 10% of A (200-40)	C	160
Net Owned Fund [(A) - (C)] (400-160)		240

Illustration 2

Bright Finance Ltd. is a non-banking financial company. It provides you with the following information regarding its outstanding amount, ₹ 200 lakhs of which instalments are overdue on 200 accounts for last

two months (amount overdue ₹40 lakhs), on 24 accounts for three months (amount overdue ₹24 lakhs), on 10 accounts for more than 30 months (amount overdue ₹20 lakhs) and on 4 accounts for more than three years (amount over due ₹20 lakhs-already identified as sub-standard assets) and one account of ₹10 lakhs which has been identified as non-recoverable by the management. Out of 10 accounts overdue for more than 30 months, 6 accounts are already identified as sub-standard (amount ₹6 lakhs) for more than fourteen months and other are identified as sub-standard asset for a period of less than fourteen months.

Classify the assets of the company in line with Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Solution

Statement showing classification as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016

		(₹ in lakhs)
Standard Assets		
Accounts (Balancing figure)	86.00	
200 accounts overdue for a period for 2 months	40.00	
24 accounts overdue for a period by 3 months	24.00	150.00
Sub-Standard Assets		
4 accounts identified as sub-standard asset for a period less than 14 months		14.00
Doubtful Debts		
6 accounts identified as sub-standard for a period more than 14 months		6.00
4 accounts identified as sub-standard for a period more than 3 years		20.00
Loss Assets		
1 account identified by management as loss asset		10.00
Total overdue		200.00

Illustration 3

While closing its books of account on 31st March, 2017 a Non-Banking Finance Company has its advances classified as follows:

	₹ in lakhs
Standard assets	*16,800*
Sub-standard assets	*1,340*
Secured portions of doubtful debts:	
– *upto one year*	*320*
– *one year to three years*	*90*
– *more than three years*	*30*

Unsecured portions of doubtful debts	*97*
Loss assets	*48*

Calculate the amount of provision, which must be made against the Advances as per

(i) the Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016; and

(ii) Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Answer

Calculation of provision required on advances as on 31st March, 2017 as per the Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016

	Amount ₹ in lakhs	*Percentage of provision*	*Provision ₹ in lakhs*
Standard assets	16,800	0.25	42.00
Sub-standard assets	1,340	10	134.00
Secured portions of doubtful debts–			
– upto one year	320	20	64.00
– one year to three years	90	30	27.00
– more than three years	30	50	15.00
Unsecured portions of doubtful debts	97	100	97.00
Loss assets	48	100	48.00
			427.00

Calculation of provision required on advances as on 31st March, 2017 as per the Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016

	Amount ₹ in lakhs	*Percentage of provision*	*Provision ₹ in lakhs*
Standard assets	16,800	0.35	58.80
Sub-standard assets	1,340	10	134.00
Secured portions of doubtful debts–			
– upto one year	320	20	64.00
– one year to three years	90	30	27.00
– more than three years	30	50	15.00
Unsecured portions of doubtful debts	97	100	97.00
Loss assets	48	100	48.00
			443.80

UNIT 3: MERCHANT BANKERS

3.1 Introduction

In banking a **merchant bank** is a financial institution primarily engaged in offering financial services and advice to corporations and wealthy individuals on how to use their money. The term can also be used to describe the private equity activities of banking.

According to Cox D., merchant banking is defined as, "merchant banks are the financial institutions providing specialist services which generally include the acceptance of bills of exchange, corporate finance, portfolio management and other banking services".

The Notification of the Ministry of Finance defines a merchant banker as, **"any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management".**

A merchant banker is an organization that acts as an intermediary between the issuers and the ultimate purchasers of securities in the primary security market. In addition to managing an issue for a client, the services offered by a merchant banker includes underwriting and providing advice on complex financings arrangements, mergers and acquisitions, and at times direct equity investments in corporations.

In exercise of the powers conferred vide Section 30 of the Securities and Exchange Board of India Act, 1992 (15 of 1992), the Board, with the previous approval of the Central Government made the SEBI (Merchant Bankers) Regulations, 1992 which specify various requirements. Further, the SEBI has amended SEBI (Merchant Bankers) Regulations, 1992 in various years i.e. 2006, 2007, 2010 and 2011. These regulations specify the norms which SEBI takes into account for considering the grant of a certificate of registration and its renewal. The code of conduct has been given in schedule III and Chapter III of these regulations contain general obligations and responsibilities of merchant bankers.

3.2 Registration of Merchant Banker

Under Regulation 3, a person can apply for grant of certificate as merchant banker under any one of the following categories:

(i) Merchant bankers who carry on activity of the issue management, which will, inter alia, consist of preparation of prospectus and other information relating to the issue, determining financial structure, tie up of financiers and final allotment and refund of subscriptions; and act as advisor, consultant, manager, underwriter, portfolio manager;

(ii) Merchant bankers who act as advisor, consultant, co-manager, underwriter, portfolio manager;

(iii) Merchant bankers who act as underwriter, advisor, consultant to an issue;

(iv) Merchant bankers who act only as advisor or consultant to an issue.

3.3 Capital Adequacy Requirement

Capital adequacy requirements have been specified by SEBI under the SEBI (Merchant Bankers) Regulations, 1992. Regulation 7 specifies that the requirement of capital adequacy shall be a net worth of not less than five crore rupees.

For the purpose of this regulation, 'Net worth' means the sum of paid-up capital and free reserves of the applicant at the time of making application under sub-regulation (1) of regulation 3.

3.4 Maintenance of Books of Account, Records etc.

Every merchant banker shall keep and maintain the following books of account, records and documents as per regulation 14:

(*a*) a copy of balance sheet as at the end of the each accounting period;

(*b*) a copy of profit and loss account for that period;

(*c*) a copy of the auditor's report on the accounts for that period;

(*d*) a statement of financial position;

(e) Records and documents pertaining to due diligence exercised in pre-issue and post issue activities of issue management and in case of takeover, buy-back and delisting of securities.

Every merchant banker shall intimate to the SEBI the place where the books of account, records and documents are maintained. Every merchant banker shall, after the end of each accounting period furnish to the Board copies of the balance sheet, profit and loss account and such other documents for any other preceding five accounting years when required by the SEBI. The merchant banker shall preserve the books of account and other records and documents maintained under regulation 14 for a minimum period of five years.

As per Regulation 28 of the SEBI (Merchant Banker) Regulations 1992, a merchant banker shall disclose to the Board, as and when required, the following information, namely :–

(i) his responsibilities with regard to the management of the issue;

(ii) any change in the information or particulars previously furnished, which have a bearing on the certificate granted to it.

(iii) the names of the body corporate whose issue he has managed or has been associated with;

(iv) the particulars relating to the breach of the capital adequacy requirements as specified in regulation 7;

(v) relating to the activities as manager, underwriter, consultant or advisor to an issue, as the case may be.

Under Regulation 29, the merchant banker shall submit a half yearly report for the period ending up to 31st March and 30th September of every year in the format specified in Schedule IV, within three months from the close of the period to which it corresponds. The merchant banker shall

SEBI has the right to appoint one or more persons as inspecting authority to undertake inspection of the books of account, records and documents of the merchant banker for any of the following purposes :

(i) to ensure that the books of account are being maintained in the required manner;

(ii) that the provisions of the Act, rules, regulations are complied with;

(iii) to investigate into the complaints received from investors, other merchant bankers or any other person on any matter having a bearing on the activities of the merchant banker; and

(iv) to investigate suo motu in the interest of securities business or investors' interest into the affairs of the merchant banker.

As per Regulation 31, it shall be the duty of the merchant banker to allow the inspecting authority to have reasonable access to the premises occupied by such merchant banker or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the merchant banker or any such other person and also provide copies of documents or other materials which, in the opinion of the inspecting authority, are relevant for the purposes of the inspection.

The SEBI may also appoint a qualified auditor to investigate into the books of account or the affairs of the merchant bankers.

SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 has specified a format for half yearly report to be submitted by merchant bankers.

3.5 Underwriting Obligations

As per Regulation 22, in respect of every issue to be managed, the lead merchant banker holding a certificate under Category I shall accept a minimum underwriting obligation of five per cent of the total underwriting commitment or rupees twenty-five lacs, whichever is less.

Further, in any issue made in accordance with Chapter XA of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 the merchant banker shall, itself or jointly with other merchant bankers associated with the issue, underwrite at least fifteen per cent of the issue size.

UNIT 4: STOCK AND COMMODITY MARKET INTERMEDIARIES

4.1 Introduction

A **stock market** or **equity market** is a public entity (a loose network of economic transactions, not a physical facility or discrete entity) for the trading of company stock (shares) and derivatives at an agreed price. These are securities listed on a stock exchange as well as those only traded privately.

Commodity markets are markets where raw or primary products are exchanged. These raw commodities are traded on regulated commodities exchanges, in which they are bought and sold in standardized contracts.

Intermediary is a firm or person (such as a broker or consultant) who acts as a mediator on a link between parties to a business deal, investment decision, negotiation, etc. In money markets, for example, banks act as intermediaries between depositors seeking interest income and borrowers seeking debt capital. Intermediaries usually specialize in specific areas, and serve as a conduit for market and other types of information.

With the removal of the ban on forward trading in all commodities, the Indian commodities futures market has been totally liberalised. Participants in the securities and other financial markets can now think of exploring the opportunities offered by the emerging commodities market. There are, however, some basic issues relating to the securities and commodity derivative markets and the likely impact of any moves for unifying the two on participant institutions, players and regulatory bodies. Neither convergence nor divergence may necessarily mean a win-win situation for the existing stock and commodity exchanges in the present situation. Even though there are differences between commodity and financial derivatives markets, they also have some close link in so far as trading practices and mechanisms are concerned. The reforms in the securities market over the past two decades were carried out both in the primary and secondary markets. The Securities and Exchange Board of India has introduced in the past decade a number of measures to streamline the capital market, professionalize trading and protect the interests of the small investor. There is complete automation of trading in the securities market. Proper risk management, governance principles and regulatory measures are in place.

In the commodities markets too the situation is changing. Some commodity exchanges are specializing in specific areas with varying degrees of success. The task force has stressed the need to have at least a third of each exchange board manned by independent directors. Licenses have been given for a multiple commodities exchange and single commodity exchanges and for conducting trading on-line. Even a single commodity exchange can trade in multiple commodities after obtaining permission from the Forward Markets Commission (FMC). FMC has issued various guidelines to control the operations of stock and commodity market intermediaries.

Commodity exchanges are promoted by institutions and associations. With convergence, there

will be an opportunity to speed up the development of the commodity markets. Because of the economies of scale in operations there will be scope for further improvement However, there are certain differences. Financial futures generally draw their strength from actively traded cash markets. The exchanges oversee the operations. While organised trading in commodities may closely resemble financials (as in bullion), one area of concern in the former case is the impact of price volatility on the market; also, commodities markets require specialised knowledge that is different from securities trading.

The task force has identified many legal and regulatory hurdles in the way of convergence of securities and commodities markets. The securities market is governed by the Securities Contracts Regulation Act, 1956 whereas the forward market is regulated by the Forward Contracts Regulation Act 1952. Another basic consideration is that stock exchanges and futures markets for financials are Central subjects whereas agriculture is under the jurisdiction of States and futures trading in commodities are with the Union Government. In reality, policies for the securities market and development of the commodities market are of different nature. Even though the volume of trading in commodities is much higher than in securities, it is better to keep them apart in the initial stages. Clearing members of a stock exchange would like to trade in a commodity exchange as it provides them another avenue for making money. The Securities Contracts Regulation Act has therefore been amended whereby members of a stock exchange can be members of a commodity exchange by forming a separate company. This is essential because at present there are two regulators and each one will exercise his supervisory powers as provided under the rules in the respective market. The net worth for becoming a clearing member can be fixed separately for the two exchanges and this will play an important role in risk management. Even if there is a risk in one market, no cascading effect will be felt in the other. There is also the fact that net worth from one market cannot be moved to another. This will provide the necessary firewall between the two markets and will benefit all the participants.

4.2 Stock Brokers

"Stock broker" means a person having trading rights in any recognised stock exchange and includes a trading member;

A stock broker can deal in securities only after getting registration with SEBI. A stock broker can function as a proprietorship firm, partnership firm or a corporate. Brokers are subject to capital adequacy requirements comprising of a basic minimum capital and additional volume related capital. Stock brokers are also eligible to act as underwriters without obtaining a separate registration as an underwriter. He may or may not appoint sub-brokers. A sub-broker is subordinate to main stock broker and acts on behalf of a stock broker as an agent or otherwise, for assisting the investors in buying, selling or dealing in securities through such stock brokers. The stock broker as a principal, is responsible to the investor for his sub-brokers' conduct and acts.

In exercise of the powers conferred by section 30 of the Securities and Exchange Board of India Act, 1992, the SEBI Board made the SEBI (Stock-Brokers and Sub-Brokers) Regulations, 1992 to exercise the control on the activities of stock brokers and their sub-brokers. In a contract for buying and selling securities, stock brokers act as agents for investors. In return for this service

they charge commission or brokerage at a specified percentage on contract value. In addition to acting as agents for others, a stockbroker may also trade directly by buying and selling securities as principals. If a stockbroker enters into a contract to buy or sale securities as principal with any person other than another stockbroker, he must secure the consent or authorization from the other party and must disclose in the agreement for buying or selling of securities that he is acting as a principal.

A sub-broker is any person not being a member of a recognised stock exchange who acts on behalf of a stock-broker as an agent or otherwise for assisting the investors in buying, selling or dealing in securities through such stockbroker.

The Securities and Exchange Board of India (Stockbrokers and sub-brokers) Rules, 1992 provides that no stockbroker or sub-broker can buy, sell or deal in securities, unless he holds a certificate of registration granted by the Securities and Exchange Board of India (SEBI). The certification of registration is granted by SEBI on an application made to it in prescribed form, subject to fulfillment of conditions specified in the Securities and Exchange Board of India (Stockbrokers and sub-brokers) Rules, 1992.

The Securities and Exchange Board of India (Stockbrokers and sub-brokers) Regulations, 1992 provides inter-alia, for the obligations and responsibilities of stock brokers regarding maintenance of proper books of accounts, records and documents and other allied matters. In the regulations, board means, the Securities and Exchange Board of India (SEBI).

4.3 Registration of Stock Brokers

No person shall act as a stock broker, unless he seeks a certificate of registration from the Board for each stock exchange in which he seeks to operate provided that no separate registration shall be required for a clearing member registered with the Board to *act* as a stock broker in the stock exchange of which he is *admitted as a member, subject to grant of approval by the concerned stock exchange.*

Payment of fees

Every applicant eligible for grant of a certificate of registration as a stock broker shall pay such fees provided that the Board may on sufficient cause being shown permit the stockbroker to pay such fees at any time before the expiry of six months from the date on which such fees become due.

Conditions of registration

Any registration granted by the Board shall be subject to the following conditions, namely,-

(a) the stock broker holds the membership of any stock exchange;

(b) he shall abide by the rules, regulations and bye-laws of the stock exchange which are applicable to him;

(c) where the stock broker proposes change in control, he shall obtain prior approval of the Board for continuing to act as such after the change;

(d) he shall pay fees charged by the Board in the manner provided in these regulations;

(e) he shall take adequate steps for redressal of grievances, of the investors within one month of the date of receipt of the complaint and inform the Board as and when required by the Board;

(f) he shall at all times abide by the Code of Conduct as specified in Schedule II; and

(g) he shall at all times maintain the minimum networth as specified in Schedule VI.

4.4 Maintenance of Proper Books of Account, Records etc. (Regulation 17)

Every stock boker is required to maintain the following books of account and records as per Rule 15 of the Securities Contracts (Regulation) Rules, 1957 and Regulation 17 of the SEBI (Stock Brokers and Sub-Brokers) Rules, 1992 :

(a) Register of transactions (Sauda Book);

(b) Clients ledger;

(c) General ledger;

(d) Journals;

(e) Cash book;

(f) Bank pass book;

(g) Documents register containing, inter alia, particulars of securities received and delivered in physical form and the statement of account and other records relating to receipt and delivery of securities provided by the depository participants in respect of dematerialized securities;

(h) Member's contract books showing details of all contracts entered into by him with other members of the same exchange or counterfoils or duplicates of memos of confirmation issued to such other members;

(i) Counterfoils or duplicates of contract notes issued to clients;

(j) Written consent of clients in respect of contracts entered into as principals;

(k) Margin deposit book;

(l) Registers of accounts of sub-brokers;

(m) An agreement with a sub-broker specifying the scope of authority, and responsibilities of the Stock Broker and such Sub-broker;

(n) Client account opening form in the format as may be specified by the Board.

In addition to the above statutory requirements, they are also required to maintain the following records/documents:

(a) Scripwise clientwise list in respect of scrips of specified group, i.e., 'A' Group (inclusive of brought forward positions);

(b) Client upla statement (i.e. carry forward position of all clients);

(c) Duplicate copies of self-certificates submitted on monthly basis (i.e., that the daily and

badla break-up have been reported correctly without netting positions of two different clients in the same scrip);

(d) Copies of all margin statements downloaded by the Stock Exchange;

(e) Copies of Valan Balance Sheet (Form 31) along with all relevant assets;

(f) Details of spot delivery transactions entered into (including securities delivered and payments made to the members);

(g) Client database and broker client agreement;

(h) Copy of registration certificate of each sub-broker issued by SEBI;

(i) Copy of approval for each remisier given by the exchange;

(j) Copy of the power of attorney/board resolution authoritizing directors, employees to sign the contract note;

(k) Copies of pool account statements.

Every stock broker shall intimate to the SEBI the place where the books of account, records and documents are maintained. Every stock broker shall, after the close of each accounting period furnish to the SEBI if so required as soon as possible but not later than six months from the close of the said period a copy of the audited balance sheet and profit and loss account as at the end of the said accounting period; provided that if, it is not possible to furnish the above documents within the time specified, the stock broker shall keep the SEBI informed of the same together with the reasons for delay and the period of time by which such documents would be furnished. Every stock broker is required to preserve the books of account and other records maintained under regulation 17 for a minimum period of five years.

SEBI may appoint one or more persons as inspecting authority to undertake inspection of the books of account, other records and documents of the stock brokers for any of the following purposes:

(a) to ensure that the books of the account and other books are being maintained in the manner required;

(b) that the provisions of the Act, rules, regulations and the provisions of the Securities Contract (Regulation) Act, and the rules made there under are being complied with;

(c) to investigate into the complaints received from investors, other stock brokers, sub-brokers or any other person on any matter having a bearing on the activities of the stock brokers; and

(d) to investigate suo motu, in the interest of securities business or investors' interest into the affairs of the stock-brokers.

The SEBI may appoint a qualified auditor to investigate into the books of account or the affairs of the stock-broker.

As per Regulation 25, a stock broker or a sub-broker who contravenes any of the provisions of the Act, rules or regulations framed there under shall be liable for any one or more of the following actions—

(i) Monetary penalty under Chapter VIA of the Act.

(ii) Penalties as specified under [Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008] including suspension or cancellation of certificate of registration as a stock broker or a sub-broker,

(iii) Prosecution under section 24 of the Act.

4.5 Preservation of Books of Accounts and Records (Regulation 18)

Every stockbroker shall preserve the books of account and other records maintained under regulation 17 for a minimum period of five years.

4.6 Obligations of Stock Broker on Inspection by the Board (Regulation 21)

It shall be the duty of broker on inspection by the Board every director, proprietor, partner, officer and employee of the stock-broker, who is being inspected, to produce to the inspecting authority such books, accounts and other documents in his custody or control and furnish him with the statements and information relating to the transactions in securities market within such time as the said officer may require.

The stock-broker shall allow the inspecting authority to have reasonable access to the premises occupied by such stock- broker or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the stock- broker or any other person and also provide copies of documents or other materials which, in the opinion of the inspecting authority are relevant.

The inspecting authority, in the course of inspection, shall be entitled to examine or record statements of any member, director, partner, proprietor and employee of the stock- broker.

It shall be the duty of every director proprietor, partner, officer and employee of the stock broker to give to the inspecting authority all assistance in connection with the inspection, which the stock broker may be reasonably expected to give.

4.7 Regulation of Transactions between Clients and Brokers

It shall be compulsory for all member brokers to keep the money of the clients in a separate account and their own money in a separate account. No payment for transactions in which the member broker is taking a position as a principal will be allowed to be made from the client's account.

4.8 Member Broker to Keep Accounts

Every member broker shall keep such books of accounts, as will be necessary, to show and distinguish in connection with his business as a member –

(a) Moneys received from or on account of each of his clients and,

(b) The moneys received and the moneys paid on Member's own account.

4.9 Obligation to Pay Money into "Clients Accounts"

Every member broker who holds or receives money on account of a client shall forthwith pay such money to current or deposit account at bank to be kept in the name of the member in the title of which the word "clients" shall appear (hereinafter referred to as "clients account").

Member broker may keep one consolidated clients account for all the clients or accounts in the name of each client, as he thinks fit. If a Member broker receives a cheque or draft representing in part money belonging to the client and in part money due to the Member, he shall pay the whole of such cheque or draft into the clients account and effect subsequent transfer.

Nothing in the above paragraph shall deprive a Member broker of any recourse or right, whether by way of lien, set-off, counter-claim charge or otherwise against moneys standing to the credit of clients account.

Moneys to be paid into "clients account"

No money shall be paid into clients account other than –

(a) Money held or received on account of clients;

(b) Such money belonging to the Member as may be necessary for the purpose of opening or maintaining the account;

(c) Money for replacement of any sum, which may by mistake or accident have been drawn from the account.

(d) A cheque or draft received by the Member representing in part money belonging to the client and in part money due to the Member.

Moneys to be withdrawn from "clients account"

No money shall be drawn from clients account other than -

(a) Money properly required for payment to or on behalf of clients or for or towards payment of a debt due to the Member from clients or money drawn on client's authority, or money in respect of which there is a liability of clients to the Member, provided that money so drawn shall not in any case exceed the total of the money so held for the time being for such each client;

(b) Such money belonging to the Member as may have been paid into the client account;

(c) Money, which may by mistake or accident have been paid into such account.

4.10 Accounts for Client's Securities

It shall be compulsory for all Member brokers to keep separate accounts for client's securities and to keep such books of accounts, as may be necessary, to distinguish such securities from his/their own securities. Such accounts for client's securities shall, inter-alia provide for the following:

(a) Securities received for sale or kept pending delivery in the market;

(b) Securities fully paid for, pending delivery to clients;

(c) Securities received for transfer or sent for transfer by the Member, in the name of client or his nominees;

(d) Securities that are fully paid for and are held in custody by the Member as security/margin etc. Proper authorization from client for the same shall be obtained by Member;

(e) Fully paid for client's securities registered in the name of Member, if any, towards margin requirements etc.;

(f) Securities given on Vyaj-badla. Member shall obtain authorization from clients for the same.

4.11 Payment and Delivery of Securities

Member Brokers shall make payment to their clients or deliver the securities purchased within two working days of payout unless the client has requested otherwise. Stock Exchange shall issue a Press Release immediately after the payout.

Member brokers shall issue the contract note for purchase/sale of securities to a client within 24 hours of the execution of the contract.

4.12 Margin

Member Brokers shall buy securities on behalf of client only on receipt of specified margin money on the price of the securities proposed to be purchased, unless the client already has an equivalent credit with the broker. Member may not, if they so desire, collect such a margin from Financial Institutions, Mutual Funds and FII's.

Member brokers shall sell securities on behalf of client only on receipt of a margin money on the price of securities proposed to be sold, unless the member has received the securities to be sold with valid transfer documents to his satisfaction prior to such sale.

4.13 Closing Out

In case of purchases on behalf of clients, Member brokers shall be a liberty to close out the transactions by selling the securities, in case the client fails to make the full payment to the Member Broker for the execution of the contract within two days of contract note having been delivered for cash shares and seven days for specified shares or before pay-in day (as fixed by Stock Exchange for the concerned settlement period), whichever is earlier; unless the client already has an equivalent credit with the Member. The loss incurred in this regard, if any, will be met from the margin money of that client.

In case of sales on behalf of clients, Member broker shall be at liberty to close out the contract by effecting purchases if the client fails to deliver the securities sold with valid transfer documents within 48 hours of the contract note having been delivered or before delivery day (as fixed by Stock Exchange authorities for the concerned settlement period), whichever is earlier. Loss on the transaction, if any, will be deductible from the margin money of that client.

4.14 Requirement of Base Minimum Capital for Stock Trading Member

The BMC (Base Minimum Capital) deposit requirement for stock brokers trading on stock exchange has been prescribed by SEBI to be commensurate with the risks (other than market risk), that the broker may bring to the system. The various technological changes and the increased speeds of trading have brought to fore the greater quantum of risks arising during the course of execution of transactions. In light of this, based on deliberations at various forums, it has been decided to realign the BMC requirements with the risk profiles of the stock brokers / trading members in cash / derivative segment of the stock exchange vide circular no. CIR/MRD/DRMNP/ 36 /2012 dated December 19, 2012 which shall be implemented by March 31, 2013. Accordingly, the requirement of BMC would be implemented in the following manner:

(i) It shall be enhanced for members holding registration as "stock-broker" in cash segment.

(ii) BMC shall be introduced for members holding registration as "trading member" in any derivative segment.

(iii) Stock brokers / trading members shall maintain the prescribed BMC based on their profiles –

Categories	*BMC Deposit*
Deposit Only Proprietary trading without Algorithmic trading (Algo)	₹ 10 Lacs
Trading only on behalf of Client (without proprietary trading) and without Algo	₹ 15 Lacs
Proprietary trading and trading on behalf of Client without Algo	₹ 25 Lacs
All Trading Members/Brokers with Algo	₹ 50 Lacs

Explanation: The profiling of members may be explained with the following example – A scenario may arise, wherein, a member has registration as a "stock broker" as well as a "trading member" and is engaged as a principal doing proprietary trading on cash segment and is also engaged as an agent and transacting only on behalf of the clients in the derivatives segment.

Further, the member may not have availed facility for algorithmic trading. In such a case, the profile of such a member shall be assessed as "Proprietary trading and trading on behalf of client without Algo". The applicable BMC deposit for such a member shall be ₹ 25 Lacs.

This BMC deposit requirement stipulated in the above table, is applicable to all stock brokers / trading members of exchanges having nation-wide trading terminals.

(iv) For stock brokers/trading members of exchanges not having nation-wide trading terminals, the deposit requirement shall be 40% of the above said BMC deposit requirements.

(v) The BMC deposit shall be maintained for meeting contingencies in any segment of the exchange. For members having registration for more than one segment of the same

exchange, the BMC deposit requirement shall not be additive for such number of segments and shall be the highest applicable BMC deposit, across various segment.

(v) No exposure shall be granted against such BMC deposit. The Stock Exchanges shall be permitted to prescribe suitable deposit requirements, over and above the SEBI prescribed norms, based on their perception and evaluation of risks involved.

(vi) Minimum 50% of the deposit shall be in the form of cash and cash equivalents. The existing guidelines on collateral composition shall continue to remain applicable.