LAW OF FINANCIAL MARKETS & TRANSACTIONS IN INDIA

Session 1 : Banking and Non Banking Regulations

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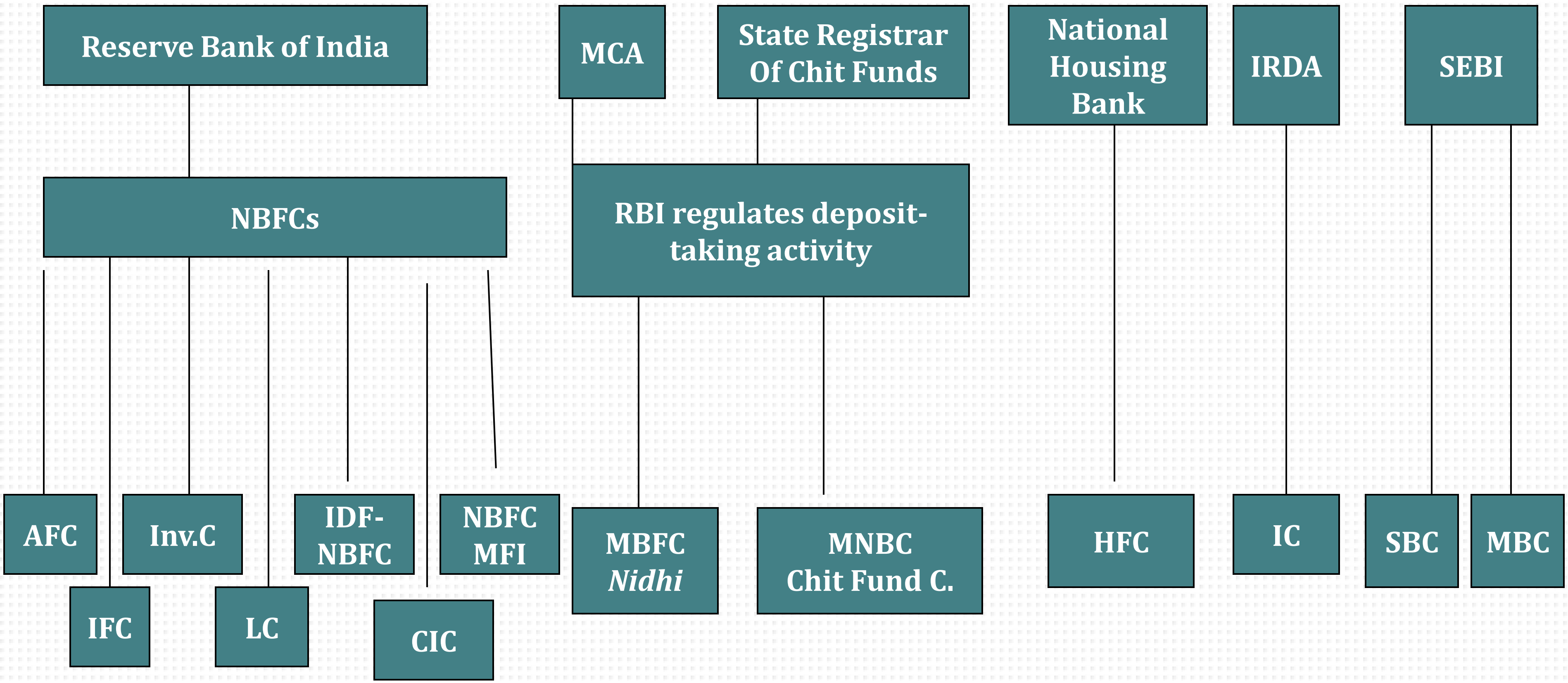
Overall scheme of financial regulations in India

India works on a multi-regulator model



Basic structure of Indian financial market

BASIC STRUCTURE OF THE INDIAN FINANCIAL MARKET

BANKING COMPANIES

NON-BANKING FINANCIAL COMPANIES

REGULATED BY:-

RESERVE BANK OF INDIA

Banking Companies:
An Overview

BANKING COMPANIES

Meaning :-

A Banking Company is a financial institution which provides financial services along with the fundamental banking services of accepting deposits which are repayable on demand.

Definition :-

Section 5(c) of the **Banking Regulation Act, 1949** defines "***Banking Company***" as "***Any company which transacts the business of banking***" [in India].

Section 5(b) of the **Banking Regulation Act, 1949** defines "***Banking***" as "***The accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, or otherwise*** "

BANKING COMPANIES (continued)

Laws governing the Banking Companies :-

- *Banking Regulation Act, 1949.*
- *Reserve Bank of India Act, 1934.*
- *Companies Act, 1956*
- *Banking Companies (Acquisition and Transfer of Undertakings) Act*
- *Bankers' Books Evidence Act*
- *Banking Secrecy Act*
- *Negotiable Instruments Act, 1881*
- *Guidelines, directions and instructions issued by RBI through notifications and circulars.*

BANKING COMPANIES (continued)

<u>Main Functions of the Banking Companies :-</u>

- *Accepting deposits, which are repayable on demand.*
- *Lending or investing the deposits to its customers.*
- *Agency functions.*
- *Provision of other financial services.*

BANKING COMPANIES (continued)

<u>Main Restrictions for the Banking Companies :-</u>

- Restrictions in respect of loans and advances-
  - *For Advances against Banks' own shares.*
  - *For Loans and Advances to own Directors/Senior officers of the company and their relatives.*
  - *For the subscription of IDRs.*
- Restrictions regarding the payment of dividend without writing off capitalized expenses.
- Restrictions on the power to remit debts.

BANKING COMPANIES (continued)

Main Restrictions for the Banking Companies (continued):-

- Restrictions in respect of compromise and arrangements.
- Restrictions in respect of non-banking businesses like trading, operating leasing etc.
- The Bank should not hold shares in a company more than 30% of the paid up capital of the company or 30% of its own paid up capital, whether as pledgee , mortgagee or absolute owner.
- The banks should not hold shares whether as pledgee, mortgagee or absolute owner, in any company in the management of which any managing director or manager of the bank is in any manner concerned or interested.
- The Banks should not provide loans to the companies for its buy-back.

BANKING COMPANIES (continued)

Main Restrictions for the Banking Companies (continued):-

- The banking companies have to maintain certain reserves with the RBI, they have been mentioned below along with the current rate imposed by the RBI:
  - *Statutory Liquid Ratio (SLR) : 23%*
  - *Cash Reserve Ratio (CRR) : 4%*

- The banking companies are required to lend a certain part of their total lending to the priority sectors, the present requirements have been shown

Categories	Domestic commercial banks / Foreign banks with 20 and above branches	Foreign banks with less than 20 branches
Total Priority Sector	40	32
Total agriculture	18	Not Specified
Advances to Weaker Sections	10	Not Specified

BANKING COMPANIES (continued)

Main Restrictions for the Banking Companies (continued):-

The following sectors are known as Priority Sectors:

- *Agriculture*
- *Micro and Small enterprises*
- *Education*
- *Housing*
- *Export Credit*
- *Others*

The loans advances to the weaker sections in the Priority Sectors includes the followings :-

- *Small and marginal farmers*
- *Artisans, village and cottage industries where individual credit limits do not exceed `50,000*
- *Beneficiaries of Swarnjayanti Gram Swarozgar Yojana (SGSY), now National Rural Livelihood Mission (NRLM)*

BANKING COMPANIES (continued)

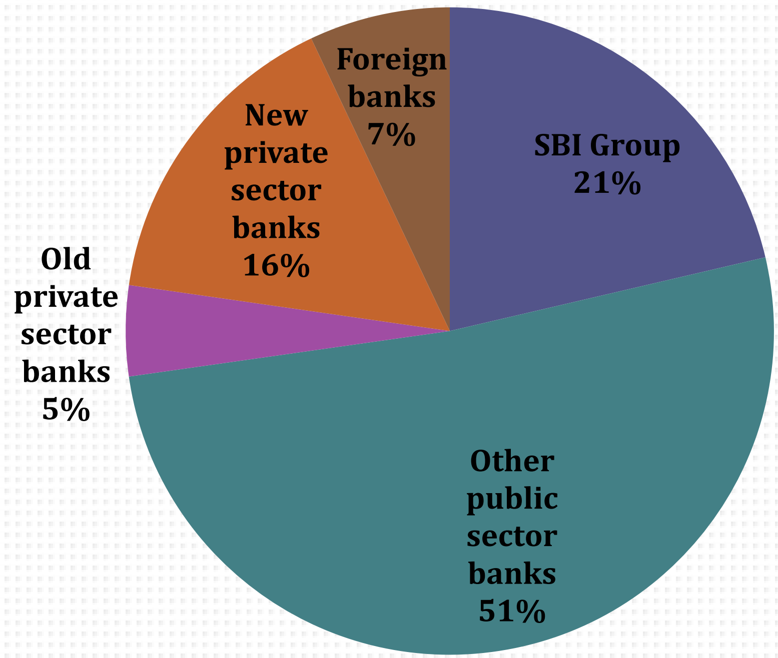
Main Restrictions for the Banking Companies (continued):-

- *Scheduled Castes and Scheduled Tribes*
- *Beneficiaries of Differential Rate of Interest (DRI) scheme*
- *Beneficiaries under Swarna Jayanti Shahari Rozgar Yojana (SJSRY)*
- *Beneficiaries under the Scheme for Rehabilitation of Manual Scavengers (SRMS)*
- *Loans to Self Help Groups*
- *Loans to distressed farmers indebted to non-institutional lenders*
- *Loans to distressed persons other than farmers not exceeding `50,000 per borrower to prepay their debt to non-institutional lenders*
- *Loans to individual women beneficiaries upto ` 50,000 per borrower*

State of banking in India

- ❑ Currently, there are 169 banks in India, including 82 regional rural banks
- ❑ About 76% of the total banking assets are in the PSU banks, though private sector banks are making a significant headway

Assets of commercial banks 31 March 2012



Banking sector (2011-12)

- No. Of Commercial Banks – 173 (100%)
  - Scheduled banks – 169 (97.7 %)
    - SBI – 6 (3.47%)
    - Nationalised Banks - 20 (11.56%)
    - Private Sector – 20 (11.56%)
      - Old Private Sector - 13 (7.51%)
      - New Private Sector - 7 (4.05%)
    - Foreign Banks – 41 (23.70%)
    - Regional Rural Banks - 82 (47.40%)
  - Non-scheduled banks – 4 (2.3%)

Nos are for number of banks, percentages – number as percentage of total number

Background

- ❑ Union Finance Minister's budget speech for 2010-11 gave indication some additional banking licenses to private sector players
- ❑ Discussion Paper was placed on its site by RBI in 2010
- ❑ Draft Guidelines were placed on RBI's site on August 29, 2011 inviting public comments
- ❑ Final Guidelines issued on February 22, 2012
  - ➢ *Keeping in view the recommendations of the Narasimham Committee, Raghuram Rajan Committee and feedback from market players*
- ❑ As on date, 22 private sector banks registered with RBI
- ❑ Previously, RBI issued guidelines in 1993
  - ➢ *10 private sector banks registered*
- ❑ Under guidelines in 2001
  - ➢ *2 private sector banks registered*

Highlights of Guidelines

- Eligibility Criteria
- ‘Fit and Proper’ criteria
- Corporate structure of the NOFHC
- Minimum voting equity capital requirements for banks
- shareholding by NOFHC
- Regulatory framework for banks and NOFHC
- Foreign shareholding in the bank
- Corporate governance of NOFHC
- Prudential norms for the NOFHC
- Exposure norms for banks and NOFHC
- Additional conditions for NBFCs promoting / converting into a bank

Who can apply?

Following can promote a bank through a wholly-owned Non-Operative Financial Holding Company (NOFHC)

- Entities / groups in the private sector that are 'owned and controlled by residents'
- Entities in public sector

Promoters / Promoter Groups with an existing NBFC

- In name of their NBFCs

Meaning of Promoter/Promoter Group

- *Promoter to mean person having control of NOFHC by virtue of his ownership of voting equity shares and includes*
  - *His relatives*
  - *All entities which form part of the Promoter Group*

- *Promoter Group have same definition as provided in SEBI SAST Regulations*
  - *All entities disclosed as a part of promoter group to stock exchanges are a part of the promoter group*
  - *All entities bearing the flagship name of a promoter group entity are also part of promoter group*

How to make the application?

Applications to be submitted to Department of Banking Operations and Development of RBI on or before July 1, 2013 in Form III

Applications to first screened by RBI

After review, referred to High Level Advisory Committee to be set up by RBI

Based on the recommendations of the said Committee, RBI to its decision on the application

In-principle approval issued by RBI to be valid for one year from the date of granting approval

Regulatory Framework

Banks

- Banking Regulation Act
- RBI Act
- FEMA
- Payment and Settlement Systems Act

NOFHC

- Companies Act
- RBI's Directions issued to NBFCs
- New set of directions to be issued by RBI

Incorporation rules for NOFHC

- New banks would require NOFHC as their holding company

- In our view, incorporation of NOFHC is not required at the time of making application
  - *As application to be made in name of banking company, not holding company*
  - *May also be incorporated before application*

- Incorporation documents
  - *MOA to limit the business only to hold shares in financial companies*
  - *AOA may contain restrictions on directorship and change in control as provided in the guidelines*

- Can existing CICs be used as NOFHCs?
  - *We are of the view, yes*

‘Fit and Proper Person’ criteria for promoters

- Promoters/ Promoter Groups to have
  - *past record of sound credentials and integrity*
  - *successful track record of running their business for at least 10 years*
- Promoter / Promoter Groups’ business model and business culture not to be misaligned with the banking model

Structure of Bank and NOFHC

Holding of NOFHC to be brought to 40% in 3 years

Promoter group

NOFHC

Banking company

NBFC/ other financial entities

Subsidiaries/JV for any specialised business

To hold up to 10%

To hold at least 51%

Individuals, relatives and associates

Non Financial Entities in which individuals hold at least 50%

Promoter Group companies in which public holding is >51%

Clarity on the 2 percentages for shareholding in the NOFHC

- Individual promoter holding
  - *Maximum 10% for each individual promoter*
    - *This includes the companies where promoter holding is 50% or above*

- Corporate holding in the promoter group
  - *Minimum 51% for corporate holdings within the promoter group*
  - *These are the companies where the promoter holding is 49.99% or less*

- Individual promoter holding is a cap
  - *This may go from 0% to 9.99% per individual*

- Company holding is a minimum
  - *This may go from 51% to 100%*

Corporate Structure of NOFHC

- NOFHC to hold shares of:
  - *Banks*
  - *All other regulated financial entities of group*
    - *All shareholding of promoters will be transferred*
    - *Entities having significant influence to be included only*
    - *Entities with minor interest of promoters may be kept outside*

- NOFHC, including all its consolidated entities, may make investments in other financial entities (which are not consolidated), to a limit of 10% of aggregate capital funds of the group
  - *Cross holding to be eliminated*

Meaning of 'regulated financial service entities'

- Includes:
  - *All banking companies,*
  - *NBFCs,*
  - *housing finance companies,*
  - *SEBI-regulated entities*
    - *CICs which do not require registration are not covered*

Shareholding in NOFHC

- 100% owned by Promoters
- Following can hold shares in NOFHC within specified limit
  - *Non-financial services companies / entities*
  - *Non-operative financial holding company*
    - *Meaning CICs; hence, CICs not requiring registration can also hold shares*
  - *Individuals*
- Shares of NOFHC cannot be held by any entity outside the Promoter Group
- No mention about foreign shareholding, hence extant FDI Policy becomes applicable
  - *Since the NOFHC is an investment company, foreign shareholding will not be allowed*

Transfer of promoters shareholding- Implications

- Stamp Duty
  - *Exempted in terms of Banking Laws (Amendment) Act, 2012*
    - *However, exemption on transfer of shares of banking company only*
  - *No issue if shares are in demat form*
    - *Significant cost might have to be incurred in case of physical shares*

- Capital Gain Tax
  - *Presently tax is applicable*
  - *Exemption may be announced in the forthcoming Union Budget*

- SEBI SAST Regulations
  - *Presently no exemption*
  - *Eventually exemption may be granted*

Shareholding in Bank

- NOFHC to hold a minimum of 40 per cent of the paid-up voting equity capital of the bank
  - *This will be locked in for a period of five years from the date of commencement of business of the bank*
  - *Holding beyond 40% shall be brought down to 40% within three years*
  - *Holding to be brought down to 20% of the paid-up voting equity capital of the bank within a period of 10 years, and to 15% within 12 years*

- Foreign Shareholding allowed up to 49% for first 5 years
  - *After 5 years, extant FDI policy to apply*
    - *As per extant FDI Policy, FDI up to 49% is allowed under automatic route and beyond 49% but up to 74% is allowed under approval route*

Capital Requirements

- For Banks
  - *Initially Rs. 500 crores (as per the Guidelines)*
    - *However, to maintain Basel II/ Basel III capital requirements which are effective from April 1, 2013*
      - *Basel III guidelines require a minimum Tier 1 capital requirement of 5.5%*
  - *Hence, Rs 500 crores, or 5.5% of risk weighted assets, whichever is higher*

- For NOFHCs
  - *To be laid by directions yet to be issued by RBI*
  - *Assuming that the NOFHC holds 100% capital of the bank, the NOFHC will need resources of Rs 500 crores*
    - *This can be a combination of equity and debt*

Capital Adequacy Requirements under Basel II/III

- For Banks
  - *Guidelines put a minimum capital requirement of 13% for a period of 3 years*
    - *Not clear how much of the 13% will be in form of Tier 1*
    - *Going by the commonly-followed 50% norm, logical to hold that the minimum common equity requirement for new banks, for first 3 years, will be 6.5% of the risk weighted assets*

- For NOFHCs
  - *Minimum capital adequacy of 13% of its consolidated risk weighted assets*
  - *As it has no substantial business other than investments in regulated financial businesses, consolidated RWA to be seen*

How can resources be raised ?

- By NOFHCs
  - *Equity*
  - *Interest bearing debt instruments*
    - *Up to a limit of 1.25 times of paid up capital and free reserves*

Provisions on distribution of Dividend

Bank	NOFHC
Can pay dividend only after writing off of all its capitalized expenditures	No bar. Can pay
Transfer of at least 20% of its net profits every year to "reserve fund" before declaration of any dividend	Transfer of at least 25% of its net profits every year to "reserve fund" before declaration of any dividend

Exposure Norms for Bank

- To be governed by RBI's Master Circular on 'Exposure Norms'

- Limits in place for investments in
  - *shares and debentures of companies,*
  - *PSU bonds,*
  - *Commercial Papers (CPs)*

- Guidelines provides that
  - *Cannot make investment in same group companies*
    - *However, allowed to invest in entities which are under NOFHC subject to guidelines of the RBI on intra-group exposures*
      - *There are draft guidelines on intra group exposure putting limit as:*
        - *10% on a single regulated financial entity, and*
        - *20% on all regulated financial entities*

Exposure Norms for NOFHCs

- To avoid round tripping of funds and to avoid circular movement of funds in the banking group, restrictions imposed
  - *Financial entities held by NOFHC to not have exposure to Promoter Group or NOFHC*
  - *Inter-se investment among financial entities prohibited*
  - *Cannot make investment in equity of other NOFHC*
    - *Investment in debt securities can be made*

Corporate Governance Norms

Directors of any CIC holding the NOFHC

- Generally speaking, directors of all registered NBFCs have to be "fit and proper" persons
- Usha Thorat recommendations lay down Clause 49 to be applicable to all NBFCs.
- so if the shareholding CICs in the NOFHC are regulated CICs, they need to abide by the applicable guidelines

Directors of the NOFHC

- Cannot hold directorship of other companies except subsidiary or a sec 25 company
- 'Fit and proper' person criteria applicable as prescribed for banks by Dr Ganguly Group Report
- At least 50% of the Board should comprise of IDs with special knowledge and practical experience
- Undertaking and declarations required from directors

Corporate Governance Norms (contd..)

Directors of Bank

- At least 51% directors to be IDs with special knowledge or practical experience in specified fields
- Directors other than chairman and WTD are restricted to hold office for more than 8 years at a stretch
- Chairman, MD and director appointed by RBI not required to hold qualification shares
- Whole time chairman to manage the bank
  - Appointment of part time chairman to be approved by RBI and MD shall be managing the bank
- Director cannot hold directorship of other banking companies
- Board to not to have more than 3 directors who shall be directors of companies exercising 20% or more voting rights in bank
- Nomination Committee to undertake process of due diligence to determine the suitability based on qualifications, technical expertise, track record, integrity, etc.
- Undertaking and declarations required from directors
- Not more than one member of family or close relative or should to be on board

Additional conditions for Banks

Bank to open at least 25 per cent of its branches in unbanked rural centres

Bank to comply with the priority sector lending targets and sub-targets as applicable to the existing domestic banks.

Banks promoted by groups having 40 per cent or more assets/income from non-financial business will require RBI's prior approval for raising paid-up voting equity capital beyond Rs. 10 billion for every block of Rs. 5 billion.

Any non-compliance of terms and conditions will attract penal measures including cancellation of license of the bank.

Banks to get its shares listed on the stock exchanges within three years of the commencement of business

Prudential Norms for NOFHCs

To comply on stand alone as well as on consolidated basis

Prudential norms guidelines for banks are applicable; to adhere to norms for

- Classification, valuation and operation of investment portfolio
- Income Recognition,
- Asset Classification and
- Provisioning pertaining to Advances

Non Banking Financial Companies:
An Overview

Meaning Of NBFCs

- Sec 45I (c) of the **RBI Act, 1934** defines "financial institution". A non-banking company carrying business of financial institution will be an NBFC.

- Activities included in the definition:

  - *Financing, whether by giving loans, advances or otherwise*
  - *Acquisition of shares, stocks or securities*
  - *Hire purchase*
  - *Insurance – excluded by notification*
  - *Management of chits, kuries, etc*
  - *Money circulation schemes*

- If principal business is industrial, trading, etc., the company will not be an NBFC.

Quick overview of the sector

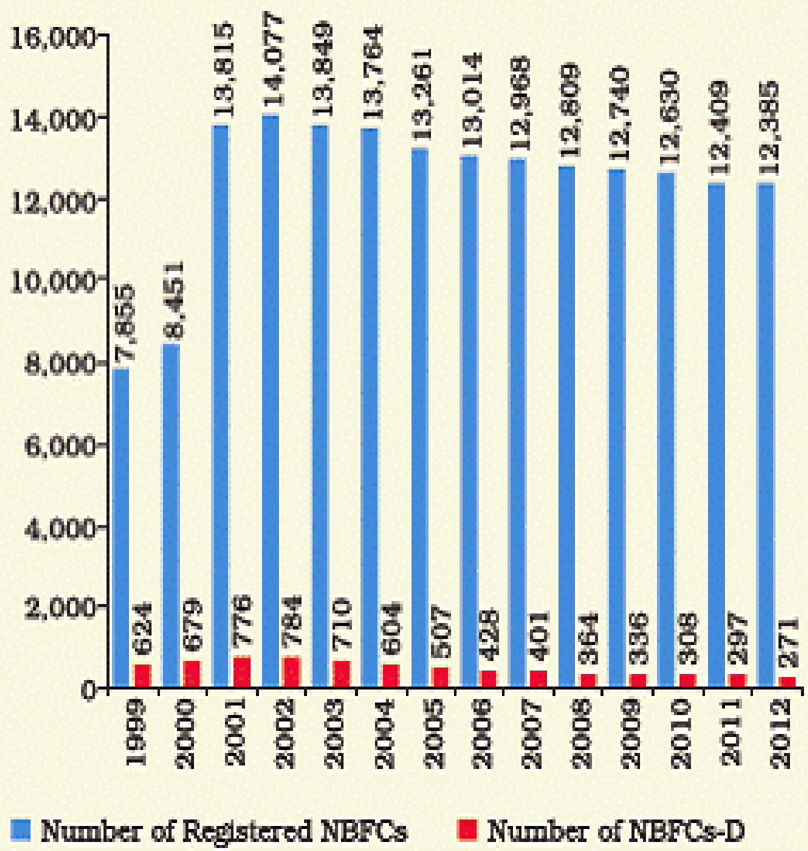
Was booming on the upswing of the equity market until the meltdown started

Several pubic offers of NBFCs had come in the recent past

Many of them were aggressively selling loans/ investment schemes/ mutual fund investments

Quick look at how many NBFCs take deposits

Chart VI.1: Number of NBFCs Registered with the Reserve Bank (As at end-March)



Number of NBFCs Registered with the Reserve Bank		
End-June	Number of Registered NBFCs	Number of NBFCs-D
1	2	3
2001	13,815	776
2002	14,077	784
2003	13,849	710
2004	13,764	604
2005	13,261	507
2006	13,014	428
2007	12,968	401
2008	12,809	364
2009 2010	12,740 12,630	336 308
2011	12,409	297
2012	12,385	271

Declining Figures In Year 2011-2012

- However, the total number of NBFCs registered with Reserve Bank of India declined to 12,385 as at end March, 2012 from 12,409 as at end March 2011.There was also a decline in NBFCs-D in 2011-12.This decline was mainly for:
  - *Cancellation of CoRs of NBFCs*
  - *Exit of NBFCs from deposit taking activities*
  - *Conversion of deposit taking companies into non-deposit taking companies*

- Though decline recorded in number of NBFCs:
  - *Total assets and NOF increased during 2011-12*
  - *Public deposits declined*

Principal Business Test

- Was introduced by a Press Release 1998-99/1269 dated April 8, 1999
- Came up with circular dated October 19, 2006 to define "principal business" as:
  - *financial assets are more than 50 per cent of its total assets (netted off by intangible assets)*
    - *Financial assets to include all assets that are financial in nature except cash, bank deposits, advance payment of taxes and deferred tax payments*
  - *income from financial assets is more than 50 per cent of the gross income*
- The criteria of income and assets are cumulative and both should be met

Principal Business Test Contd..

However, qualitative factors are also important as principality of business cannot change year to year but figures do

Following also to be examined:

- nature of the business of an entity,
- its principal thrust areas,
- schematic and consistent distribution of assets, resources and activities.

RBI Goes Fishing For NBFCs

- RBI recently sending notices to companies which have been registered with RoC under the "financial code"
  - *"Financial code" includes all financial intermediation, except insurance and pension funding (division 65 as per NIC code 2004) and all activities auxiliary to financial intermediation (division within its ambit)*

- The notice also requires companies to submit their financial statements and details of other companies in the same group.
  - *These in any case available in public domain*

- This come in the heels of Usha Thorat Panel Report which sought a major recast of NBFC regulations.
  - *Although, the recommendations were only to ease RBI's pressure on monitoring financial companies, this step by RBI is a complete volte face*

Applicable laws

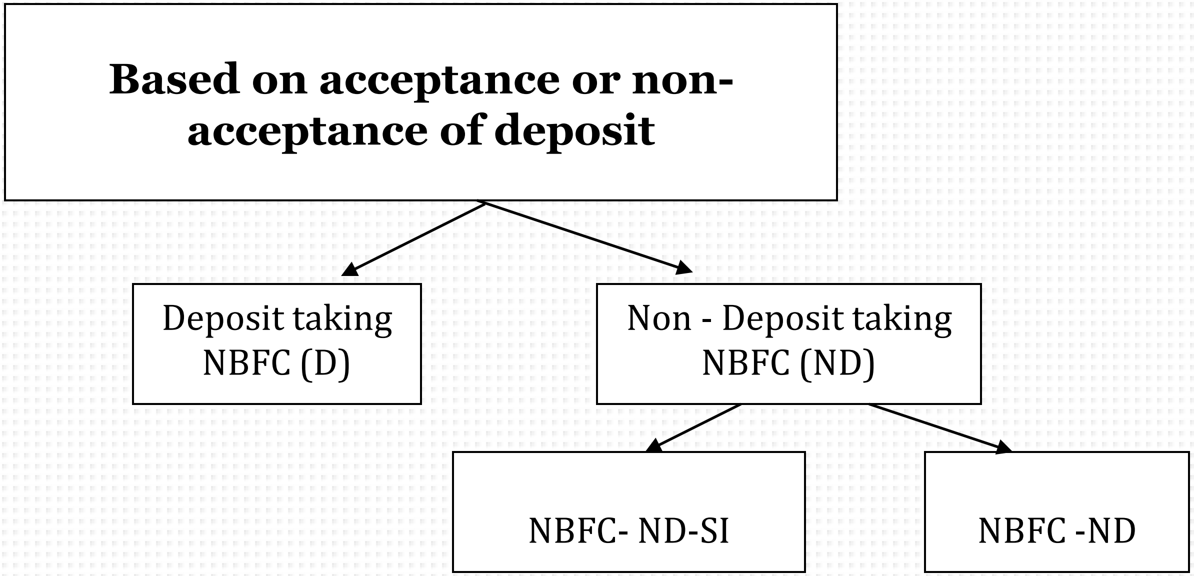
Laws governing the Non-Banking Finance Companies :-

- *Companies Act, 1956*
- *Reserve bank of India Act, 1934*
- *NBFC (Acceptance of Public Deposits) Directions, 1998*
- *NBFC (Deposit Accepting or Holding) Prudential Directions, 2007*
- *NBFCs Auditors Directions, 2008*
- *Guidelines, directions and instructions issued by RBI through notifications and circulars.*

Types of NBFCs by assets

- **Based on the nature of business**
  - Asset Finance Companies
  - Loan companies
  - Investment Companies
  - Infrastructure debt fund companies
  - Micro Finance Companies
  - Core Investment Companies
  - Infrastructure Finance Companies

Types of NBFCs by regulatory intensity



Classes of NBFCs

- The existing "equipment lease" and "hire purchase" classification was dropped in Dec 2006, and "asset finance company" was brought in
  - *If the company qualifies as asset finance company, it may approach the regional office for reclassification*

- Further vide circular dated Sept 15, 2008 three categories of NBFCs emerged
  - *Asset finance company*
  - *Loan company*
  - *Investment company*

- Further following categories introduced:
  - *NBFC-IFC (by notification dated Feb 12, 2010)*
  - *NBFC-CIC (by notification dated April 21, 2010)*
  - *NBFC-IDF (by notification dated Nov 21, 2011)*
  - *NBFC-MFI (by notification dated Dec 02, 2011)*

REGISTRATION REQUIREMENT FOR NBFCs

- It should be registered as per Section 3 of Companies Act, 1956
- It should have Net Owned Funds of at least Rs. 2 Crores.
  - *However, there are separate specific capital requirements for NBFC-MFI, NBFC-Factor and NBFC-CIC.*
- It should obtain Certificate of Registration from Reserve Bank of India.

Concentration of Credit/ Investment

NBFC-D & NBFC-ND-SI

Lend or Invest

- 15% of owned fund to single borrower
- 25% of owned fund to a single group of borrowers

Lend and Invest

- 25% of owned fund to single borrower
- 40% of owned fund to a single group of borrowers

Exception: Asset Finance Company can further exceed the ceilings by 5%

Capital Adequacy Requirement

- Minimum capital ratio consisting of Tier I and Tier II capital:
  - *15% in case of NBFC-D*
  - *10% in case of NBFC-ND-SI of its aggregate risk weighted assets on balance sheet and of risk adjusted value of off-balance sheet items. To be increased to 12% CRAR by March 31, 2010 and 15% CRAR by March 31, 2011.*
- Total of Tier II capital: Not exceeding 100% of Tier I capital
- Risk Weights
  - *On balance sheet items*
  - *Off balance sheet items viz. guarantees, underwriting obligations, lease contracts*

Fair Practices Code 10th Oct 2007

Sets an important point – borrowers must be aware of the rate of interest

Copies of loan agreements to be furnished to all borrowers

New set of NBFC Regulations

- Pursuant to the Governor's mid-term credit policy 2006-07, there was a proposal for comprehensive review of NBFC directions

- The basic object of the Govt was to remove regulatory arbitrage between NBFCs and banks, such that if the activities are substantially similar, the regulation applicable is similar too

- Consequently a new class of NBFCs, called "systemically important NBFCs" was envisaged by the Nov 3 2006 draft rules.

- Finally, in Feb 2007, two different sets of Regulations were announced.
  - *NBFC- D*
  - *NBFC – ND*

- Consequently, we now have 4 classes:
  - *NBFC –D – SI*
  - *NBFC – D*
  - *NBFC- ND*
  - *NBFC – ND- SI*

- The new sets are not very different from the existing regulations

What is systemically important?

- In case of depository and non-depository companies, mean companies holding assets of Rs 100 Crore or more as per last balance sheet
  - *Assets mean total assets*
  - *Assets mean book value of assets*
  - *On the face of it, current liabilities cannot be netted off from current assets*
  - *In case of subsidiaries, assets do not have to be consolidated*
  - *Miscellaneous expenditure pending write off is not an asset*

- Is it as per last balance sheet? A 4th July 2009 circular makes a departure. Says as and when NBFCs attain asset size of Rs 100 crore, they may start complying with the norms.
  - *Obvious difficulty is to find when does the asset size exceed Rs 100 crore*
    - *There may be a profit on sale of an asset, which may be used to pay off liabilities. Asset size does go up temporarily*

- However, if size of assets comes down, it will remain SI company "till specific dispensation is obtained from the RBI".

Additional Regulatory/ Reporting Requirements For NBFC-ND-SI

- All prudential norms apply to NBFC-ND-SI
- Monthly reporting requirement
  - *Primarily capital market exposure*
- Asset liability management framework applies
- Additional disclosures in balance sheet apply
- CRAR required for these companies is 12%
- Liquidity adjustment facility of the RBI extended to NBFC-ND-SI
- Capital Adequacy for NBFC-ND-SI was enhanced to 12% on 31.03.2010 & 15% on 31.03.2011

New Regulations For NBFC - D

- Not much of a change
- The word 'asset finance companies' seems to be replacing the erstwhile "equipment leasing" and "hire purchase companies"
- Limit on investment in unquoted equity shares and real estate:
  - *Was there earlier*
  - *20% in case of asset finance companies*
  - *10% in case of loan/investment companies*
- SI companies have to make monthly disclosure of their capital market exposure within 7 days of the end of the month
- Several new provisions about project loans

New Regulations For NBFC-ND

- The most significant change is that there is no exemption from prudential guidelines for NBFC – ND- SI
  - *In other words, capital adequacy and concentration limits apply to such companies.*
  - *Also required to make additional disclosures in Balance Sheet from the year ending March 31, 2009 relating to*
    - *CRAR,*
    - *exposure to real estate sector and*
    - *assets and liabilities mismatches.*
  - *Further three new reports have also been introduced for ALM reporting.*
    - *Statement of short term dynamic liquidity - monthly*
    - *Statement of structural liquidity – half yearly*
    - *Statement of Interest Rate Sensitivity - half yearly*

- In case of Systemically unimportant companies, existing exemption from capital requirements and concentration continues to apply

Restrictions On NBFCs

- Loan against NBFC's own shares prohibited

- NBFC accepting public deposits, not allowed to invest

  - *in land & building (more than 10% of its owned fund)*
  - *Unquoted shares of another company (more than 20% of its owned fund)*

- NBFC which has defaulted in repaying public deposit are prohibited from making loans and investments as long as the default continues

Credit Rating Reporting

All NBFCs (Excluding RNBCs)

- NBFC-D
- NBFC-ND
  - Asset size 100 crore and above

Report RBI of any change in rating

- Upgrading/downgrading of financial product
  - Commercial paper, debentures, etc.
  - In writing within 15 days of change from previous level.

Investments by NBFCs

- All NBFCs other than RNBCs
  - *In unencumbered approved securities*
    - *Not less than 15% of public deposit*
    - *10% or more of public deposits in:*
      - *Unencumbered approved securities*
      - *Unencumbered term deposits with scheduled commercial bank, SIDBI or NABARD*
      - *Bonds issued by SIDBI or NABARD*
        - *Aggregate amount not to be less than 15% of public deposits.*

Bank Finance to NBFCs

- To lay down RBI's regulatory policy regarding financing of Registered NBFCs by banks
- Statutory guidelines issued under section 35A of Banking Regulation Act, 1949
- Applicable to all Scheduled Commercial Banks, except Regional Rural Banks
  - *Banks can extend the working capital or term loan facilities to the NBFCs engaged in infrastructure financing, equipment leasing, hire purchase, loan, factoring and investment activities*
  - *Banks may also extend finance against second hand assets financed by NBFCs*
  - *Banks may formulate suitable loan policies with approval of their BOD within prudential guidelines and exposure norms*

Bank Finance to NBFCs contd..

- Banks may take credit decisions on basis of factors like
  - *Purpose of credit*
  - *Nature and quality of underlying assets*
  - *Repayment capacity of borrowers*
  - *Risk perception;*

While granting loan to NBFCs **not requiring** any registration. A few of them are:

- *Insurance Companies*
- *Nidhi Companies*
- *Chit Fund Companies*
- *Stock Broking Companies*
- *Bank may finance to registered RNBCs. However, the finance to be restricted to their Net Owned Fund (NOF)*

Short term foreign funds

- NBFC-ND-SI allowed to raise short term foreign currency borrowing under approval route.
  - *On availment furnish monthly return within 10 days from end of the month of taking loan.*
- Maximum amount: not to exceed 50% on NOF or USD 10 million, whichever is higher.
- Maturity: should not exceed 3 years.
- End-use: only for refinancing of short term liabilities.

FDI in NBFCs

- 100% FDI is allowed under automatic route, subject to capitalisation norms, in NBFCs engaged in:
  - *Merchant Banking*
  - *Underwriting*
  - *PMS*
  - *Investment advisory services*
  - *Financial consultancy*
  - *Stock and Forex broking*
  - *Asset Management*
  - *Venture Capital*
  - *Custodian Services*
  - *Factoring*
  - *Credit Rating Agencies*
  - *Leasing and Finance (financial leases only)*
  - *Housing Finance*
  - *Credit Card business*
  - *Money changing business*
  - *Micro and Rural Credit*
- Approval of RBI required for FDI in investment company

Additional Certification for FDI compliance- circular dated Feb 4, 2010

NBFCs having FDI whether under automatic route or under approval route required to submit a certificate from their Statutory Auditors on half yearly basis certifying compliance with the existing terms and conditions of FDI

To be submitted not later than one month from the close of the half year to which the certificate pertains

Downstream investments by NBFCs

Step down subsidiaries for specific NBFC activities can be set up by

- 100% foreign owned NBFCs or NBFCs having foreign investment above 75% and below 100%
- with a minimum capitalization of US$ 50 million

No limit on number of operating subsidiaries

No requirement of bringing in additional capital

Minimum capitalization condition not applicable to such downstream subsidiaries

ECB by NBFCs

- An NBFC is an eligible borrower as per ECB Guidelines

- NBFCs engaged in following can raise ECB under automatic route:
  - *NBFC-MFI*
    - *Up to USD 10 million or equivalent during a financial year*
  - *NBFC-IFC*
    - *upto 75% of their owned funds*
  - *ECBs can be raised from:*
    - *International banks*
    - *International capital market*
    - *Multilateral financial institutions (such as IFC, ADB, CDC, etc.)*
    - *Export credit agencies*
    - *Suppliers of equipments*
    - *Foreign collaborators*
    - *Foreign Equity Holders*

- All other terms and conditions as mentioned in ECB Guidelines are to be complied with

ECB by NBFCs-AFC – Recent Amendment

- NBFC-AFC are allowed to raise ECB under automatic route vide RBI circular date 8th July, 2013 with min average maturity period of 5 years
  - *To finance the import of infrastructure equipment for leasing to infrastructure projects*
  - *Upto 75% of its net owned fund*
    - *subject to a maximum of USD 200 million or its equivalent per financial year*
    - *ECB above 75% will require prior approval of RBI*

- ECB by issue of FCCBs can be raised
  - *Subject to compliance with Financial Action Task Force (FATF) Guidelines*
    - *upto 75% of their owned funds), subject to a maximum of USD 200 million or its equivalent per financial year.*

Public Deposits by NBFCs

Meaning of Deposit per RBI Act

- Simple meaning: money given/taken in advance to execute a monetary transaction

- Sec 45I(bb) of RBI Act provides inclusive definition as to include any receipt of money by way of deposit or loan or in any other form but excludes:
  - *amounts raised by way of share capital;*
  - *amounts contributed as capital by partners of a firm;*
  - *amounts received from banks and financial institutions*
  - *amounts received by way of security deposit or advance against orders*
  - *any amount received from a registered money lender*
  - *any amount received by way of subscriptions in respect of a chit.*

Meaning of "Public Deposit" as per RBI Regulations

- Paragraph 2(i)(xii) of NBFC Directions defines 'public deposit' as a 'deposit' as defined by RBI Act but further excludes:
  - *Amount received from Public financial institutions*
  - *Amount received from any other company*
  - *Share/debenture application money*
  - *Amount received from directors, or shareholders in case of a private company*
  - *Amount received by issue of secured mortgage bonds, or convertible bonds into equity*
  - *Promoters' loans brought according to loan agreement with term lending institutions*
  - *Amount received from mutual funds*
  - *Hybrid debt or subordinated debt, maturity not less than 60 months provided no call option to issuer*
  - *Amount received on issue of commercial papers*
  - *Any amount received by SI-NBFC-ND by issuance of 'perpetual debt instruments' in accordance with the rules framed by the RBI from time to time.*

Major provisions of NBFC (Deposit) Directions 1998: Meaning of Deposit

- Mostly concerned with acceptance of deposits

- Deposits
  - *As defined in RBI Act*
  - *As further excluded in the Directions*

- Deposits as defined in sec 45I (bb):
  - *Any receipt of money by way of a loan or deposit or in any other form*
    - *Monetary deposits only*
    - *Excludes*
      - *Share capital*
      - *Security deposit, advances against orders*
      - *Amount received from a registered money lender*

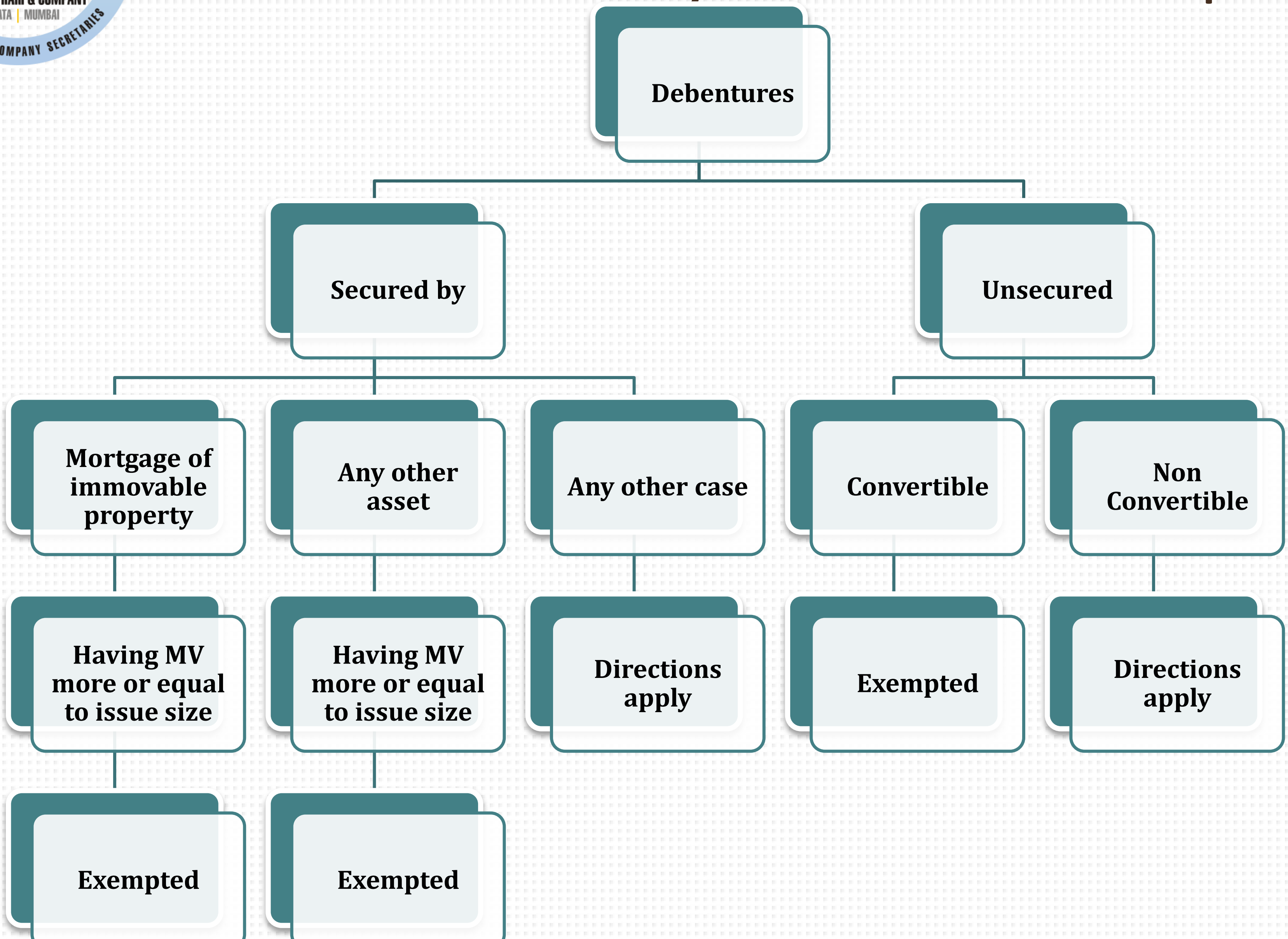
Major provisions of NBFC (Deposit) Directions 1998: Meaning of Deposit (continued)

- As per exclusions given in the Directions
  - *Amount received from Public financial institutions*
  - *Amount received from any other company*
  - *Share/debenture application money*
  - *Amount received from directors, or shareholders in case of a private company*
  - *Amount received by issue of secured mortgage bonds, or convertible bonds*
  - *Promoters' loans brought according to loan agreement with term lending institutions*
  - *Amount received from mutual funds*
  - *Hybrid debt or subordinated debt, maturity not less than 60 months*
  - *Amount received on issue of commercial paper*

Restrictions on acceptance of deposits

- Minimum credit rating: investment grade (requirement not applicable to leasing/hire purchase company
- Tenure of deposit – 12-60 months
- Capital Adequacy: 15% for deposit accepting companies and 12% for non-depository companies
- Rate of interest – as specified from time to time
- Brokerage – 2%, expenses 0.5%
- Interest on overdue deposits – may be paid if deposit renewed
- Detailed provisions about the content of the application form
- Detailed provisions about the content of the advertisement
- Provisions on premature repayment of deposits
- Appointment of branches and agents to receive deposits

Issue of Debentures by NBFCs- When Public Deposit?



RBI Guidelines on Private Placement of debentures

- Guidelines are effective from 27th June, 2013
  - *All issue after the effective date will require compliance with Guidelines*

- Guidelines taken away the wind of NBFCs
  - *Clarification issued within 5 days of issue*

- Regulates "Preferential Allotment" or "Private placement"
  - *Initially, terms defined to mean an issue of capital made by an NBFC in pursuance of a resolution passed under section 81(1A) of the Companies Act, 1956.*
    - *Meaning excluded NCDs as Sec 81(1A) covers CCDs only?*
  - *Realising this, definition has been amended to include NCDs also*

- Guidelines provided minimum time gap between two issues as 6 months
  - *Withdrawn by the Clarification circular*

- NBFCs to formulate a Board approved policy for resource planning, covering the planning perspective and periodicity of private placement, before close of business on September 30, 2013

Snapshot of the Guidelines

Number of subscribers	• restricted to 49 overriding Section 67 (3) of the Companies Act.
Upfront Identification	• of names of the subscribers
Cant deploy funds	• on its own Balance Sheet and not to facilitate resource requests of group entities/ parent company / associates
Offer Document	• to be issued within 6 months from Board approval with "For Private Circulation Only" printed on the same
Minimum Subscription Amount	• Rs. 25 lakhs for single investor and in multiples of Rs. 10 lakh thereafter.
security cover	• to be sufficient at the time of issue, sufficient otherwise security to be created within 1 month and proceeds to be kept in escrow

Amendments in Public Deposits Directions

Prior to Amendment	Post Amendment
Exemption was to debentures issued with ***an option to convert them into shares*** of the company.	***Debentures compulsorily convertible into equity*** are excluded ***[Option to issue OCDs completely out of picture now]***
Exemption was to hybrid debt or subordinated debt with minimum maturity period of sixty months.	Such instruments will be exempted only if ***no recall option to issuer has been given.***

New DRR requirements for NBFCs

- Reduced DRR requirements as per MCA circular dated February 11, 2013

- CICs has also been treated at par with NBNCs
  - *Circular covers only registered NBFCs*

Category	Amount of DRR to be maintained as per 2002 Circular	Amount of DRR to be maintained as per 2013 Circular
NBFCs registered with the RBI under Section 45-IA of the RBI (Amendment) Act, 1997	• 50% of the value of debentures issued through public issue as per SEBI (Disclosure and Investor Protection) Guidelines 2000. • No DRR in case of privately placed debentures.	• 25% of the value of debentures issued through public issue as per present SEBI (Issue and Listing of Debt Securities) Regulations, 2008. • No DRR in case of privately placed debentures.

Exemptions from provisions of RBI Act, 1934

- Some entities exempted from requirement of Chapter III B of RBI Act, 1934
  - *Housing Finance Institutions*
  - *Merchant Banking Company*
  - *Government Companies*
  - *Venture Capital Fund Companies*
  - *Alternative Investment Fund Companies*
  - *Insurance/Stock Exchange/Stock Broker/Sub- Broker*
  - *Nidhi Companies*
  - *Chit Companies*
  - *Mortgage Guarantee*
  - *Mortgage and Reconstruction Companies*

Proposed New Regulatory Framework for NBFCs
RBI's Draft

Blast of a reform

- The 12th Dec 2012 notice of proposed Regulations by the RBI proposes a complete perestroika of NBFC regulations

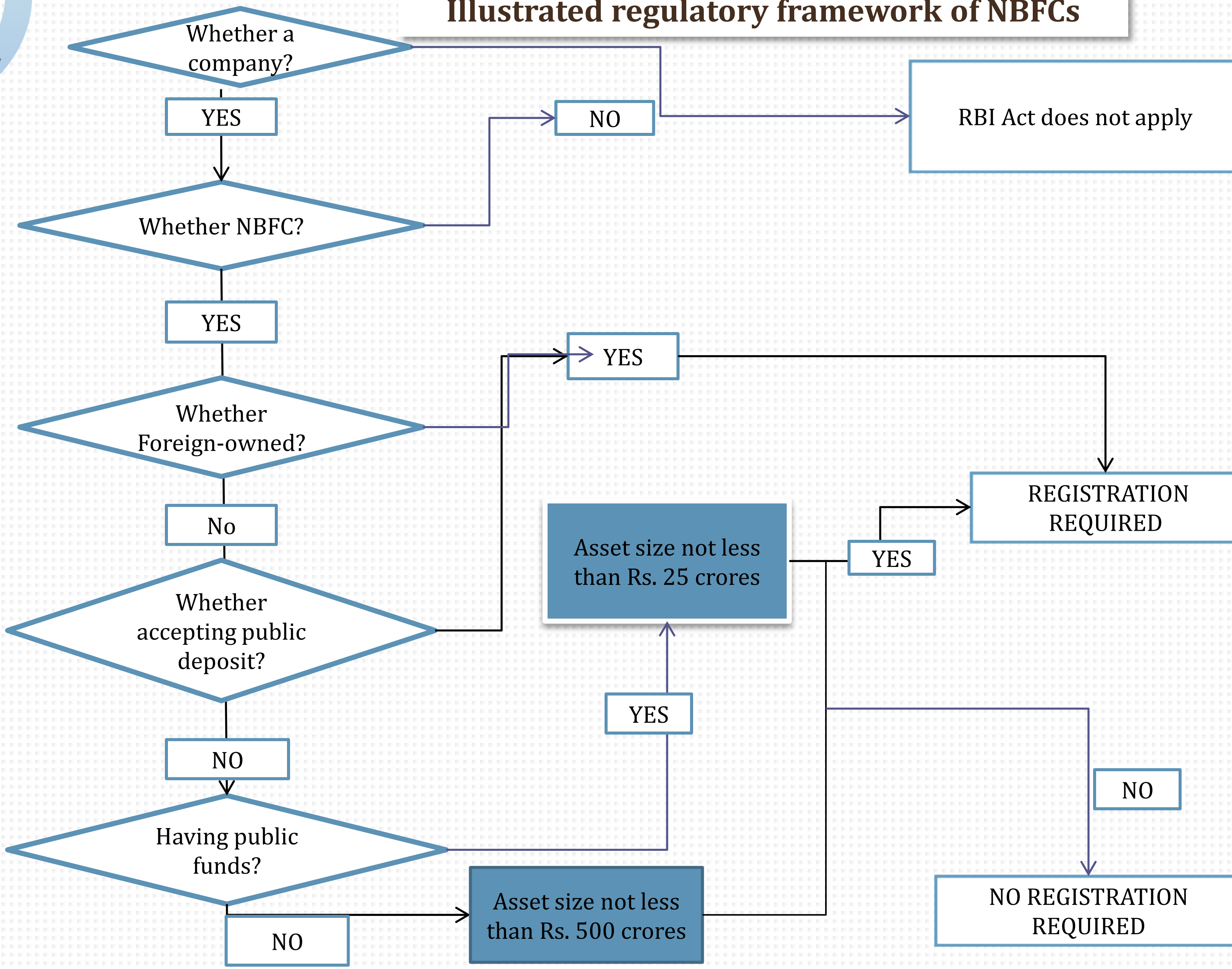
- The Regulations are still in draft stage – the invitation for comments has not put the actual draft of the proposed regulations on RBI website
  - *Explanatory notes on proposed changes have been put*

- Primarily, following major changes:
  - *Huge deregulation of the NBFC sector, taking lot of NBFCs out of the regulatory net*
  - *Extensive corporate governance controls on NBFCs, particularly for NBFCs with asset base of Rs 1000 crores or above*
  - *Capital requirements increased with 12% Tier 1 capital in case of captive NBFCs and "sensitive asset" NBFCs*
  - *Higher risk weights for capital market and CRE exposures*
  - *Increased provision for standard assets*
  - *Deposit option limited to rated AFCs, upto 2.5 times of NOF*

Entry point norms: major deregulation proposed

- This is one of the boldest moves, to take away from the registration net a whole lot of small NBFCs
- Size- based regulation proposed in case of all non-depository companies
  - *Companies holding public funds:*
    - *Asset size of less than Rs 25 crores*
  - *Companies not holding public funds*
    - *Asset size of less than Rs 500 crores*
  - *Either of the above are "exempted" from registration*
  - *Minimum NOF requirement remains the same – Rs 2 crores*
- Meaning of "public funds"
  - *Word may have the same meaning as in CIC Regulations – includes bank funding, debentures, ICDs, etc*
- Important point on "principal business"
  - *In case of entities with asset size ≥ Rs 1000 crores, the principal business criteria is changing from BOTH income and assets to EITHER income or assets*

Illustrated regulatory framework of NBFCs



What about existing companies?

- ❑ Existing NBFCs, not requiring registration under the new regime, may continue registration
  - ➢ *Provided it gives a road map of how it will attain the regulatory asset size (Rs 25 crores/ Rs 500 crores) within 2 years*
  - ➢ *The road map may be given within 3 months of the notification*

- ❑ All existing NBFCs, not needing registration, may also de-register themselves.

- ❑ Core investment company regulations may also become redundant

Thank You