NHB makes multiple changes to enhance corporate governance standards for HFCs

Housing Finance Companies (HFCs) are non-banking financial institutions that play an important role in the housing finance sector. They are registered and licensed financial institutions offering home loans and other related products. However, unlike the other Non-Banking Finance Companies (NBFCs) which are governed by the Reserve Bank of India (RBI), the housing finance companies are governed by the National Housing Bank (NHB). NHB, is the apex financial institution for housing that registers, regulates and supervises HFCs to promote housing finance institutions both at local and regional levels. NHB, as a regulator, not only regulates the mechanism and functioning of the HFCs but also provide financial and other support incidental to such institutions and for matters connected therewith.

In recent times, the growing need for a fair, efficient and transparent administration system has encouraged the regulators to monitor the accountability and responsibility of the company towards its stakeholders. Also, the extent to which entities observe the basic principles of good corporate governance is an important factor for attracting foreign investment. Consequently, various measures have been taken by the Securities Exchange Board of India (SEBI) and the RBI to protect the interest of corporate stakeholders by adopting good standards of corporate governance.

Listed companies and NBFCs which adhere to rules framed by SEBI and RBI respectively, are already required to comply with the respective regulator's guidelines on corporate governance. The universal applicability of corporate governance has no exception to HFCs, which also are essential corporate entities. Recently, in order to enable HFCs to adopt best practices and greater transparency in their operations, the NHB has come out with the following directions:

1. "Housing Finance Companies – **Corporate Governance** (National Housing Bank) Directions, 2016"[1]
2. "Housing Finance Companies – **Approval of Acquisition or Transfer of Control** (National Housing Bank) Directions, 2016"[2]
3. "Housing Finance Companies – **Auditor's Report** (National Housing Bank) Directions, 2016"[3]

The aforesaid directions aim to strengthen the requirement for compliance of corporate governance and enhance the role of board of directors of the HFCs. The intention of NHB is to

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[1] Notification No. NHB.HFC.CG-DIR.1/MD&CEO/2016 dated 09th February, 2017
[2] Notification No. NHB.HFC.ATC-DIR.1/MD&CEO/2016 dated 09th February, 2017
[3] Notification No. NHB.HFC.AR-DIR.1/MD&CEO/2016 dated 03rd February, 2017

ensure that not only big corporates but also small unlisted entities adopt the best corporate practices to increase the confidence of investors and other stakeholders. Further, the provisions of these directions shall be read in addition to, and not in derogation of the provisions of any other laws, rules, regulations or directions, for the time being in force.

In this article, we shall look into the various provisions as enumerated under these directions.

Directions on Corporate Governance

For the purpose of these guidelines, all non-deposit HFCs with minimum asset of Rs.50 crore and all public deposit taking HFCs have been referred to as Applicable HFCs.

These Applicable HFCs are required to take the following measures and steps in order to comply with the requirements of the Directions:

Constitution of Committees of the Board

The Applicable HFCs shall be required to constitute the following committees of the board of directors:

- **Audit Committee**

All Applicable HFCs shall be required to constitute an Audit Committee, constituted under the provisions of Section 177 of the Companies Act, 2013 ("Act, 2013") and in terms of NHB directions in this regard. The Audit Committee must ensure that an Information System Audit of the internal systems and processes is conducted at least once in two years to assess operational risks faced by the HFCs.

- **Nomination Committee**

A Nomination Committee to ensure 'fit and proper' status of proposed/ existing the same powers, functions and duties, must also be constituted ' in compliance with the provisions of Section 178 of the Act, 2013 and in conformity with the NHB guidelines issued in this regard from time to time.

Earlier, as per the provisions of the Act, 2013, only such HFCs were required to constitute the Audit and Nomination Committee who satisfied any of the following prescribed conditions as on the date of last audited Financial Statements:

(i) public company with a paid up capital of ten crore rupees or more;

(ii) public company having turnover of one hundred crore rupees or more;

(iii) public company, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

However, these directions have extended the scope to all HFCs fulfilling the minimum asset criteria of Rs.50 crore or the deposit taking criteria.

- **Asset-Liability Management Committee**

An Asset-Liability Management Committee ("ALCO") must be constituted in accordance with the guidelines. The ALCO's primary goal is to evaluate, monitor and approve practices relating to risk due to imbalances in the capital structure. The HFC shall have a Board approved Asset Liability Management Policy in place and required disclosures to the effect shall be made from time to time.

The constitution of ALCO was previously applicable on Banks and certain NBFCs. HFCs, being financial institutions are also exposed to several major risks and hence there was a need for an effective risk management system. The extended applicability for Applicable HFCs shall unable them to address the risks associated with their operations in a structured and planned manner.

- **Risk Management Committee**

To manage the integrated risk, all Applicable HFCs shall also set up a Risk Management Committee which shall ensure that progressive risk management system and risk management policy and strategy followed by the HFC are put in place.

Presently, as per the requirement of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, Risk Management Committee is constituted by listed entities whose specified securities are listed. NHB has now extended the scope to include unlisted Applicable HFCs also.

Fit and Proper Criteria

The directors of the company are responsible for looking after its day-to-day management and operations. To exercise its responsibility in a diligent manner it is essential to ascertain and ensure that the person who is proposed to be appointed on the board of the company is suitable for the post on basis their qualifications, technical expertise, track record, integrity etc. It becomes imperative for a company to lay down the specific criteria that must be fulfilled by the proposed director before its appointment and also during his/her tenure as a director. Accordingly, RBI regulated banks and applicable NBFCs are required to ensure the process of due diligence for determining the suitability for appointment or continuing to hold appointment as a director, this also includes the satisfaction of fit and proper criteria by the proposed director.

As per the aforesaid directions, all Applicable HFCs shall ensure that a policy is put in place, based upon such guidelines as laid down therein the directions, with the director's approval to ascertain the fit and proper criteria of the directors at the time of appointment, and on a continuing basis. Further, at the time of such appointment or re-appointment, a declaration and undertaking along with a Deed of Covenant must also be obtained from the directors, requiring them to give additional information in the prescribed format.

Additionally, as required under the above referred NHB directions, the HFC shall ensure to furnish to the NHB on a quarterly basis, statement on change of directors and a certificate from the Managing Director of the respective HFC confirming that fit and proper criteria in selection of the directors has been followed. The same should be submitted to the NHB within 15 days of the close of the respective quarter and the statement for the quarter ending March 31, should be certified by the auditors.

Disclosure and transparency

Applicable HFCs shall update their board of directors through the Risk Management Committee, on annual basis or such other frequency as decided by the board of directors, the following:

1. The progress made in putting in place a progressive risk management system and risk management policy and strategy followed by the HFC;
2. Conformity with corporate governance standards viz., in composition of various committees, their role and functions, periodicity of the meetings and compliance with coverage and review functions, etc.

The following shall be disclosed in the Company's annual financial statements, w.e.f. March 31, 2017:

1. registration/ licence/ authorisation, by whatever name called, obtained from other financial sector regulators;
2. ratings assigned by credit rating agencies and migration of ratings during the year;
3. penalties, if any, levied by any regulator;
4. information namely, area, country of operation and joint venture partners with regard to Joint ventures and overseas subsidiaries
5. asset-liability profile, NPAs and movement of NPAs, details of all off- balance sheet exposures, exposure to real estate, exposure to capital market, disclosure of complaints as also securitization / assignment transactions and other disclosures, as may be prescribed by NHB from time to time.

Rotation of partners of the Statutory Auditors Audit Firm

The need for good corporate governance has been gaining increased emphasis over the years. Globally, Companies are adopting best corporate practices to increase the stakeholder' confidence. Scrutiny of the books of account conducted by auditors rotated periodically would add further value in strengthening corporate governance.

In this context, all Applicable HFCs shall stipulate rotation of partners of audit firms appointed for auditing the company. The partner/s of the Chartered Accountant firm conducting the audit could be rotated every three years. However, the partner so rotated will be eligible for conducting the audit of the HFC after an interval of three years, if the HFC, so decides. HFCs may incorporate appropriate terms in the letter of appointment of the firm of auditors and ensure its compliance.

Framing of Internal Guidelines

All applicable HFCs shall be required to frame their internal guidelines on corporate governance with the approval of the board of directors, enhancing the scope of the guidelines without sacrificing the spirit underlying the aforesaid guidelines and it shall be published on the HFC's website, if any, for the information of various stakeholders.

To Dos under the Corporate Governance Directions

1. Formation of committees, namely, Audit, Nomination, Asset Liability Management and Risk Management Committee;
2. Framing a policy for ascertaining the fit and proper criteria;
3. Obtain a declaration and undertaking along with a Deed of Covenant from the existing directors and henceforth upon every appointment and re-appointment;
4. Submission of a statement on change of directors and a certificate from the Managing Director confirming the compliance of fit and proper criteria;
5. Disclosure requirement w.r.t the annual financial statements is to be complied with;
6. Framing internal guidelines on corporate governance.

Directions requiring approval of Acquisition or Transfer of Control

The provisions of this direction is applicable on all HFCs registered under NHB Act, 1987, unless otherwise directed by the NHB, for any takeover or acquisition or control, any change in the shareholding or any change in the management occurring henceforth. These directions replace the provisions contained under Paragraph 19 of the Housing Finance Companies (NHB) Directions, 2010 (“HFC Directions, 2010”) and shall come into force with immediate effect.

Requirement to obtain prior approval of NHB for acquisition or transfer of control of HFCs

In accordance with the direction, prior approval of the NHB is required in the following circumstances:

a) any takeover or acquisition of control of an HFC, which may or may not result in change of management; where, the definition of control is as assigned to it under clause (e) of sub-regulation (1) of regulation 2 of Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011. As per the definition provided therein, control includes the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner. The proviso to the definition further states that a director shall not be considered to be in control over a company, merely by virtue of holding such position.

b) any change in the shareholding of an HFC, including progressive increases over time, which would result in acquisition / transfer of shareholding of 26 per cent or more of the paid up equity capital of the HFC.

Since there is no specific exemption to intra group transfers, the same shall also require prior approval of the NHB. Further, the progressive increase shall be tracked on a regular basis upon occurrence of any acquisition or transfer, to ascertain the change in shareholding.

However, prior NHB approval is not required in case of any shareholding going beyond 26% (twenty six percent) due to buyback of shares/ reduction in capital of the HFC where approval of the competent court has already been obtained. In such an event the same is required to be reported to the NHB within 1 (one) month from its occurrence.

c) any change in the management of the HFC which would result in change in more than 30 per cent of the directors, excluding independent directors.

This prior approval for change in more than 30 per cent of the directors shall be required for all HFC's irrespective of the strength of the board. In a case where an HFC is having only three directors and where anyone of them is being replaced by someone else, obtaining the prior approval every time there is such a change in management can act as a hindrance in the smooth and efficient functioning of the HFC.

However, the NHB approval is not required for those directors who get re-elected on retirement by rotation.

HFCs shall continue to inform the NHB regarding any change in their directors / management as required in HFC Directions, 2010.

Application seeking prior approval

The application for obtaining the prior approval of NHB shall be submitted to the General Manager, Department of Regulation & Supervision, National Housing Bank, New Delhi, o the company's letter head, along with the following documents:

a) Information about the proposed directors / shareholders as per Annex-I;

b) Sources of funds of the proposed shareholders acquiring the shares in the HFC;

c) Declaration by the proposed directors / shareholders that they are not associated with any unincorporated body that is accepting public deposits;

d) Declaration by the proposed directors / shareholders that they are not associated with any company, the application for Certificate of Registration (CoR) of which has been rejected by the NHB;

e) Declaration by the proposed directors / shareholders that there is no criminal case, including for offence under section 138 of the Negotiable Instruments Act, against them; and

f) Bankers' Report on the proposed directors/ shareholders.

Other requirements

A public notice of at least 30 days providing the intention to sell or transfer ownership/ control, details of the transferees, reasons for such sale/ transfer, shall be given before effecting the sale of, or transfer of the ownership/ control, by the HFC and by the concerned other party (jointly or severally), after obtaining the prior permission of the NHB. The notice shall be published in at least one leading national and in one leading local (covering the place of registered office) vernacular newspaper.

The aforesaid directions are on similar lines of the guidelines issued by the RBI for NBFCs. However, additionally in case of acquisition or transfer of control of HFC holding CoR valid for accepting public deposits, the NHB reserve the right to review the grant of permission to accept public deposits.

Directions on additional disclosure under Auditor's Report

The aforesaid directions issued by NHB provide for additional directions on matters to be reported by the auditors of a HFC.

As per the provisions of the said directions, every auditor of an HFC shall be required to report separately on the matters as specifically provided in the directions, to the board of directors. This report is in addition to the report made by the auditor under Section 143 of the Act, 2013 on the accounts of a HFC.

The auditor's report on the accounts of a HFC shall include a statement on the following matters, namely:-

(A) In case of all Housing Finance Companies

I. Whether the HFC has obtained a Certificate of Registration (CoR) from the NHB.

II. Whether the company is meeting the required Net Owned Fund (NOF) requirement[4].

(B) In case of a Housing Finance Companies accepting/holding public deposits

Apart from the matters enumerated in (A) above, the auditor shall include a statement on the following matters, namely:-

i. Whether the HFC has complied with Section 29C of the National Housing Bank Act, 1987;

ii. Whether the public deposits accepted by the HFC together with other borrowings indicated below are:

   a. From public by issue of unsecured non-convertible debentures/ bonds;

   b. From its shareholders (if it is a public limited company); and

[4] As prescribed under Section 29A of the National Housing Bank Act, 1987 including paid up preference shares which are compulsorily convertible into equity

c. Not excluded from the definition of 'public deposit' in the HFC Directions, 2010 are within the limits admissible to the company as per the provisions of the HFC Directions, 2010;

iii. Whether the public deposits held by the HFC in excess of the quantum of such deposits permissible to it are regularised in the manner provided in the HFC Directions, 2010;

iv. Whether the HFC is accepting/holding public deposits without having minimum investment grade credit rating from an approved credit rating agency as per the provisions of HFC Directions, 2010;

v. In respect of HFC referred to in clause (iv) above,

a. whether the credit rating, for each of the fixed deposits schemes that has been assigned by one of the Credit Rating Agencies mentioned in the HFC Directions, 2010 is in force; and

b. whether the aggregate amount of deposits outstanding as at any point during the year has exceeded the limit specified by the such Credit Rating Agency;

vi. Whether the HFC has defaulted in paying to its depositors the interest and /or principal amount of the deposits after such interest and/or principal became due;

vii. Whether the total borrowings of the HFC are within the limits prescribed under paragraph 3(2) of the HFC Directions, 2010;

viii. Whether the HFC has complied with the prudential norms on income recognition, accounting standards, asset classification, loan-to-value ratio, provisioning requirements, disclosure in balance sheet, investment in real estate, exposure to capital market and engagement of brokers, and concentration of credit/investments as specified in the HFC Directions, 2010;

ix. Whether the capital adequacy ratio as disclosed in the Schedule-II return submitted to the NHB in terms of the HFC Directions, 2010 has been correctly determined and whether such ratio is in compliance with the minimum capital to risk weighted asset ratio (CRAR) prescribed therein;

x. Whether the HFC has furnished to the Bank within the stipulated period the Schedule-II return as specified in the HFC Directions, 2010;

xi. Whether the HFC has complied with the liquid assets requirement as prescribed by the NHB in exercise of powers under section 29B of the National Housing Bank Act, 1987 and the requirements as specified in paragraphs 14 and 15 of the HFC Directions, 2010;

xii. Whether the HFC has furnished to the NHB within the stipulated period the Schedule-III return on Statutory Liquid Assets as specified in the HFC Directions, 2010;

xiii. Whether, in the case of opening of new branches /offices or in the case of closure of existing branches/offices, the HFC has complied with the requirements contained in the HFC Directions, 2010.

xiv. Whether the HFC has complied with the provisions contained in paragraph 38 and 38A of the HFC Directions, 2010;

xv. Whether the HFC has violated any provisions contained under restriction on acceptance of public deposits, period of public deposits, Joint public deposit, particulars to be specified in application form soliciting public deposits, ceiling on the rate of interest and brokerage and interest on overdue public deposits, renewal of public deposits before maturity as provided in HFC Directions, 2010.

(C) In case of a Housing Finance Companies not accepting/holding public deposits

Apart from the matters enumerated in (A) above, the auditor shall include a statement on the following matters, namely:-

i. Whether the HFC has complied with Section 29C of the National Housing Bank Act, 1987;
ii. Whether the board of directors has passed a resolution for non-acceptance of any public deposits;
iii. Whether the HFC has accepted any public deposits during the relevant period/year;
iv. Whether the total borrowings of the HFC are within the limits prescribed under paragraph 3(2) of the HFC Directions, 2010;
v. Whether the HFC has complied with the prudential norms on income recognition, accounting standards, asset classification, loan-to-value ratio, provisioning requirements, disclosure in balance sheet, investment in real estate, exposure to capital market and engagement of brokers, and concentration of credit/investments as specified in the HFC Directions, 2010;
vi. Whether the capital adequacy ratio as disclosed in the Schedule-II return submitted to the NHB in terms of the HFC Directions, 2010 has been correctly determined and whether such ratio is in compliance with the minimum capital to risk weighted asset ratio (CRAR) prescribed therein;
vii. Whether the HFC has furnished to the Bank within the stipulated period the Schedule-II return as specified in the HFC Directions, 2010;
viii. Whether the HFC has furnished to the NHB within the stipulated period the Schedule-III return on Statutory Liquid Assets as specified in the HFC Directions, 2010;
ix. Whether, in the case of opening of new branches /offices or in the case of closure of existing branches/offices, the HFC has complied with the requirements contained in the HFC Directions, 2010;
x. Whether the HFC has complied with the provisions contained in paragraph 38 and 38A of the HFC Directions, 2010.

Reasons to be stated for unfavourable or qualified statements

An auditor is required to state the reason for an unfavourable/ qualified statement issued with respect to the aforesaid matters. In case, the auditor is unable to express any opinion, the fact together with reason should be stated.

Obligation of auditor to report to the NHB

An auditor is required to make a report comprising any unfavourable/ qualified statement issued with respect to any matter specified above or about the non-compliance[5] of the following:

a. the provisions of Chapter V of the National Housing Bank Act, 1987 (53 of 1987); or
b. HFC Directions, 2010; or
c. Housing Finance Companies issuance of Non-Convertible Debentures on private placement basis (NHB) Directions, 2014

Such an exception report is to be submitted to the Department of Regulation & Supervision, National Housing Bank, New Delhi.

Conclusion

HFCs play an important role in the Indian Housing Finance system, and hence, special focus on the corporate governance in this sector becomes crucial. The directions issued by NHB shall help in establishing strategic objectives and a set of corporate values to develop and implement a sense of responsibility and accountability within the institution.

These directions are not new to the world at large, banks and NBFCs were already complying with the guidelines issued by the RBI on similar lines. The scope has now been extended to include other financial institutions like HFCs under its ambit.

5 The auditor shall report only the contraventions of the provisions of NHB Act, 1987, and Directions, Guidelines and such report shall not contain any statement with respect to compliance of any of these provisions.