

# **Non-banking financial companies– A primer**

## **By Vinod Kothari**

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In Indian financial sector, non-banking companies and the non-banking financial sector is admittedly a very significant component. There is tremendous interest in non-banking financial companies in India. This primer, written in FAQ format, answers most commonly raised questions on NBFCs. There are several presentations and articles on our site which have explored variety of other matters concerning NBFCs.

## **Generally about NBFC business**

### **Why is there so much of interest in NBFCs in India?**

There are several reasons:

- The term NBFC in India is a motley group of entities engaged in activities ranging from investments in stocks, loans, leasing, hire purchase, deposit-taking, etc. Globally, there would be several classes of entities allowed to do these businesses – for example, credit unions, savings institutions, personal credit institutions, leasing companies, etc., would all be doing different businesses. In India, registration as a non-banking finance company almost takes the entity at par with a banking company, except that NBFCs cannot seek deposits withdrawable on demand or by checking. India is one of few countries that allows NBFCs to seek deposits from the public. Since NBFCs are quite close to banks, and getting into banking business is a huge privilege, people vie to have an NBFC company.
- For certain activities, NBFC registration is mandatory – for example, investing in shares. In most other countries, it is inconceivable that a “financial company” registration is required for investing in stocks.
- Since even shareholding companies are regarded as NBFCs, business groups need companies to hold their group shares – hence, every leading business group has dozens of NBFCs.
- NBFCs are also seen as entry route to banking business.

### **What is an NBFC?**

Sec 45I (c) of the RBI Act 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*

The activities listed above may be taken as “financial business”.

In addition, operating leasing or asset renting are not financial activities. We hold the view that even factoring, which is acquisition of receivables in true sense and not just their funding, is also not a financing transaction. Hence, these activities also do not constitute financial business.

However if principal business is industrial, trading, etc., the company will not be an NBFC. RBI circulars have specified majority of assets and majority of income as the criteria for defining NBFC.

Principality of activity is what is important: assets and turnover are indicative, but not definite test of what is an NBFC.

### **I am carrying business as unincorporated entity. Am I an NBFC?**

Certainly not. Any form of entity other than a company under the Companies Act is not an NBFC. Accordingly, individuals, partnership firms, LLPs, trusts, etc. carrying on financial business are not NBFCs.

There is nothing about carrying financial business in an unincorporated entity. However, such entity cannot accept deposits from public as per sec 45S of the RBI Act. An LLP is a strange exception – it is an incorporated entity, and yet not a company.

### **I am carrying business financial business, is it better for me to an NBFC?**

This is purely a matter of one’s own strategy. If you have growth plans and would like to leverage your business, clearly NBFC is the choice. If you want to carry financial business with self-owned funds, there is no reason to have an NBFC.

Some people wrongly contend that if one is carrying a financial business in unincorporated form, money lending laws applicable. This is a misnotion as money lending laws are applicable in most states on companies, including financial companies too. See question below on this.

### **The definition of an NBFC is based on “principal business”. What is the meaning of “principal business”?**

As per the Press Release no. 1998-99/1269 dated April 8, 1999, the Reserve Bank of India, laid down the criteria for determining the principality of business in order identify whether a particular company is a non-banking financial company or not. Accordingly,

both the assets and the income pattern as evidenced from the last audited balance sheet of the company will be considered to decide its principal business. As per this Press Release, principality of business has been given a numerical dimension. If the financial assets of a company are more than 50 per cent of its total assets (netted off by intangible assets) and income from financial assets is more than 50 per cent of the gross income, then the company will be a NBFC. The criteria of income/assets are cumulative, that is, both the tests are required to be satisfied simultaneously as the determinant factor for principal business of a company.

The RBI has been proceeding with the view that both the income and the assets should primarily be out of a financial business, as defined above. Based on the above press release, the RBI has been insisting on obtaining an annual certificate from the auditor of an NBFC that the company continues to carry on the business of an NBFC – see *Circular No. DNBS (PD) C.C. No. 81/03.05.002/2006-07 dated October 18, 2006*.

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### **Is share trading business also a financial business?**

Yes.

### **My company is holding shares of private limited companies. Am I required to hold NBFC registration?**

Any company engaged in the business of acquisition of shares, whether of public companies or private companies, provided such business is “principal” business as discussed above, will require NBFC registration.

It is possible to contend that mere passive holding of shares by so-called holding companies does not amount to the business of investments. There are some rulings to this effect. Also, the RBI came out with an exception in case of “core investment companies” making such companies exempt from requirements of registration.

### **What is core investment company?**

See Vinod Kothari’s article linked here: [http://india-financing.com/whatz\\_NBFC.html](http://india-financing.com/whatz_NBFC.html)

### **My company is an NBFC. Can I now start lending business, or are there any further approvals required?**

Most states have moneylending laws as well. The Kerala High court has in *Link Hire-Purchase And Leasing Co. (Pvt.) Ltd. And Premier Kuries And Loans (Private) Ltd. vs State Of Kerala And Ors.* 103 Comp. Cas 941 (Ker) held that the moneylending laws of the State are applicable to a company even if the company is a financial company. However, in *Vellanki Leasing & Finance Pvt Ltd v. Pfimex Pharmaceuticals Ltd* and two others <http://www.indiankanoon.org/doc/1662308/> the AP High court dealing with a case under sec 138 of the NI Act refused to give consideration to the fact that the plaintiff was

not a registered money-lender, holding that the Act applied only to “professional moneylenders”. In any case, there is no exception in case of NBFCs under moneylending laws. Hence, technically speaking, NBFCs should seek registration under money lending laws too.

The Gujarat High Court passed a ruling to the effect that the States’ control on money lenders amounts to an overlap with the regulation of NBFCs by the RBI and therefore, regulated NBFCs are not covered by state money lending laws. See Vinod Kothari’s [article](#).

### **In an NBFC, can I also do non-financial business?**

Certainly yes, to the extent that the non-financial business does not become “principal” business discussed above.

### **In my NBFC, can I give housing finance?**

Companies principally engaged in the business of housing finance need registration with the National Housing Bank. Hence, NBFCs can give housing finance only to the extent it does not become “principal” business.

### **Can I do financial business in an unincorporated body?**

There is no bar at all in doing financial business in an unincorporated body – sec 45S of the RBI Act prohibits acceptance of deposits by such an entity. However, if the business is carried without accepting “deposits” as defined in the Act, there is no bar on doing the business.

### **Can I do financial business in an LLP?**

There is no bar at all in doing financial business in an LLP. In fact, LLP is an incorporated body. Even the restriction in sec 45S of the RBI Act is not applicable in case of an LLP.

## **Starting an NBFC**

### **How long does it take to get NBFC registration from the RBI?**

Application for registration is to be filed with the Regional office of the RBI. With more than 17000 NBFCs already registered, the RBI is certainly not very eager to allow more companies to come into existence. Though, if all formalities are complete and pre-conditions are satisfied, there is no reason for the RBI not to permit registration, nevertheless, the officers go quite slow. The process may take anywhere between 2 to 6 months’ time. Rejection on not-very-sound grounds are common.

### **What exactly does the RBI see in an application?**

Registration for non-depository companies, that is, companies that will not take deposits from the public, should be relatively easier. The details of the applicant and the applicant’s board of directors are given as required in the form. The RBI needs to satisfy itself that the persons in charge of the NBFC are fit and proper persons.

## **It is possible to acquire an existing NBFC?**

Certainly yes. Of course, there are formalities for implementing the change in control.

### **Formalities that must be complied with are:**

- - Public notice should be given atleast 30 days prior to effecting the sale or transfer;
- - In two newspapers one English and local vernacular language,
- - Jointly by NBFC, transferor and transferee,
- - Within seven days of publication of such notifications, intimation to the Reserve Bank of India.

### **For Deposit Accepting NBFCs:**

- - Prior approval of RBI
- - Obligations towards deposit holders are to be met.

There are certain advantages too of acquiring an existing NBFC. For example those NBFCs which were registered before 1999 needed an initial capital of Rs.25 lakhs only whereas the stipulated equity now is Rs.2 crore.

## **Foreign investment in and by an NBFC**

### **Can NBFCs be owned by non-residents?**

Foreign direct investment rules regulate foreign investment in NBFCs. The permitted activities of such NBFCs are listed in the FDI circular – there are 18 permitted activities. Conspicuously absent there is investment activity. That is, foreign owned NBFCs cannot carry investment activity. This does not imply that such an entity cannot make any investments at all – investments can only be incidental. Step down subsidiaries can be floated by NBFCs with foreign capitalization of USD 50 million or above.

There are minimum capitalization norms depending on the percentage of foreign holding envisaged. Upto 51%, it is USD 0.5 million, 51% - 75% - it is USD 5 million, and for 100% foreign owned entities, it is USD 50 million. Minimum capitalization refers to the capital brought by foreign investors – it is not the total paid up capital of the NBFC nor the par value of the shares.

### **Can NBFCs make investments overseas?**

Foreign investments overseas may be either in form of shares of a joint venture company or a wholly owned subsidiary (referred to as overseas direct investment or ODI), or portfolio investments in overseas stocks. ODI by NBFCs is permitted in financial sector entities in the foreign countries, subject to registration with appropriate regulatory bodies of the host country. The precondition is that the investing company must have made profits for 3 years. The limit of investment is 400% of net worth of the investing company.

## Operating restrictions

### What are the operating controls on the business of NBFCs?

There are not much of operational restrictions. However, here is a brief idea of the regulations:

- There is no restriction on interest rates that NBFCs can charge, though money-lending laws of several states do have restrictions on interest rates. The RBI simply says – NBFCs shall not charge “excessive” interest rates, leaving it to anyone’s subjectivity as to what is excessive interest rate.
- **Disclosure of true rate of interest:** Though interest rates are not regulated by RBI, rates of interest beyond a certain level may be seen to be excessive and can neither be sustainable nor be conforming to normal financial practice. Advising the Boards of NBFCs to lay out appropriate internal principles and procedures in determining interest rates and processing and other charges, the Reserve Bank of India, vide its Master Circular on Fair Practices Code being No. RBI/2010-11/25 DNBS (PD) CC No.185/03.10.042 /2010-11 dated July 01, 2010 directed that:

(a) The Board of each NBFC shall adopt an interest rate model taking into account relevant factors such as, cost of funds, margin and risk premium, etc and determine the rate of interest to be charged for loans and advances. The rate of interest and the approach for gradations of risk and rationale for charging different rate of interest to different categories of borrowers shall be disclosed to the borrower or customer in the application form and communicated explicitly in the sanction letter.

(b) The rates of interest and the approach for gradation of risks shall also be made available on the web-site of the companies or published in the relevant newspapers. The information published in the website or otherwise published should be updated whenever there is a change in the rates of interest.

(c) The rate of interest should be annualised rates so that the borrower is aware of the exact rates that would be charged to the account.

**Fair lending code:** The Reserve Bank of India vide its Master Circular No. RBI/2010-11/25 DNBS (PD) CC No.185/03.10.042 /2010-11 dated July 1, 2010 laid down Guidelines on Fair Practices Code for NBFCs. The relevant extracts from the Circular as regard the loans by NBFCs are furnished below:

#### (i) Applications for loans and their processing

(a) Loan application forms should include necessary information which affects the interest of the borrower, so that a meaningful comparison with the terms and conditions offered by other NBFCs can be made and informed decision can be taken by the borrower. The loan application form may indicate the documents required to be submitted with the application form.

(b) The NBFCs should devise a system of giving acknowledgement for receipt of all loan applications. Preferably, the time frame within which loan applications will be disposed of should also be indicated in the acknowledgement.

## **(ii) Loan appraisal and terms/conditions**

The NBFCs should convey in writing to the borrower by means of sanction letter or otherwise, the amount of loan sanctioned along with the terms and conditions including annualised rate of interest and method of application thereof and keep the acceptance of these terms and conditions by the borrower on its record.

It is understood that in a few cases, borrowers at the time of sanction of loans are not fully aware of the terms and conditions of the loans including rate of interest, either because the NBFC does not provide details of the same or the borrower has no time to look into detailed agreement.

Accordingly, it was advised that not furnishing a copy of the loan agreement or enclosures quoted in the loan agreement is an unfair practice and this could lead to disputes between the NBFC and the borrower with regard to the terms and conditions on which the loan is granted.

NBFCs are, therefore, advised to invariably furnish a copy of the loan agreement along with a copy each of all enclosures quoted in the loan agreement to all the borrowers at the time of sanction / disbursement of loans.

## **(iii) Disbursement of loans including changes in terms and conditions**

(a) The NBFCs should give notice to the borrower of any change in the terms and conditions including disbursement schedule, interest rates, service charges, prepayment charges etc. NBFCs should also ensure that changes in interest rates and charges are effected only prospectively. A suitable condition in this regard should be incorporated in the loan agreement.

(b) Decision to recall / accelerate payment or performance under the agreement should be in consonance with the loan agreement.

(c) NBFCs should release all securities on repayment of all dues or on realisation of the outstanding amount of loan subject to any legitimate right or lien for any other claim NBFCs may have against borrower. If such right of set off is to be exercised, the borrower shall be given notice about the same with full particulars about the remaining

claims and the conditions under which NBFCs are entitled to retain the securities till the relevant claim is settled/paid.

**(iv) General**

(a) NBFCs should refrain from interference in the affairs of the borrower except for the purposes provided in the terms and conditions of the loan agreement (unless new information, not earlier disclosed by the borrower, has come to the notice of the lender).

(b) In case of receipt of request from the borrower for transfer of borrowal account, the consent or otherwise i.e. objection of the NBFC, if any, should be conveyed within 21 days from the date of receipt of request. Such transfer shall be as per transparent contractual terms in consonance with law.

(c) In the matter of recovery of loans, the NBFCs should not resort to undue harassment viz. persistently bothering the borrowers at odd hours, use of muscle power for recovery of loans, etc.

(v) The Board of Directors of NBFCs should also lay down the appropriate grievance redressal mechanism within the organization to resolve disputes arising in this regard. Such a mechanism should ensure that all disputes arising out of the decisions of lending institutions' functionaries are heard and disposed of at least at the next higher level. The Board of Directors should also provide for periodical review of the compliance of the Fair Practices Code and the functioning of the grievances redressal mechanism at various levels of management. A consolidated report of such reviews may be submitted to the Board at regular intervals, as may be prescribed by it.

(vi) Fair Practices Code based on the guidelines outlined hereinabove should be put in place by all NBFCs with the approval of their Boards within one month from the date of issue of this circular. NBFCs will have the freedom of drafting the Fair Practices Code, enhancing the scope of the guidelines but in no way sacrificing the spirit underlying the above guidelines. The same should be put up on their web-site, if any, for the information of various stakeholders.

• **KYC norms**

The 'Know Your Customer' guidelines were issued in February 2005 revisiting the earlier guidelines issued in January 2004 in the context of the Recommendations made by the Financial Action Task Force (FATF) on Anti Money Laundering (AML) standards and on Combating Financing of Terrorism (CFT). These standards have become the international benchmark for framing Anti Money Laundering and combating financing of terrorism policies by the regulatory authorities. Compliance with these standards by the banks/financial institutions/NBFCs in the country have become necessary for international financial relationships. *See: Master Circular No. 184 dated July 01, 2010.*



With reference to the said Master Circular referred to above on Know Your Customer (KYC) norms /Anti-Money Laundering (AML) standards/Combating of Financing of Terrorism (CFT) Obligation of NBFCs under PMLA,2002, the Reserve Bank of India recently vide its Circular No. RBI/2010-11/419 DNBS. (PD) CC No 212 /03.10.42/2010-11 dated 8th March, 2011 made certain modifications in terms of which:

- NBFCs are required to apply enhanced due diligence measures on high risk customers. Some illustrative examples of customers requiring higher due diligence have also been given in the paragraph under reference. NBFCs have been further advised that in view of the risks involved in cash intensive businesses, accounts of bullion dealers(including sub-dealers) and jewelers should also be categorized by NBFCs as 'high risk' requiring enhanced due diligence.
- It is advised that NBFCs are also required to subject these 'high risk accounts' to intensified transaction monitoring. High risk associated with such accounts should be taken into account by NBFCs to identify suspicious transactions for filing Suspicious Transaction Reports (STRs) to FIU-ND.

#### **Anti money laundering responsibilities –**

In terms of the Master Circular No. 184 dated July 01, 2010 on Know Your Customer (KYC) norms /Anti-Money Laundering (AML) standards, certain responsibilities have been cast upon NBFCs and persons authorised by NBFCs including brokers/agents etc. to adhere to the Anti Money Laundering Standards.

With reference to the said Master Circular referred to above on Know Your Customer (KYC) norms /Anti-Money Laundering (AML) standards, the Reserve Bank of India recently vide its Circular No. RBI/2010-11/162 DNBS. (PD) CC No 192 /03.10.42/2010-11 dated August 09 , 2010 made certain modifications in terms of which:

#### **Suspicion of money laundering/terrorist financing**

With a view to preventing NBFCs from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing, it is clarified that whenever there is suspicion of money laundering or terrorist financing or when other factors give rise to a belief that the customer does not, in fact, pose a low risk, NBFCs should carry out full scale customer due diligence (CDD) before opening an account.

#### **Filing of Suspicious Transaction Report (STR)**

NBFC should not open an account (or should consider closing an existing account) when it is unable to apply appropriate CDD measures. It is clarified that in the circumstances when a NBFC believes that it would no longer be satisfied that it knows the true identity of the account holder, the Company should also file an STR with FIU-IND.

### **Politically Exposed Persons (PEPs)**

In the event of an existing customer or the beneficial owner of an existing account, subsequently becoming a PEP, NBFCs (including RNBCS) should obtain senior management approval to continue the business relationship and subject the account to the CDD measures as applicable to the customers of PEP category including enhanced monitoring on an ongoing basis. It is further clarified that the instructions are also applicable to accounts where PEP is the ultimate beneficial owner. Further, in regard to PEP accounts, it is reiterated that NBFCs should have appropriate ongoing risk management procedures for identifying and applying enhanced CDD to PEPs, customers who are close relatives of PEPs, and accounts of which PEP is the ultimate beneficial owner.

### **Principal Officer**

The role and responsibilities of the Principal Officer should include overseeing and ensuring overall compliance with regulatory guidelines on KYC/AML/CFT issued from time to time and obligations under the Prevention of Money Laundering Act, 2002, rules and regulations made thereunder, as amended from time to time.

There has been an amendment to Prevention of Money Laundering (Maintenance of Records of the Nature and Value of Transactions, Procedure and Manner of Maintaining and Time for Furnishing Information and Verification and Maintenance of Records of the identity of the Clients of the Banking Companies, Financial Institutions and Intermediaries) Amendment Rules, 2010, in respect of certain obligations to be followed by **NBFCs** and **RNBCs**.

The crux of the amendments is as follows:

- Explanations inserted
  - Transaction involving financing of activities related to
    - Terrorism
    - Involves funds suspected or to be related to
    - To be used for terrorism, terrorist act
    - Or those who are attempting to financing of terrorism
- “Records of the identity of clients” shall include
  - records of the identification data
  - Account files and
  - Business correspondence

- “Cessation of the transaction” means termination of an account or business relationship
- **Sub-rules substituted**
  - Every banking company, financial institution and intermediary to determine
    - If client acting on behalf of beneficial owner
    - To identify beneficial owner
    - Take reasonable steps to verify his identity
  - Every banking company, financial institution and intermediary to exercise
    - Ongoing due diligence
    - Examine the transactions to ensure their consistency with the knowledge of their client, business and risk profile
  - No banking company, financial institution and intermediary to allow
    - Opening or keep any anonymous account
    - Open or keep account in fictitious names
    - Open or keep account on behalf of persons whose identity is undisclosed or not verified