Non-banking financial companies: International and Indian regulatory framework

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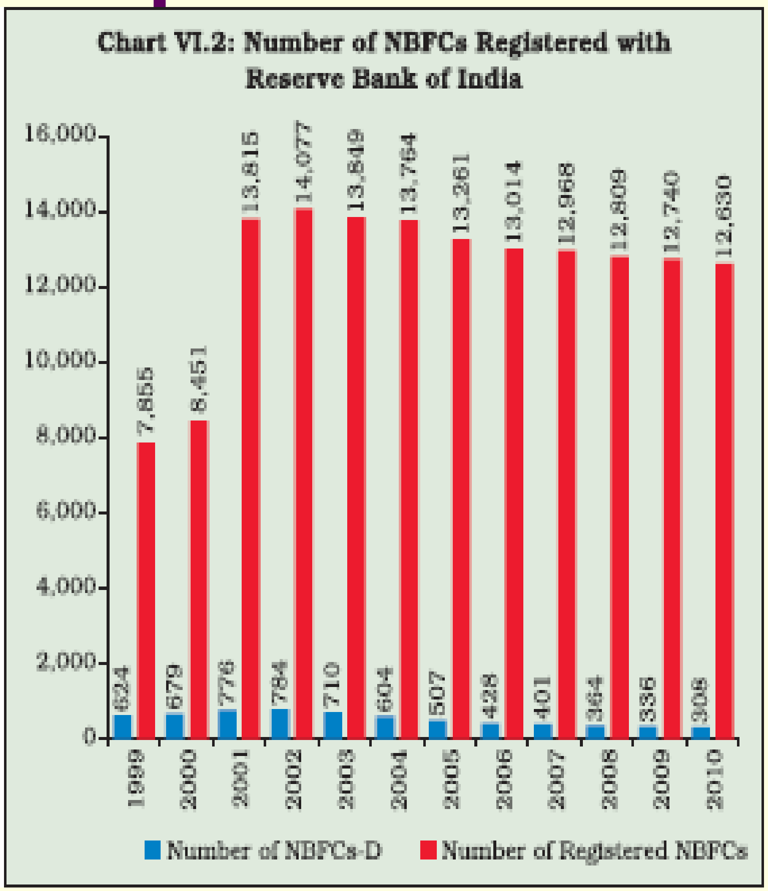
Quick overview of the sector

- 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



Number of NBFCs Registered with the Reserve Bank

End-June	Number of Registered NBFCs	Number of NBFCs-D
1	2	3
1999	7,855	624
2000	8,451	679
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	12,740	336
2010	12,630	308

Declining figures in year 2009-2010

- However, the total number of NBFCs registered with Reserve Bank of India declined to 12,630 as at end June, 2010 from 12,740 as at end June, 2009.There was also a decline in NBFCs-D in 2009-10.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

Consolidated balance sheets - Depository

- Rise in Investments on account of rise in on-SLR investments.
- Hire purchase assets contribute over 2/5th of total assets.
- Loans & advances is another important asset category.

Item	As at End-March	
	2008-09	2009-10 P
1	2	3
Liabilities		
1. Paid up capital	3,817	3,361
	(4.9)	(3.6)
2. Reserves & Surplus	9,412	12,237
	(12.2)	(13.1)
3. Public Deposits	1,971	2,727
	(2.6)	(2.9)
4. Borrowings	55,897	69,070
	(72.5)	(73.7)
5. Other Liabilities	6,031	6,314
	(7.8)	(6.7)
LIABILITIES/ASSETS	**77,128**	**93,709**
Assets		
1. Investments	15,686	19,335
	(20.3)	(20.6)
i) SLR Securities @	9,412	10,773
	(12.2)	(11.5)
ii) Other Investments	6,274	8,562
	(8.1)	(9.1)
2. Loan & Advances	21,583	30,802
	(28.0)	(32.9)
3. Hire Purchase Assets	35,815	38,549
	(46.4)	(41.1)
4. Equipment Leasing Assets	613	241
	(0.8)	(0.3)
5. Bill business	24	44
	(0.0)	(0.0)
6. Other Assets	3,407	4,739
	(4.4)	(5.1)

Profile of depository NBFCs and RNBCs

Profile of NBFCs

(Amount in Rs. Crore)

Item	As at end-March			
	2008-2009		2009-2010 P	
	NBFCs	of which: RNBCs	NBFCs	of which: RNBCs
1	2	3	4	5
Total Assets	97,408	20,280	1,09,324	15,615
		(20.8)		(14.3)
Public Deposits	21,566	19,595	17,247	14,520
		(90.9)		(84.2)
Net Owned Funds	13,617	1,870	16,178	2,921
		(13.7)		(18.1)

P: Provisional.

Note : 1. NBFCs comprise NBFCs-D and RNBCs.

2. Figures in parentheses are percentages to respective total of NBFCs.

3.Out of 311 deposit taking NBFCs,227 filed ARs for FY ended 2010

Systematically important companies

- The show-stealer was the NBFC-ND-SI segment, which grew tremendously upto June 2008

TableVI.38: Liabilities of NBFCs-ND-SI

(Amount in Rs.crore)

	As at end		
Items	March 2007	March 2008	June 2008
1	2	3	4
Total Liabilities	**3,17,898**	**4,08,705**	**4,23,083**
of which:			
a) Paid up Capital	18,904 (5.9)	24,490 (6.0)	27,217 (6.4)
b) Preference Shares	2,192 (0.7)	4,573 (1.1)	4,845 (1.1)
c) Reserve & Surplus	52,090 (16.4)	81,055 (19.8)	78,467 (18.5)
d) Secured Loans	93,765 (29.5)	1,21,082 (29.6)	1,23,764 (29.3)
e) Unsecured Loans	1,18,221 (37.2)	1,50,206 (36.8)	1,55,727 (36.8)

Note : Figures in parentheses are percentages to Total Liabilities.
Source : Monthly return by NBFCs-ND-SI.

NBFCs-ND-SI

- ND-SI sector is growing rapidly and unsecured borrowings comprise largest source of funds.
- The leverage ratio of the entire ND-SI sector rose during 2009-10. IFCI and Tourism Corporation were restored to NBFC status.
- Financial performance of NBFCs-ND-SI
  - The financial sector improved marginally.
  - As on March'10, 78 companies out of 188 relied on owned fund
  - As on March'10 ND-SI companies were largely dependent on nationalised banks for term loans, working capital loans and CPs/ debentures.

Table VI.38: Financial Performance of NBFCs – ND-SI

(₹ crore)

Item		March 2009	March 2010	June 2010
1		2	3	4
1.	Total Income	60,091	58,628	16,366
2.	Total Expenses	43,885	43,227	10,959
3.	Net Profit	10,800	10,897	3,792
4.	Total Assets	4,82,907	5,63,476	5,99,388
Financial Ratios				
(i)	Income as % to Total Assets	12.4	10.4	2.7
(ii)	Expenditure as % to Total Assets	9.1	7.7	1.8
(iii)	Net Profit to Total Income	18.0	18.6	23.2
(iv)	Net Profit to Total Assets	2.2	1.9	0.6

Source: Monthly Return on ND-SI (₹100 crore and above).

Assets of systemically important companies

Table V.40: Select Indicators on Application of Funds by NBFCs-ND-SI

(Amount in Rs. crore)

Item	As at end					
	March 2006		March 2007		June 2007	
	Amount	Per cent to Total Application of Funds	Amount	Per cent to Total Application of Funds	Amount	Per cent to Total Application of Funds
1	2	3	4	5	6	7
Secured Loan	63,120	29.2	1,14,898	41.5	1,25,417	42.5
Unsecured Loan	82,996	38.4	69,609	25.2	74,050	25.1
Hire Purchase Assets	22,613	10.5	28,160	10.2	28,221	9.6
Long-term Investment	30,817	14.3	43,309	15.7	47,350	16.0
Current Investment	16,665	7.7	20,671	7.5	20,236	6.9
Total	**2,16,211**	**100.0**	**2,76,647**	**100.0**	**2,95,274**	**100.0**
Memo:						
Capital Market Exposure	59,583	27.6	81,435	29.4	84,947	28.8
of which:						
Equity Market	27,467	12.7	34,196	12.4	31,658	10.7

Source : Monthly Returns by NBFCs-ND-SI.

Profile of systematically important NBFCs

Table VI.40: Liabilities of NBFCs-ND-SI

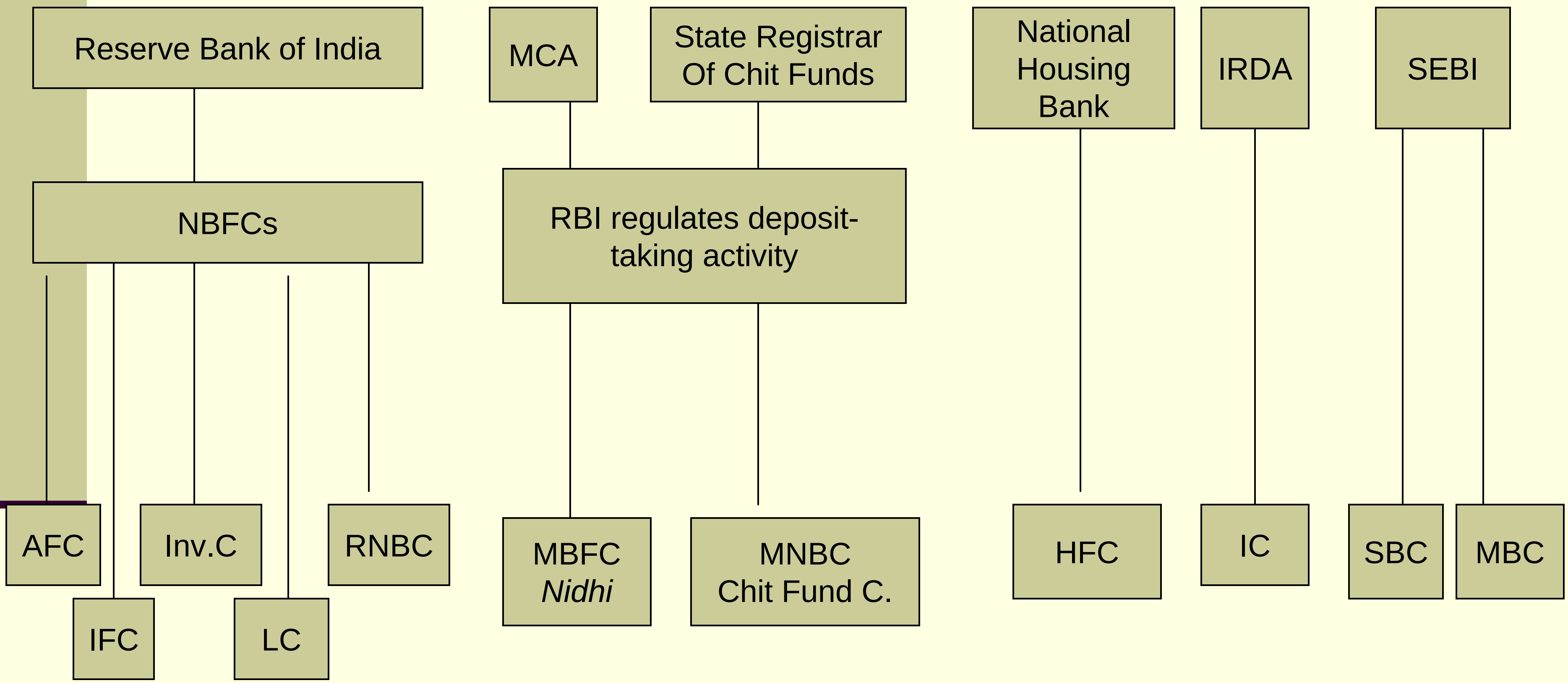
(Rs. crore)

Item	As at end		
	March 2008	March 2009	June 2009
1	2	3	4
No. of Companies	**189**	**234**	**232**
Total Liabilities	**4,08,705**	**4,94,673**	**5,08,026**
Paid-up Capital	24,490	30,173	30,358
	(6.0)	(6.1)	(6.0)
Preference Shares	4,573	4,311	3,835
	(1.1)	(0.9)	(0.8)
Reserves & Surplus	81,055	1,05,726	1,07,191
	(19.8)	(21.4)	(21.1)
Secured Borrowings	1,21,082	1,48,314	1,48,576
	(29.6)	(30.0)	(29.2)
Un-Secured Borrowings	1,50,206	1,70,994	1,81,712
	(36.8)	(34.6)	(35.8)

Note: Figures in parentheses are percentages to Total Liabilities.
Source: Monthly Return on NBFCs-ND-SI.

Regulatory framework - India

India works on a multi-regulator model



What is an NBFC?

- Sec 45I (c) of the RBI 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
- 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

Banks and Non-Banking Finance Companies

	Banks	NBFCs
Definition	Definition: banking is acceptance of deposits withdrawable by cheque or demand; NBFCs cannot accept demand deposits	NBFCs are companies carrying financial business
Scope of business	Scope of business for banks is limited by sec 6 (1) of the BR Act	There is no bar on NBFCs carrying activities other than financial activities
Licensing requirements	Licensing requirements are quite stringent. Transfer of shareholding also controlled by RBI	It is quite easy to form an NBFC. Acquisition of NBFCs is procedurally regulated but not approval required
Major limitations on business	No non-banking activities can be carried	Cannot provide checking facilities
Major privileges	Can exercise powers of recovery under SARFAESI and DRT law	Do not have powers under SRFAESI or DRT law
Foreign investment	Upto 74% allowed to private sector banks	Upto 100% allowed

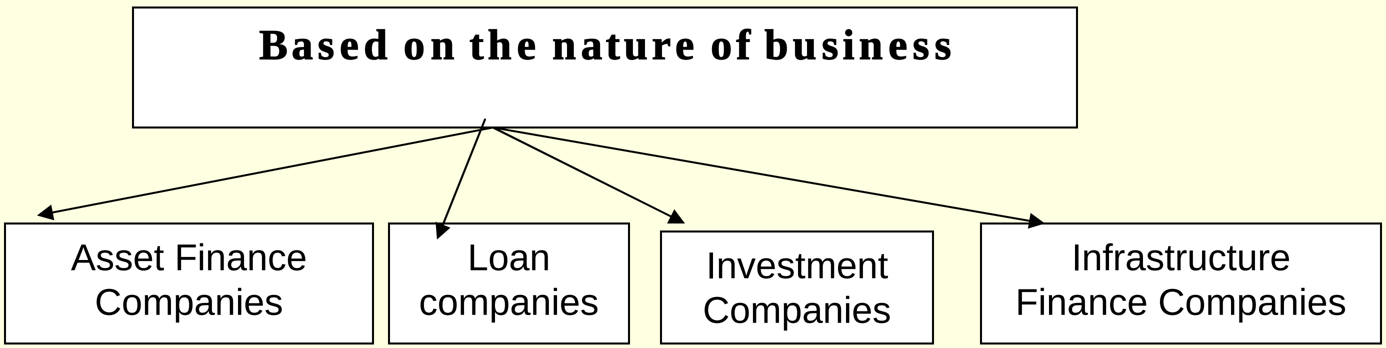
Banks and NBFCs

	Banks	NBFCs
Regulations	BR Act and RBI Act lay down stringent controls over banks	Controls over NBFCs are relatively much lesser
SLR/CRR requirements	Banks are covered by SLR/ CRR requirements	NBFCs have to maintain a certain ratio of deposits in specified securities; no such requirement for non-depository companies
Priority sector lending requirements	Certain minimum exposure to priority sector required	Priority sector norms are not applicable to banks

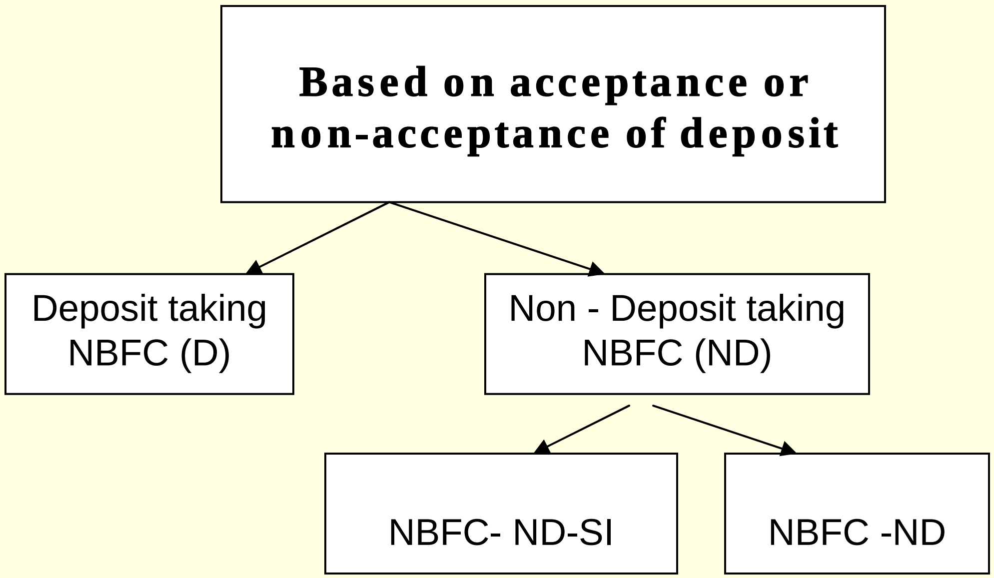
Basic regulatory framework on NBFCs

- Basic regulatory instruments:
  - RBI Act
  - NBFC (Acceptance of Public Deposits) Directions, 1998
  - NBFC (Deposit Accepting or Holding) Prudential Directions 2007
  - NBFC (Non Deposit Accepting or Holding) Prudential Directions 2007
  - NBFCs Auditors Directions 2008
  - Several circulars and press notes of the RBI issued from time to time

Types of NBFCs by assets



Types of NBFCs by regulatory intensity



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
- 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

Other provisions

- Opening of a CSGL account with a commercial bank or SHCIL for custody of SLR securities
- balance sheet to be filed with the RBI within 15 days of the general meeting
- Auditors' certificate that the liabilities to depositors are properly reflected in the balance sheet
- Returns to be submitted to the RBI
- Submission of half yearly return within three months, i.e. as on September and March in NBS 2
- NBFC having assets of Rs. 50Crore and above shall constitute an Audit Committee

New set of NBFC Regulations

- Pursuant to the Governor's mid-term credit policy 2006-7, 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
- 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

Accounting requirement for Investments

- Quoted current investments for each category shall be valued at cost or market value whichever is lower.
- Unquoted equity shares in the nature of current investments shall be valued at cost or break up value, whichever is lower.

Capital Adequacy Requirement

- Minimum capital ratio consisting of Tier I and Tier II capital:
  - 12% 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, 2009 and 15% CRAR by March 31, 2010.
- 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

Restriction 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

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%

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".

What are the 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 systematically unimportant companies, existing exemption from capital requirements and concentration continues to apply

Carrying on of business

- Oct 19, 2006 notification reiterated an old requirement of 1999:
  - All NBFCs should annually submit a certificate from auditors that the NBFC carries on a principal business as such
- Para 15 of the new Prudential Regulations require an annual certificate:
  - Should mention the asset/income pattern for the purpose of its classification as NBFC
- Time limit for submission of such Certificate extended by Circular dated Oct, 22, 2009: Certificate to be submitted-
  - within one month from the date of finalization of the balance sheet and in any case not later than December 30th of that year

Corporate Governance guidelines

- May 8, 2007 notification
- Addressed to all NBFC – D with deposits of Rs 20 crore or more, and NBFC-ND-SI
  - Presumably applicable to these NBFCs only
- Audit committee required where:
  - Assets are Rs 50 crore or more
  - Deposits of Rs 20 crore or more
- Nomination committee in the above cases:
  - To ensure directors are fit and proper
- Connected lending relationships (not still enforced):
  - Rules were intended to make regulations at par with banks
  - However, they are actually much more stringent

Corporate Governance guidelines (Contd....)

- Rotation of partners of Statutory Auditors firm where (*desirable, not mandatory*):
  - Public deposits/Deposits are of Rs. 50 crore or above
  - Partners of CA firm be rotated every 3 years
- Asset liability management committee required when:
  - Asset are Rs. 100 crore or above
  - Deposits are Rs. 20 crore or above
  - To understand asset liability mismatch risk, etc
  - A Risk management committee can be formed in addition to ALCO
- The company must put before the board a periodic statement about progress made towards risk management system and conformity with corporate governance standards.

Connected lending relationships

- By notification of July 11 2007, this part of the corporate governance guidelines is kept on hold
- Loans/non-fund based facilities to the following should not be granted to:
  - Directors/their relatives
  - Firms in which directors are partners/employees
  - An individual in respect of which director is a guarantor
  - Companies in which directors hold substantial interest
    - Substantial interest is paid up value of Rs 5 lacs or more or 10% of paid up capital whichever is higher
    - As Rs 5 lacs is such a small value, there would be lots entities falling within “connected lending relationships”
    - All NBFCs falling within the guidelines must ensure listing of all such entities regularly
  - Any company in India/outside where the flagship name reflects association with the NBFC
- Existing relations should not continue beyond the agreed term
- Quarterly information about such loans needs to be given to the regional office
- If no term has been fixed, such loans must be recovered within 1 year

Ceiling on rates of interest for deposits and SLR requirements

- 24th April 2007 notification increases the maximum rate of interest to 12.5%
- SLR requirements remain 15%
  - Deposits in NABARD and SIDBI also now qualify

Specific auditor duties – Non Depository Companies – SI and Non-SI

- All directions are applicable to SI companies
- Non SI – exemption from only two requirements – concentration and capital adequacy
- Income recognition : as per GAAPs
- Income on non performing assets not to be recognized
- Investments to be classified into long term and current – requirements same as before
- Audit committee required in case of companies with assets of Rs 50 crore or above
- Balance sheet to have a schedule as per Prudential guidelines

New auditors’ Directions, Sept 18, 2008

- Salient features
  - Applicable to all NBFCs - depository, non depository, systemically important or unimportant
  - Virtually amounts to appointing the auditors the compliance agents of the RBI
  - Applicable to all financial years closing on or after Sept 18 – that is, to apply to financial year 2008-09 onwards.
  - Report to be given to board of directors
    - In addition to sec 227 report, not an annexure to it
    - Hence, it is not mandatory to circulate the report to members
  - Requires reasons for unfavourable opinion
  - Requires additional reporting by the auditor to:
    - Board of directors
    - In case of exceptions, to the regional office of the RBI

Exception report

- Para 5 casts the scope of the exception report wide enough
- Not only adverse comments in the report, but
  - Any violation of
    - The RBI Act
    - the Acceptance of Deposit Directions
    - the Prudential Directions needs to be reported
- Saving grace – only contravention needs to be reported, not compliance

Additional reporting

- In case of all NBFCs:
  - Whether the company is engaged in NBFC business, and has obtained a CoR
    - Hence, the reporting is not restricted to registered NBFCs
  - Based on the asset/income pattern as on 31st March, whether the NBFC should continue to hold the CoR
  - Is the NBFC correctly classed as “asset finance company”
- In case of non-depository companies:
  - Whether the board has passed a resolution for non-acceptance of deposits
  - Whether the company has accepted any deposits during the relevant period
  - Has the complied with the prudential norms on income recognition, accounting standards, asset classification and provisioning, to the extent applicable to non-depository companies
- In case of ND-SI:
  - CRAR
  - Additional reporting as laid down by Prudential standards

Frauds : 1st July, 2010-Circular

- Frauds, whether by employees or customers, with amount involved being Rs 1 lac or above, involving:
  - misrepresentation,
  - breach of trust,
  - manipulation of books of account,
  - Fraudulent encashment of FDRs
  - unauthorised handling of securities charged to the NBFC,
  - misfeasance,
  - embezzlement,
  - misappropriation of funds,
  - conversion of property,
  - cheating,
  - shortages,
  - irregularities, etc.
- To be reported to Fraud Monitoring Cell of the RBI within 3 weeks of detection, if Rs 25 lakhs or above, and to regional office, if less than that.
- Frauds of customers involving Rs 5 lac and above to be reported.
- In addition, quarterly reports of frauds outstanding to be submitted in FMR - 2
- Reporting to the board of frauds above Rs. 1 lac.
- Review by the board; frauds of Rs 25 lakhs and above to be reviewed by the Audit Committee , if any ,or any other Board where there is no Audit Committee.
- Frauds committed by NBFC employees above Rs. 10,000 to be reported to police.

Perpetual Debt Instruments

- Systemically Important Non Deposit taking NBFCs may augment their capital funds by issue of Perpetual Debt Instruments (PDI).
- Eligible for inclusion as Tier I capital upto 15%, excess may be included in Tier II capital.
- Minimum investment of at least Rs. 5 lakhs by a single investor.
- Shall not be treated as public deposit.
- NBFCs-ND-SI shall issue PDI as plain vanilla instruments only. However, may be issued with a call option.
- Superiority of claims of PDI investors.
- Disclosure requirements.

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.

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 class of NBFCs – monitored NBFCs, vide circular dated 24th Sept,2008

- Applicable to NBFC – ND with Asset size >= 50 crore but < 100 crore
  - Quarterly return – hard and soft copy
    - Within one month from close of quarter
    - Basic information
      - Position of assets and liabilities as at the end of quarter
      - Sources and application of funds
      - Capital market exposure

Interest regulation, 2nd Jan, 2009

- Applicable to all NBFCs
  - Adopt interest rate model based on:
    - Cost of funds
    - Margin and risk premium, etc.
  - Disclose to borrowers or customer
    - Rate of interest
    - Method of risk gradation
    - Rationale for differential rate to different borrowers
  - Interest rates to be annualised rates.

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.

Liquidity constraints

- Applicable to NBFCs-ND-SI meeting following eligibility:
  - CRAR as per guidelines
  - Net profit in previous 2 years
  - Net NPAs as per last Balance Sheet date not exceeding 5%
- Liquidity met through SPVs
  - IDBI SASF Trust notified SPV
    - Purchase short term papers- CPs and NCDs
    - Residual maturity not more than 3 months
    - Investment grade
    - Issued after 31st March 2009

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.

Treatment of Deferred tax assets and liabilities in computing CAR – 31st July 2008 circular

- DTA or DTL in balance sheet
- Balance in DTL excluded from Tier I or Tier II for CAR
- DTA being intangible asset will be deducted from Tier I capital
- A 9th June 2009 circular clarifies:
  - DTL will be created by debiting P/L or revenue reserves and will appear as a part of "other liabilities and provisions"
  - DTA will be created by credit P/L or revenue reserves and will be part of "others"
- All intangible assets will be deducted from Tier 1 capital
- DTL shall not be adjusted against brought forward losses nor added to Tier 1 capital

PMLA obligations of NBFCs – Aug 2008

- NBFCs should have in place software that throws info about transactions inconsistent with the categorization and profile of customers
- To regularly file cash transactions report and suspicious transactions report with Financial Intelligence Unit- India
- This report to be submitted every month
- CTR requirements:
  - all cash transactions of the value of more than rupees ten lakhs or its equivalent in foreign currency;
  - all series of cash transactions integrally connected to each other which have been valued below rupees ten lakhs or its equivalent in foreign currency where such series of transactions have taken place within a month;
  - all cash transactions where forged or counterfeit currency notes or bank notes have been used as genuine or where any forgery of a valuable security or a document has taken place facilitating the transactions;
  - all suspicious transactions whether or not made in cash
- STR requirements
  - gives rise to a reasonable ground of suspicion that it may involve the proceeds of crime; or
  - appears to be made in circumstances of unusual or unjustified complexity; or
  - appears to have no economic rationale or bonafide purpose; or
  - gives rise to a reasonable ground of suspicion that it may involve financing of the activities relating to terrorism

Prevention of Money Laundering, Amendment Rules, 2010-Obligation of banks

- 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-Obligation of Banks to be followed by **NBFCs** and **RNBCs**
- 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

Prevention of Money Laundering, Amendment Rules, 2010-Obligation of banks (Contd….)

- **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

Repossession of assets -24th April 2009

- Agreement should contain the following:
  - (a) notice period before taking possession;
  - (b) circumstances under which the notice period can be waived;
  - (c) the procedure for taking possession of the security;
  - (d) a provision regarding final chance to be given to the borrower for repayment of loan before the sale / auction of the property;
  - (e) the procedure for giving repossession to the borrower and
  - (f) the procedure for sale / auction of the property.
- A copy of such terms and conditions must be made available to the borrowers
- Copy of the loan agreement and all enclosures must be furnished to the borrower

Regulation of excess interest – 2 Jan 2009

- An atrocious circular has been issued on 2 Jan 2009. Presumably for regulating excess interest charged by NBFCs
- Apparently no distinction has been made for SI and non-SI NBFCs – hence, this circular is apparently applicable to all
- As there is no control on rate of interest, what is “excess interest” is not understood
- NBFC should adopt an interest rate model for charging differential rates from different categories of borrowers
- The rationale for charging different rates of interest from different borrowers should be disclosed to the borrowers
- Rates of interest and categories of borrowers should also be disclosed on the websites of the NBFCs

NBFC (Deposit Accepting) (Approval of Acquisition or Transfer of Control) Directions, 2009

- Directions notified on Sept 17, 2009
- Prior written approval of RBI shall be required in cases of acquisition or transfer of control of deposit taking NBFCs

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

New category of NBFC introduced by notification dated Feb 12, 2010

- Fourth category of NBFC "Infrastructure Finance Companies“ (IFCs)
- IFC is defined as NBFC-ND which has:
  - a minimum 75% of total assets deployed in infrastructure loan
  - NOF of Rs. 300 crore or above
  - Minimum credit rating "A" or equivalent of CRISIL, FITCH, ICRA, CARE or equivalent rating by any other CRA
  - CRAR of 15% (with minimum Tier I capital of 10%)
- The extant prudential norms for income recognition, asset classification and provisioning norms shall apply

Relaxation to IFCs: Concentration of Credit/Investment

IFC

Exceed in lending by

10% of owned fund to single borrower

15% of owned fund to a single group of borrowers

Exceed in lending and Investing by

5% of owned fund to single borrower

10% of owned fund to a single group of borrowers

Risk weights & exposure norms in respect of bank exposure to IFCs

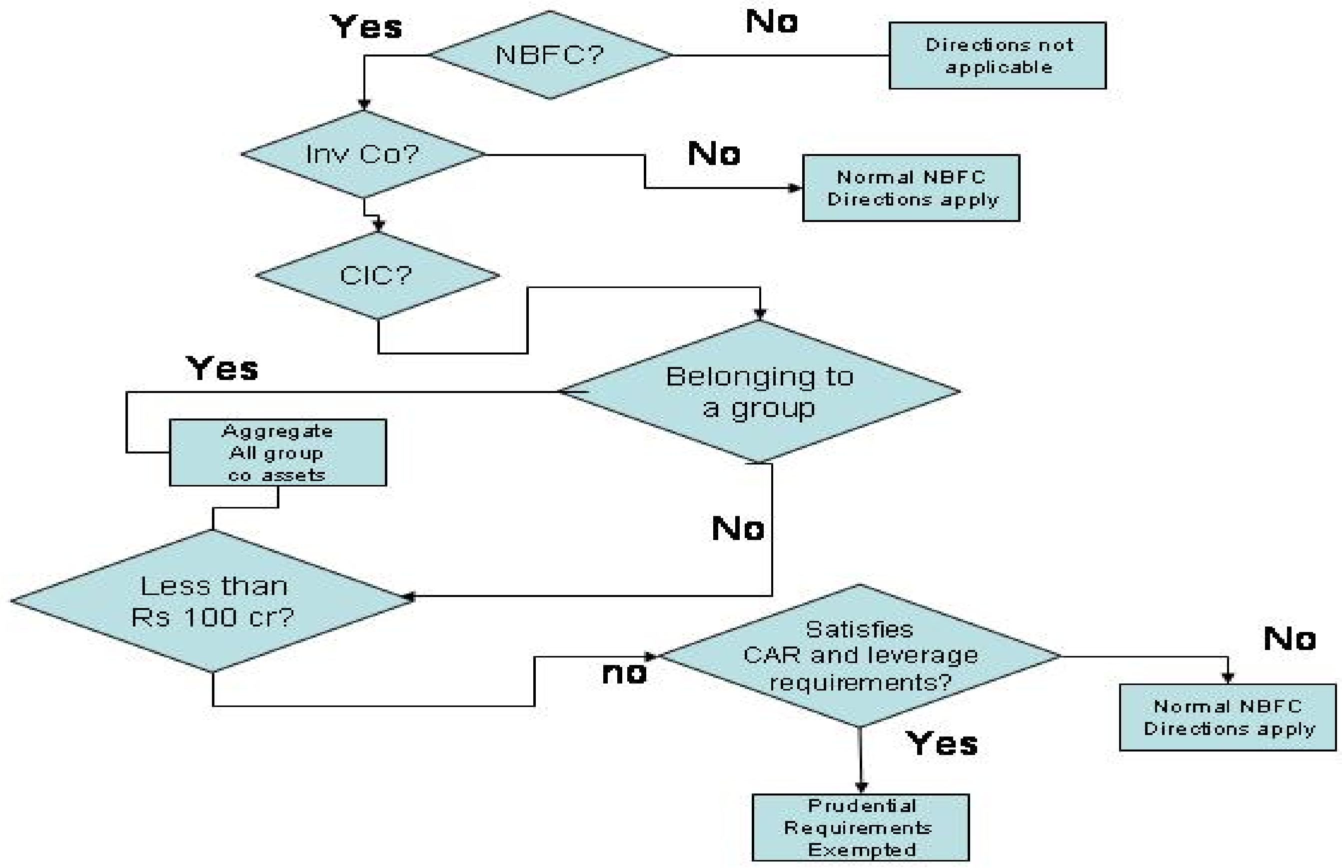
- Banks' exposures to NBFC-IFCs will henceforth be risk weighted as per the ratings assigned by the CRA accredited by the RBI

- Exposure of bank to IFCs should not exceed 15 % of its capital funds as per its last audited balance sheet, with a provision to increase it to 20% if the same is on account of funds on-lent by the IFCs to the infrastructure sector

RBI proposed regulatory framework for SI-ND- Core Investment Companies (CICs)- April 21, 2010

- CIC defined as:
  - not less than 90% of their net assets were in investments in shares or debentures for the purpose of holding stake in the investee companies
  - Its investment in group companies constitute not less than 60% of its net assets
  - not trading in these shares except for block sale (to dilute or divest holding)
  - not carrying on any other financial activities,
  - not holding / accepting public deposits

Quick review of CICs



Regulatory framework for CICs

- Notification dated 5th January, 2011
- CICs with asset size < **Rs 100 crore** exempted from the requirement of registration with RBI
- All CICs having an asset size of Rs.100 crore or more would be required to obtain CoR from the RBI
- CICs-ND-SI should apply to RBI within six months, for obtaining CoR
- Every CIC shall apply to RBI for CoR within 3 months from date of becoming CICs-ND-SI
- **90 per cent** of the total assets of CICs-ND-SI should be in investments in equity, debt, or loans in group companies, provided that the investment in equity shares of Group companies for the purpose of holding stake in these companies is not **less than 60% of total assets**
- CICs should not carry on any other financial activities, except investments in bank deposits, Govt. securities, loans to and investments in debt issuances of group companies, or guarantees issued on behalf of group companies;
- <u>Capital requirements:</u>
  - Minimum Capital Ratio to be maintained at all times
  - Adjusted Net Worth shall not be less than 30% of its aggregate risk weighted assets on balance sheet and risk adjusted value of off balance sheet items as on the date of the last audited balance sheet.

Regulatory framework Contd….

- Leverage ratio: The Outside liabilities of a CIC-ND-SI shall not exceed 2.5 times of its Adjusted Net Worth calculated as on the date of the last audited balance sheet;
- Adjusted Net worth means-
  - Aggregate of owned funds as appearing in the last balance sheet:
    - Increased /reduced by-
      - 50% of unrealized appreciation /diminution in the book value of quoted investments
      - Increase /reduction, if any, in equity share capital
- Systematically important CIC
  - Company having asset not less than Rs. 100 crore
  - Either individually or with other group CICs
  - Which raises or holds public deposits

  - Submission of Annual Statutory Auditor's Certificate by CIC-ND-SI
    - Compliance of requirements of the directions
    - Within one month from date of finalisation of balance sheet

Anomalities in the proposed regulations

Definition of CIC- two things stated at two places

- not less than 90% of their assets were in investments in shares for the purpose of holding stake in the investee companies

- 90 per cent of the total assets of CICs-ND-SI should be in investments in equity, debt, or loans in group companies, provided that the investment in equity shares of Group companies for the purpose of holding stake in these companies is not less than 60% of total assets

- **Group company definition- Under NBFC directions, words and expressions undefined shall borrow meaning from Companies Act. Further, Explanation II to section 45-IA provides that "companies in the same group" will have same meaning as under Companies Act. It means an arrangement involving two or more entities related to each other through the relationship of Subsidiary-Parent (AS 21), Associate (AS 23), Joint Venture (AS 27)Promoter-Promotee [as provided in SEBI (Acquisition of Shares and Takeover) Regulations, 1997] for listed companies , a related party (AS 18)**

Adjusted Net Worth defined

- The aggregate of
  - Owned Funds as defined in Non Banking Financial (Non Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;
  - 50% of the amount standing to the credit of the Revaluation Reserve arising from valuation of shares, if any, as per the latest audited Balance Sheet; and
  - an amount equal to 50% of the appreciation in the book value of quoted investment (calculated as the excess of the aggregate market value of quoted investments over the book value of such investment as appearing in the latest audited Balance Sheet).
- reduced by the amount of diminution in the aggregate book value of quoted investments

Exemptions

- CICs exempted from:
  - maintenance of statutory minimum NOF
  - requirements of Prudential norms for non-deposit accepting NBFC.
- CICs-ND-SI required to submit an annual certificate from their statutory auditors regarding compliance with the Directions.

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
  - Micro Finance Companies
  - Government Companies
  - Venture Capital Fund Companies
  - Insurance/Stock Exchange/Stock Broker/Sub- Broker
  - Nidhi Companies
  - Chit Companies
  - Mortgage Guarantee
  - Mortgage and Reconstruction Companies

Standard Assets of NBFCs

- Guided by:
  - Non-Banking Financial (Deposit Holding or Accepting) Companies Prudential Norms (Reserve Bank) Directions, 2007
  - Non-Banking Financial (Non-Deposit Holding or Accepting) Companies Prudential Norms (Reserve Bank) Directions, 2007
- All NBFCs required to make provisions for non-performing assets
- All NBFCs required to make provisions for standard assets
  - 0.25% of outstanding standard assets
  - Shall not be reckoned for arriving at net NPAs
  - To be shown separately as 'Contingent Provisions against Standard Assets'
  - Allowed to include 'General Provisions in Standard Assets in Tier II Capital'
  - 'General Provisions in Standard Assets' together with 'general provisions/loss reserves', admitted as Tier II capital to a maximum of 1.25% of total risk-weighted assets

Loans against Gold Jewellery

- Master Circular February 2, 2011
- Not entitled under Agriculture sector when:
  - Loans sanctioned to NBFCs for on lending to individuals or other entities against gold jewellery
  - Investments made by banks in securitised assets originated by NBFCs, underlying assets are gold jewellery
  - Purchase/assignment of gold loan portfolio from NBFCs

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)

Facilities to physically/visually challenged NBFCs

- NBFC had discriminated against physically/visually challenged persons
- NBFCs are therefore, advised to hold no discrimination in extending facilities and products on grounds of disability
- NBFCs to advise their branches to render all possible assistance to such persons

International Regulations - highlights

Highlights of international regulations

- Very few countries regulate companies based on nature of business; they are regulated based on
  - Whether they raise deposits from public
  - Whether they issue securities to public
  - Whether they sell derivatives/ securities to public
- Very few countries in the world allow NBFCs to raise deposits from the public
- There is an investment company regulation in the USA but investment company means a mutual fund
- Conclusion
  - India is a unique example of NBFI regulation