# NBFCs and IBC: The Lost Connection

- ***Sikha Bansal***

***Editor's Note:*** *IBC, as expressly stated by BLRC, is not intended for entities having dominantly a 'finance function'. As such, IBC is not applicable to 'financial service providers' as these entities are excluded from the definition of 'corporate person'. Financial service, as defined in section 3(16), includes services as rendered by banks, insurance companies, merchant bankers, investment bankers or alike – the term does not explicitly include a 'non-banking financial company'.*

*A non-banking financial company can take different forms depending upon the business it undertakes – for instance, a core investment company invests solely in its group companies. Such an NBFC cannot be said to be falling in the category of financial service provider. In order to be classified as financial service provider, the NBFC should undertake an activity which falls in the definition of 'financial service'. However, the adjudicating authorities/appellate authority in multiple cases have held a non-banking financial company to be a financial service provider against which corporate insolvency resolution process cannot be initiated under the Code. This article[20] analyses the connect or disconnect between IBC and NBFCs.*

The Code seems to have thrown open a host of complicated questions before the stakeholders. One such incertitude is in the context of applicability of the Code to NBFCs. The Code excludes 'financial service providers' from the definition of 'corporate person'; as such, an entity which is engaged in providing 'financial services' cannot be made to undergo corporate insolvency resolution process under the provisions of the Code. Notably, the Code no-where uses the expression 'non-banking financial company/ies'. As such, the crux would be to identify whether an NBFC can fall within the definition of 'financial service provider'.

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In *Randhiraj Thakur, Director Mayfair Capital Private Limited v. Jindal Saxena Financial Services Private Limited* [Company Appeal (AT) (Insolvency) Nos. 32 & 50 of 2018], the NCLAT held the NBFC to be a financial service provider and thus exempted from being a debtor under the Code.

The NBFC was being granted a certificate of registration by RBI to commence or carry on the business of non-banking financial institution. The MoA of the company shows the main object of the NBFC includes carrying on the business of an investment company to carry on all types of financial operations and all types of financial services including housing finance, consumer finance and industrial finance etc. The NCLAT noted that the NBFC had entered into "an inter-corporate deposit agreement" with the respondent, which was the financial creditor, and thus, has undertaken a 'financial service' by accepting such deposit. *The amount was thus, not accepted towards public deposit.* Hence, the NBFC, being a financial service provider and thus excluded from the definition of corporate person, an application for initiation of corporate insolvency resolution process under the

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Code was not maintainable against the NBFC. The NCLAT remarked that being a consolidating legislationonly those acts are permitted which are mentioned in the Code and it cannot be made applicable to 'financial service providers' including 'non-banking financial institutions' and MFI's banks, which have been kept outside the purview of the Code.

The author would seek humble deviation from the views of Hon'ble NCLAT, attempting to provide explanations for the divergent opinion.

## NBFCs: Whether financial service providers

The Code defines a 'financial service provider' as "a person engaged in the business of providing financial services in terms of authorisation issued or registration granted by a financial sector regulator" – section 3 (17). A financial service provider is excluded from the definition of 'corporate person' – section 3(7), and thus cannot be a 'corporate debtor'.

The definition has two necessary ingredients – (i) the entity should be providing 'financial services', and (ii) the entity shall be authorised to do so by a 'financial sector regulator'. These conditions are **cumulative** – where there is a certificate from RBI, to carry on an activity which does not qualify to be a financial service; the entity cannot be called a 'financial service provider'. Such an entity would therefore be appropriately covered under the provisions of the Code.

## Scope of Financial Service

What all constitute 'financial services' have been put under section 3(16) of the Code. The definition is *inclusive* and mentions the following categories of services as financial services (for ease of understanding, the respective category of entities providing such service is also mentioned) –

| Clause | Particulars | Entities engaged in the activity |
|---|---|---|
| **(a)** | accepting of deposits; | Banks, deposit taking NBFCs/ HFCs |
| **(b)** | safeguarding and administering assets consisting of financial products, belonging to another person, or agreeing to do so | Depository |
| **(c)** | effecting contracts of insurance; | Insurance Company |
| **(d)** | offering, managing or agreeing to manage assets consisting of financial products belonging to another person; | Custodian/ Investment Managers |
| **(e)** | rendering or agreeing, for consideration, to render **advice** on or soliciting for the purposes of— | |
| | (i) buying, selling, or subscribing to, a financial product; | PMS/ Stock brokers/ Investment advisors |
| | (ii) availing a financial service | Stock Brokers/ Investment Bankers |
| | (iii) exercising any right associated with financial product or financial service; | Investment Advisors |
| **(f)** | establishing or operating an investment scheme; | Collective Investment Scheme |
| **(g)** | maintaining or transferring records of ownership of a financial product | Registrars and Transfer Agents |

| | | |
|---|---|---|
| **(h)** | underwriting the issuance or subscription of a financial product | Underwriters |
| **(i)** | selling, providing, or issuing stored value or payment instruments or providing payment services | Prepaid payment instruments/ Credit Card providers |

In clause (a) of section 3(16), the word 'deposit' should not be interpreted to refer to all or any kind of deposit. The word 'deposit', in view of the intent of the draftsmen, can only refer to deposits taken from public at large.

It may be argued that the definition of 'financial service' under section 3(17) is inclusive and thus can be extended to all services being rendered by non-banking financial companies. However, the rule of *ejusdem generis* is to be respected in this case too. On perusal of section 3(17) of the Code, it is well understood that the provision seeks to cover activities which are substantive and crucial to the economy, accepting public deposits being one of them. Behind such backdrop and after applying the rule of *ejusdem generis*, there seems no reason to consider a non-deposit taking NBFC, as to be considered a financial service provider, irrespective of the activity which it carries out.

## Financial institutions and FSPs – one and same?

Note that the definition of 'financial service provider' has no direct connection with the definition of 'financial institution'. Safeguarding and administering assets consisting of financial products belonging to other person is a financial service, and financial product includes loans and advances by banks and financial institutions. So, a financial institution is not necessarily a "financial service provider". Only such financial institutions which are providing "financial services" can be categorised as "financial service providers". Therefore, only a non-banking institution which carries on a business classifiable in any of the clauses between (a) to (i) of section 3(16) of the Code is eligible to be classified as "financial service provider" and exempted from the definition of corporate debtor under the Code.

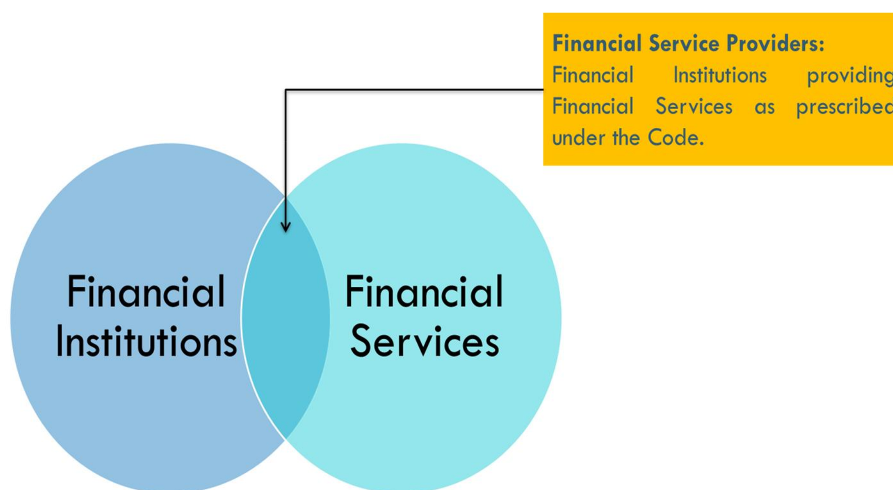


Figure 7: What are FSPs

For instance, while a deposit taking NBFC can be categorised under clause (a) of section 3(16) of the Code as a financial service provider, a non-deposit taking NBFC cannot be taken in the same category.

## Intent to exclude FSPs

The Bankruptcy Law Reforms Committee had the mandate of suggesting comprehensive reforms in the area of bankruptcy of individuals and non-financial firms. The exclusion of 'financial firms' was in view of the work of the Financial Sector Legislative Reforms Commission ("FSLRC") which made recommendations for the failure of ***financial firms*** in the then proposed Indian Financial Code, 2013.

In Volume – I of its Report, while identifying the basic subject matter of regulation (namely, financial products and services), FSLRC opined that particular forms of dealings in financial products, such as securities, insurance contracts, deposits and credit arrangements, constitute the rendering of financial services. This includes services such as, sale of securities, acceptance of public deposits, operating investment schemes and providing credit facilities. The FSLRC, however, recognised that "a principles-based approach to defining financial products and financial services comes with the risk of unintentionally casting the net of regulation too wide. Therefore, it was decided that financial regulation should apply *to only those persons* who are engaged in the business of carrying on financial services."

FSLRC, at several instances in its Report, emphasises on the systemic importance of such financial entities. The Report says,

> "Market discipline does play an important role in ensuring safety and soundness of many financial service providers, but it is often not enough. This inadequacy of self- regulation and market discipline becomes particularly problematic for financial service providers making certain kinds of obligations, and financial service providers of systemic importance.
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> . . .
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> The Commission also notes that for certain kinds of financial service providers, if obligations are not fulfilled, there are adverse consequences for specific consumers. If bank deposits are lost due to a bank failure, the consequences for consumers, whose savings are deposited with the bank, will be quite adverse. If a large financial service provider fails, the entire financial system, and the larger economy, may be adversely affected.
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> …
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> For systemically important financial institutions, safety and soundness should be taken to mean reducing the probability of firm failure, and for all other micro-prudentially regulated persons, it should mean *reducing the probability of the event of regulated person failing to meet the obligations made to consumers*"

Failure of financial firms can be highly disruptive for the consumers, the market and the economy as a whole. Therefore, the FSLRC recommended a specialised resolution mechanism and establishment of a 'resolution corporation' "that will concern itself with all financial firms that make highly intense promises to consumers, such as banks, insurance companies, defined benefit pension funds, and payment systems. The corporation will also take responsibility for the graceful resolution of systemically important financial firms, even if they have no direct link to consumers."

In the Report of Committee to Draft Code on Resolution of Financial Firms (2016), which submitted the draft Financial Resolution and Deposit Insurance Bill, 2016, it was stated that all regulated financial service providers, except individuals, should be covered by insolvency regime proposed

under the Bill. Accordingly, the Financial Resolution and Deposit Insurance Bill, 2016 defined 'financial service provider' as to have the same meaning as assigned to it in section 3(17) of IBC. The Bill was however, withdrawn in August, 2018.

Notably, section 227 of the Code empowers the Central Government to notify financial service providers or categories of financial service providers for the purpose of their insolvency and liquidation proceedings, which may be conducted under this Code. Such power, however, can only be exercised in respect of entities which are 'financial service providers'.

## The inter-connectivity argument

It may be argued that NBFCs hold a major chunk of their liabilities in the form of bank loans and advances. As such, initiating processes under the Code in respect of such NBFCs can trigger contagion effect. However, this argument seems to have ignored the fact that the corporate debtors under the Code too, have their liabilities side burdened with bank debts. *Ipso facto*, there is no difference between the NBFCs and the non-financial companies under the Code.

## Concluding Remarks

The discussion above clearly implies that there is no generic exemption for NBFCs from being a 'debtor' under the Code – the applicability/non-applicability has to be decided on case-to-case basis.

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