New regulatory regime for NBFCs

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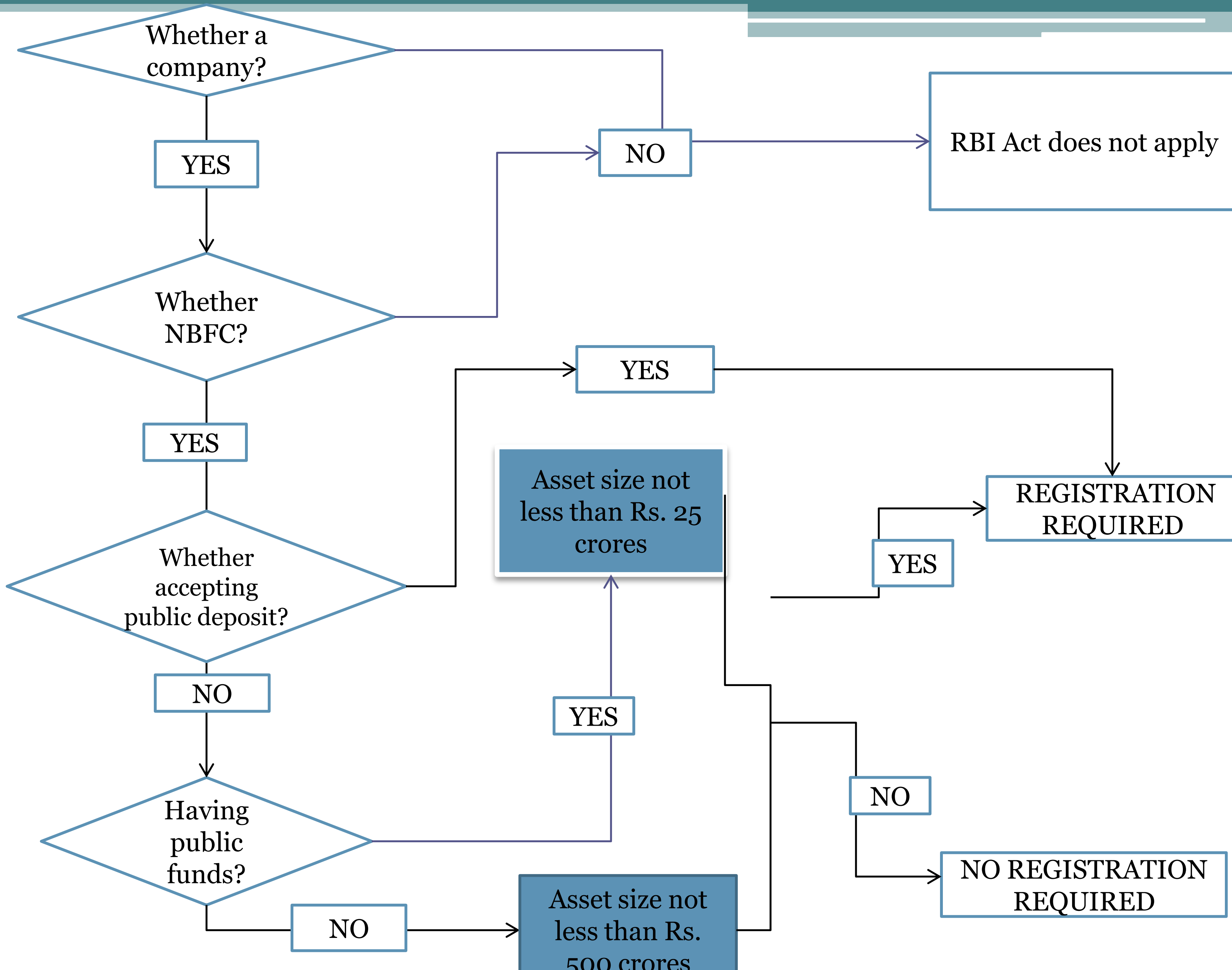
Blast of a reform

- The 12th Dec 2012 notice of proposed Regulations by the RBI proposes a complete perestroika of NBFC regulations
- The Regulations are still in draft stage – the invitation for comments has not put the actual draft of the proposed regulations on RBI website
  - Explanatory notes on proposed changes have been put
- Primarily, following major changes:
  - Huge deregulation of the NBFC sector, taking lot of NBFCs out of the regulatory net
  - Extensive corporate governance controls on NBFCs, particularly for NBFCs with asset base of Rs 1000 crores or above
  - Capital requirements increased with 12% Tier 1 capital in case of captive NBFCs and "sensitive asset" NBFCs
  - Higher risk weights for capital market and CRE exposures
  - Increased provision for standard assets
  - Deposit option limited to rated AFCs, upto 2.5 times of NOF

Entry point norms: major deregulation proposed

- This is one of the boldest moves, to take away from the registration net a whole lot of small NBFCs
- Size- based regulation proposed in case of all non-depository companies
  - Companies holding public funds:
    - Asset size of less than Rs 25 crores
  - Companies not holding public funds
    - Asset size of less than Rs 500 crores
  - Either of the above are "exempted" from registration
  - Minimum NOF requirement remains the same – Rs 2 crores
- Meaning of "public funds"
  - Word may have the same meaning as in CIC Regulations – includes bank funding, debentures, ICDs, etc
- Important point on "principal business"
  - In case of entities with asset size ≥ Rs 1000 crores, the principal business criteria is changing from BOTH income and assets to EITHER income or assets


Whether a company?
YES
NO
RBI Act does not apply
Whether NBFC?
YES
YES
Asset size not less than Rs. 25 crores
REGISTRATION REQUIRED
YES
Whether accepting public deposit?
NO
YES
NO
Having public funds?
NO
Asset size not less than Rs. 500 crores
NO REGISTRATION REQUIRED

Registration requirements in case of "investment companies"

- If the company in question is not holding any "public funds", it may escape registration upto an asset limit of Rs 500 crores
  - Practically, a shareholding company may avoid leverage qualifying as "public funds" and thus go out of the regulatory ambit
  - Rs 500 crores is a reasonably big size
  - Expectedly, a whole lot of companies will go out of registration requirement

What about existing companies?

- Existing NBFCs, not requiring registration under the new regime, may continue registration
  - Provided it gives a road map of how it will attain the regulatory asset size (Rs 25 crores/ Rs 500 crores) within 2 years
  - The road map may be given within 3 months of the notification
- All existing NBFCs, not needing registration, may also de-register themselves
- Core investment company regulations may also become redundant

What are the implications of losing registration?

- What if it is an NBFC, but exempted NBFC?
  - Several regulations/ laws/ circulars of the RBI refer to "NBFCs holding valid registration certificate"
  - Obviously, there will be nothing in case of exempted companies
  - It may take quite some time for all such laws/regulations to realise this
- However, if the law/regulation refers merely to a non-banking financial company, such exempted continues are covered by the expression NBFC
  - For example, sec 67 (2) of the Companies Act relating to private placements

Principality of business

- Citing systemic risks, RBI mandates NBFCs to keep their non-financial activities under limits
- Thus,
  - NBFCs with asset size < Rs 1000 crores need to have 75% of gross income AND 75% of assets out of financial activities
  - NBFCs with asset size ≥ Rs 1000 crores need to have 50% of gross income OR 50% of assets out of financial activities
- Redefining the meaning of asset finance companies also accordingly
  - That is, AFC has to reach a level of 75% of income and assets to qualify as such
    - Not clear whether the asset-size-based distinction (75%, 50%) applies here as well

Systematically important companies

- In case of systematically important companies, asset size will be clubbed as "group" level
- The word "group" has a broad definition
  - Holding – subsidiary
  - Joint venture
  - Associate
  - Promoter-promotee
  - Related party
  - Entities using same brand name
  - Investment in equity shares of 25% or above
- All companies treated as "group companies" should be financial companies
  - That is, no need to club assets of non-financial companies

Corporate governance controls

- Sweeping corporate governance controls have been proposed on NBFCs
  - Appointment of CEO requires RBI approval
    - In case of entities with asset size of Rs 1000 or more
    - Difficult to justify
      - There are regulations in other countries on managerial compensation in case of financial entities, but a straight approval requirement seems inappropriate
      - Shareholders and Board judgement subject to RBI's wisdom
  - Directors of NBFCs to be "fit and proper" and further sign a covenant with the NBFCs
  - Whole lot of disclosures added
  - Clause 49 of Listing agreement applies to all companies with assets of Rs 1000 crores and above
  - Managerial compensation guidelines

Change of Control

- All acquisitions or change of control in case of all registered NBFCs require prior approval of the RBI
- Acquisition is defined to include increase in shareholding to 25% or above
- The actual language of the rule needs to be seen, but it is not same as SAST Regulations
  - Creeping acquisitions are not covered
  - Not sure if indirect acquisitions are covered too

Directors of NBFCs

- Fit and proper person criteria replicates much of the current guidelines applicable to banks
- Directors required to give an undertaking
- Most important part is the covenant that a director signs
  - It is quite clearly seeming like an agreement of a whole-time director
    - For example, “not evade responsibility in regard to matters entrusted to him / her by the Board”
  - In short, the covenant will expose independent directors to substantial risks

Additional disclosure requirements

- Approval of RBI in case of any takeover or acquisition of control:
  - All registered NBFCs both deposit taking and non deposit taking should take prior approval from RBI where there is a change in control and / or increase of shareholding to the extent of 25 percent or in excess thereof, of the paid up equity capital of the company by individuals or groups, directly or indirectly.
  - For any acquisitions and for all mergers under Section 391-394 of the Companies Act, 1956 by or of an NBFC, the NBFC involved should approach the Reserve Bank (even before filing for the same in the Courts) to ensure adherence to the basic tenets of corporate governance and overall health of the sector.
  - Non-adherence to these guidelines will result in cancellation of the CoR of the concerned NBFC.
  - There can be no change in control of the NBFC prior to commencement of business and regularization of its CoR.
- Approval required for appointment of CEO:
  - Appointment of CEOs of NBFCs with asset size of Rs. 1000 crore and above would require the Reserve Bank's prior approval.

Additional disclosure requirements

- Limit to number of Directorship:
  - For all NBFCs with asset size of Rs. 1000 crores or more, the number of Directorships held by a single director of any NBFC, public or private, may not exceed the maximum number prescribed under Section 275 of the Companies Act 1956.
- Compliance relating to remuneration and compensation:
  - All registered NBFCs with assets of Rs. 1000 crore and above shall constitute a Remuneration Committee to decide on the compensation payable to the executives.
- Compliance relating to fit and proper criteria of directors:
  - RBI has laid down the following drafts in this regard:
  - guidelines for ascertaining fit and proper criteria of directors
  - declaration and undertaking to be given by the directors
  - deed of covenant to be signed between the director and the company

Additional disclosure requirements

- Disclosure in financial statement:
  - All registered NBFCs should disclose their registration with other regulator(s) such as SEBI, IRDA, Stock Market and Commodity Exchanges, as well as any credit ratings assigned by rating agencies.
  - NBFCs with asset size of Rs. 1000 crore will need to disclose the following:
    - Provision
    - Coverage ratio, liquidity ratio
    - Asset liability profile
    - Extent of financing of parent company
    - Products
    - NPAs and movement of NPAs
    - Details of all off-balance sheet exposures, structured products issued by them as also securitization/assignment transactions and other disclosures.