Update

RBI takes the wind out of NBFC's sails: imposes restrictions on Private Placement of Debentures

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The primary market for corporate debt in India is mainly dominated by private placements of debts (93% of total issuance in 2011-12) as corporates prefer this route to public issues because of operational ease, i.e., minimum disclosures, low cost, tailor made structures and speed of raising funds. Banks/FIs (42.3% of total issuances) followed by finance companies (26.4%) were the major issuers of debentures in 2011-12.[1]

As per RBI's report on 'Trend and Progress of Banking in India', 2011-12, NBFCs-D has borrowed Rupees 238 billion by issue of debentures during the year 2011-12 constituting 29.42% of total borrowings of these NBFCs[2]. During the same period, Rupees 2950 billion has been raised by NBFC-ND-SI constituting 46.11% of total borrowings. Such debentures consisted of both- secured and unsecured issues. As apparent from these figures, NBFCs-ND are the companies having largest source of borrowings through issue of debentures. Thus, privately placed debt is undoubtedly the lifeline for majority of NBFCs.

However, with the intent to regulate such privately placed issues of debentures by NBFCs and to ensure minimum compliances, RBI vide Notification dated 27th June, 2013 (**the Notification**) has inter-alia issued Guidelines on Private Placement of securities by NBFCs (**the Guidelines**). The Guidelines has come into existence with immediate effect from the date of the Notification.

The Guidelines seems to have startled the NBFCs. This is evident from the quantum of queries and clarifications raised by the industry resulting in issue of another notification clarifying some of the provisions of the Guidelines (**the Clarifications)** by RBI within 5 days of issue of Guidelines.

Definition of 'Private Placement'

Ideally clarifications are issued solely for the purpose of clarifying things already stated or issued. Imagine the irony, as RBI in its so called "Clarification" has completely changed the meaning and applicability of the Guidelines! Initially, the Guidelines defined 'private placement' as to include ***issue of capital by an NBFC pursuant to Section 81 (1A) of the Companies Act, 1956.*** It is pertinent to note that Section 81 (1A) requires approval of shareholders in case of convertible debentures only issued on preferential basis and does not cover any issue of non convertible debentures (**NCDs**). However,

[1] Source: http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?id=742
[2] NBFCs-D here are loan and asset finance companies

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RBI's intent was to regulate the private placements of NCDs because for convertible debentures, there already exist appropriate regulations [for listed NBFCs- SEBI ICDR Regulations and for unlisted public NBFCs- Companies (Preferential Allotment of Shares) Rules, 2003 as amended from time to time]. Thus the very basis of issue of Guidelines could have been lost.

However, realizing the same, in guise of Clarification RBI immediately replaced the definition of 'private placements' to include '***non-public offering of NCDs by NBFCs to such number of select subscribers and such subscription amounts, as may be specified by the Reserve Bank from time to time'*** and the excluded instrument of the Guideline became the main crux of the Clarification. What was the only thing excluded in the Guidelines became the sole substance of the Clarifications!

Time gap between two successive issues of debentures

Borrowing by issue of debentures is the backbone of an NBFC. Some NBFCs issue debentures almost every month, every week to fulfill its funding needs. However, previously, in the Guidelines, RBI seemed to adopt a stricter norm and provided a minimum time gap of at least 6 months in between the two private placements. However, after receiving several comments from the non banking industry regarding this condition, RBI has withdrawn the minimum time gap condition for the time being.

Taking away the current facility of issuing NCDs and implementing the minimum time gap requirements between two issues will surely lead to Asset Liability Mismatch (ALM)

Restriction on number of subscribers in a private placement

Overriding the provisions relating to 'deemed public offer' as prescribed by Section 67(3) of the Companies Act, 1956 which exempted NBFCs, the Guidelines have put a limit of maximum number of subscribers as 49 under a private placement issue or issue on preferential basis of debentures. Thus, though the Companies Act exempts NBFCs, RBI Guidelines have now introduced the 'deemed public offer' provision for NBFCs for issue of debentures at least.

Other Highlights of the Guidelines

The other highlights of the Guidelines, as amended/clarified by the Clarification are as under:

- ✓ Names of all subscribers to be identified upfront;

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- ✓ NBFCs to issue secured debentures only. If the security cover is not sufficient at the time of making issue, sufficient security to be created within 1 month and till then issue proceeds are to be kept in escrow account. However, security cover will not be required on issue of sub-debt instruments;
- ✓ Offer Document should be issued within maximum period of 6 months from the date of the Board Resolution authorizing the issue and the documents should contain the phrase 'for private circulation only';
- ✓ Minimum subscription amount for a single investor shall be Rs. 25 lakh and in multiples of Rs.10 lakh thereafter;
- ✓ Debentures shall be issued by NBFCs only for deployment of funds on its own balance sheet and not to facilitate resource requests of group entities/ parent company / associates (with an exemption to CICs as clarified by RBI)

Our Analysis

The requirement of maintenance of security cover at all points of time was initially applicable to all debenutres issued, including short term NCDs. However, realizing that subordinated debt are primarily unsecured, later excluded the same in the Clarifications.RBI by this Notification has also suitably amended Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 (**the Directions**) thereby clarifying that only debentures that are *compulsorily convertible into equity* or fully secured would be exempted from the definition of public deposits. Further, it has been clarified that hybrid debt or subordinated debt would be excluded if such instruments have been issued with no recall option within the tenure of the instrument.

As the Directions now have been amended to exclude debentures 'compulsorily convertible into equity', the route of raising funds by way of issue of Optionally Convertible Debentures (OCDs) has been put an end by the RBI. Generally, companies followed a practice of issue of OCDs with an option to issuer to convert them into shares of the company and no need to mention that such an option is never intended to exercise. Thus in guise of OCDs, companies were taking advantage of the existing clause in the Directions and were getting exemption from the applicability of directions by issuing OCDs on tailor made terms and conditions. However, NBFCs-ND will now require to mandatorily issue Compulsorily Convertible Debentures, as issuance of OCDs will qualify as Public Deposits.

Conclusion

The Guidelines seems to have been issued against the backdrop of recent ruling of the Supreme Court in Sahara Real Estate Corporation (Sahara case) pertaining to raising of money by issue of OCDs which were issued on "private placement basis", wherein nearly Rs 20000 crores of money had been raised, from 22.1 million investors, using services of nearly a million agents, at 2900 branches. And all this were regarded to be a private placement. In view of such adverse features brought to the notice of RBI, wherein NBFCs have been raising resources from the retail public on a large scale, through private placement, especially by issue of debentures, RBI has issued the Guidelines overriding other instructions in this regard for NBFCs, wherever contradictory and has introduced the concept of 'deemed public offer' for NBFCs also.

The purpose behind issuing the Guidelines is to curb the practice followed by NBFCs of raising resources from the retail public on a large scale, through private placement, especially by issue of debentures and to ensure proper resource planning to be undertaken by NBFCs. In view of the same, as per the Clarifications, RBI has directed 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.

Despite being excluded from the limit of 49 investors under the Companies Act, NBFCs will not be able to privately place their debentures with more than 49 investors as per the Guidelines. The stringent condition requiring sufficient security cover even for privately placed debentures, including NCDs, will surely affect the NBFCs who primarily raise money by issue of debentures. However, RBI seems determined to correct the faulty resource planning of NBFCs and may come up with a circular specifying the minimum time gap between two private placements too in near future.

Also see our other related write-ups:

- **See our detailed write up on the NBFC Debentures Guidelines at https://india-financing.com/Private_Placement_of_Debentures_by_NBFCs.pdf**
- **See our primer on debentures at https://india-financing.com/Primer_on_debentures.pdf**
- **Article on 'MCA Circular widens scope for secured corporate debentures,**

grants exemption from Public Deposit norms' at http://india-financing.com/MCA Circular widens scope for secured corporate debentures grants exemption from Public Deposit norms.pdf

- **Article on 'Corporate Bond Market-Removing the Bottlenecks' at http://india-financing.com/Corporate Bond Market-Removing the Bottlenecks.pdf**
- **Article on 'New DRR provisions- will they promote or demote the Bond Market' at http://india-financing.com/New Debenture Redemption Reserve Provisions-%20Will they promote or demote the Bond Market.pdf**
- **Article on 'Understanding Compulsory Convertible Debentures' at http://india-financing.com/Understanding Compulsory Convertible Debentures.pdf**
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