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Regulations pertaining to Deposit taking NBFCs

The law and practice relating to Non Banking Financial Companies (NBFCs) has undergone an enormous change over the last couple of decades. From a relatively simple set of regulations governing lakhs of NBFCs, we now have an exceedingly complex set of regulations governing few thousands of companies. The lesser number of NBFCs has resulted in professionals like CAs, CSs, Tax Advisors, etc., often not keeping abreast with all the latest developments – and developments are frequent – in this field. It is, then, not uncommon that – except for large and active NBFCs - it is only after non-compliance/violation of the requirements that the NBFC and its advisors are confronted with the situation. The objective of this paper – which is in the context of a comprehensive issue of this Journal on various issues relating to NBFCs - is to give a current overview of the law relating to deposit accepting NBFCs as governed by the Reserve Bank of India. NBFCs of course are governed by many other laws too such as the Companies Act, 1956, that governs every company, some special laws that may apply to NBFCs such as law relating to money lending and special issues that NBFCs face under tax law. However, this paper focuses only on the law as governed by the Reserve Bank of India.

Further, such law also governs non-companies engaged in non-banking finance activity. There are also numerous types of companies that are engaged in non-banking finance type of activities such as mutual funds, venture capital companies, collective investment schemes, etc., many of which are not governed by RBI but by SEBI or other regulators. Similarly, even RBI governs several types of companies that are engaged in such finance business but are given another name or category. All of these raise monies in various forms though technically called deposits and they do carry on business in finance. However, to maintain focus, this article covers the three main types of deposit accepting NBFCs, viz., loan companies, investment companies and asset finance companies. A recent report on the status of the law relating to NBFCs and recommendations for the same is also highlighted here.

Background

The business of non-banking finance is essentially of acting as a financial intermediary, akin to banks but with important differences. An NBFC raises moneys from people who have savings and lend these monies to those who need funds, keeping a spread for themselves. Aggressive and even misleading techniques by such NBFCs over a period resulted in large losses to depositors of such NBFCs, causing loss of credibility in the market and pressure on the Government and RBI to do something. The result

was a fairly stringent set of norms – drastic in one sense but creating close scrutiny and supervision in another. These were introduced in 1997 by amendments to the Reserve Bank of India Act, 1934.

The important amendments brought forth were as under:-

1) Compulsory prior registration with the Reserve Bank of India for acting as NBFCs. All existing NBFCs also had to apply for registration to continue as such.

2) Minimum net owned funds – as defined – of ₹ 2 crores (increased gradually from original ₹ 25 lakhs which limit continues for certain old non-deposit accepting companies).

3) Detailed Directions for acceptance of Public Deposits, Prudential Norms and special reporting by auditors.

4) Several other miscellaneous directions, circulars and notifications and even press releases.

The above resulted in, on one hand elimination of perhaps lakhs of NBFCs, and, on the other hand, resulting in company by company review for registration and monitoring thereafter. These Regulations have been amended and clarified on by the Reserve Bank of India numerous times over the years. A separate category of directions introduced for a sub-category of investment companies, i.e., Core Investment Companies (CICs) have also been notified recently.

Important laws regulated by Reserve Bank of India for NBFCs

The following are the principal provisions that govern NBFCs:-

1) The Reserve Bank of India Act, 1934 ("the Act"), particularly Chapters IIIB, IIIC and V.

2) The Non Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 ("the Deposits Directions").

3) The Non Banking Financial (Deposit accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.

4) The Non Banking Financial (Non-deposit accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.

5) The Non Banking Financial Companies Auditors' Report (Reserve Bank) Directions, 2008.

Apart from above, there are numerous other Directions, notifications, circulars, press releases, etc. Further, like some other laws administered by Reserve Bank of India, this law too needs keeping updated with actual practices and policies that Reserve Bank of India follows as regards interpretation, procedures and other requirements.

Finality of views on laws and facts of Reserve Bank of India on some important aspects

There are certain peculiar provisions in the law relating to NBFCs. This point is particularly relevant since the law relating to NBFCs has become fairly complex and punishment for violation fairly stringent. Often, two preliminary important questions arise. Is a particular company an NBFC? If it is an NBFC, what category does it belong to? The Directions of Reserve Bank of India say that if either of this question is an issue, the view of the Reserve Bank of India will be final on this matter. And the view of the Reserve Bank of India is not appealable. Further, even there are issues relating to the law relating to Prudential Norms by deposit accepting NBFCs, the interpretation of the Reserve Bank of India will be final and binding on the NBFC.

Law relating to NBFCs says some important aspects like whether a Company is an NBFC or

not, what category to which belongs, etc. are to be decided at sole discretion of the RBI, and is final and binding and not appealable.

Definition of NBFC

For a Company to be eligible to accept deposits, it has to first qualify to be an NBFC, then register itself as such and then comply with the requirements for accepting deposits. Now, what, in simple terms, is an NBFC?

A fairly convoluted definition of what is a non-banking financial company has been laid down in Section 45-IA and related provisions of the Act. Simplified and taking into account certain clarifications, a NBFC is, firstly, a Company. Its principal business is of specified types of finance activities which for the purposes of this paper is investments, loans and asset finance (i.e., hire purchase or leasing). What constitutes "principal" business is not specifically defined but taking into account certain circulars of the Reserve Bank of India, it can be said that if at least 50% of the income and 50% of the assets relate to specified finance activities, the Company is an NBFC.

An important concept often overlooked is even if a company seeks to carry on NBFC business with its own funds, registration is a must. In other words, borrowing funds from outside sources is not a pre-condition for the requirement of registration. There are of course additional provisions for deposit accepting NBFCs.

Registration as an NBFC is mandatory even if no Public Deposits are sought to be accepted and own funds are used for investments, lending, etc.

Registration as an NBFC

A prior registration as an NBFC is a must for commencing the business of NBFC. This rule applies not just to new NBFCs but even existing companies seeking to change their nature of business into an NBFC. Often companies who close down their existing business by sale, etc., end up carry on business of finance. Such companies too need prior registration as an NBFC with Reserve Bank of India. For acceptance of deposits, there are further requirements.

Carrying on business of NBFC without registration

The Reserve Bank of India Act, 1934, provides very stringent punishment for carrying on business of NBFC without registration. This is one of those rare violations whose consequences is mandatory imprisonment and that too of a minimum period of one year and up to five years and with fine. And there are no provisions of compounding.

Non-registration as NBFC is punishable, on prosecution, by mandatory imprisonment and fine and is not compoundable.

Net Owned Funds

Except for certain old, non-deposit accepting companies, generally, the rule is that for registration as an NBFC, a minimum net owned funds of ₹ 2 crores is mandatory. The definition of NOF is stringent to ensure that funds are not recirculated within group companies to build up the minimum ₹ 2 crores required. The minimum size of companies also ensures that not many companies are eligible for registration. This also thus ensures that the RBI has lesser number of companies to scrutinise and supervise.

The calculation of NOF is as per a detailed formula. It is basically a two step process. First, the "owned funds" has to be calculated. The "net owned funds" is calculated by carrying out certain prescribed deductions from such "owned funds". These two terms are used for various different purposes including registration, as a base for calculating limits for deposits acceptance, etc.

Categories of NBFCs

While NBFCs – whether regulated by the Reserve Bank of India or otherwise – come in

various types and objectives, for the purposes of the present article, the three relevant categories are:-

1) Loan Companies.

2) Investment Companies

3) Asset Finance Companies

Deposits and Public Deposits

The terms Deposits and Public Deposits are the core definitions of the law relating to NBFCs. However, the term is vastly different from what is commonly understood. It is artificially and widely defined. Apart from the widely framed definitions, there are numerous exceptions. These two terms have so many issues/controversies that a detailed discussion would be the subject matter of a separate lengthy article.

To quickly summarise, a few points are relevant. To begin with raising of funds in almost any form is Deposits, which is defined in Section 45-I(bb) of the Act. However, there are specific exclusions in that clause. The term Public Deposits is defined in the Deposits Directions. This definition essentially makes some more specific exceptions to the broad definition of Deposits under the Act. The net result is that while any amount raised is Public Deposits to begin with, there are some exceptions to this. Share Capital is obviously not Public Deposits. Loans from Directors and their relatives are also not Public Deposits. Loans from shareholders by a private limited company are not Public Deposits. Loans from another company are also not Public Deposits. And so on.

Suffice is to say that Public Deposits do not, as often commonly misconstrued, include only deposits raised from the public by issue of a public advertisement.

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Acceptance of Deposits Directions

Unlike a commonly prevailing misconception, and as stated earlier, acceptance of deposits is not a pre-requisite for registration. Registration is required as NBFC even if the finance activity is carried on with own funds. However, if an NBFC wants to accept pubic deposits, it further needs to comply with several more requirements contained in the NBFC Public Deposits Directions. The requirements relate to limits up to which such deposits can be accepted, the minimum credit rating required, the capital adequacy ratio, etc.

"Public Deposits" is defined very widely and includes borrowings from any source though there are specific exemptions. The term "public" is thus misleading and it includes borrowings even from "private" sources. Moreover, the term "deposits" is also misleading since this term has a certain meaning in law while public deposits for the present context includes any form of borrowings or deposits.

Having said that, there are very few companies in India who are eligible, as per regulatory requirements relating to NBFCs, to accept public deposits. The concern, however, is that many NBFCs end up accepting public deposits without realising that what they have accepted is public deposits. The consequences of accepting public deposits without complying with the regulatory requirements are quite serious.

The Deposits Directions provide for detailed provisions relating to acceptance of deposits some of which are discussed later herein.

Prudential Norms Directions

All NBFCs are required to follow certain Prudential Norms. Those who are exposed to banking regulation are quite familiar with this term and indeed the Prudential Norms are derived from the Prudential Norms prescribed by Reserve Bank of India to banks those of course they are diluted and adapted to the circumstances of an NBFC.

Prudential Norms – as one can imagine from the word "prudential" – are norms to provide an extra level of prudency in accounting, disclosure, etc. Prudence is even otherwise a basic accounting concept followed in accounting. However, where one is dealing with other people's money, the standards of prudence are raised higher. Thus, the Prudential Norms require an NBFC to be extra prudent in some areas and more than as required by Accounting Standards. For example, provision for bad debts is required up to specified minimum levels once they are overdue beyond a certain period. Loans/investments in a single entity or a group of entities are permitted only to specified extent. A minimum capital adequacy requirement has been placed which will thus prevent NBFCs from over trading and over leveraging. RBI has prescribed separate Prudential Norms for deposit accepting and non-deposit accepting NBFCs. However, since Prudential Norms is covered by a separate detailed article in this issue, more discussion is not made herein.

Directions relating to reporting by Auditors

One of the most widely framed reporting requirements by Auditors are contained in these Directions. Even at a glance, it can be seen that the Auditors are not only required to check whether each and every requirement prescribed by Reserve Bank of India are complied with by the NBFC but they go even much beyond.

The Auditors are required to check things such as whether the Company has applied for registration as NBFC or not, whether the conditions of registrations are complied with or not, whether the Company has accepted deposits without being eligible to do so, or if eligible, whether it has complied with the requirements relating to acceptance of deposits, etc. The reporting requirements are detailed and comprehensive. However, what is of interest is an additional all-encompassing requirement that refers to almost all the requirements of law relating to NBFCs. It requires the auditor to specify whether these are not complied with. Further, in case of non-compliance, the Auditors are also required to report to the Reserve Bank of India directly.

It is quite common to find that Auditors have qualified their audit reports to point out some non-compliance of certain Directions of RBI but failed to report the same to the RBI. In some other cases, the RBI finds on its own that the NBFC has not complied with certain requirements and the Auditors have not reported the same to it. Notices are issued in such cases not just to the NBFC but even to the Auditors.

The Auditors have to verify almost every statutory provision relating to NBFC including some fundamental questions – is the Company an NBFC? Is the NBFC no more an NBFC? Is the NBFC eligible to accept deposits? Has its classification changed or eligibility changed which will result in reduced ability to accept Public Deposits? They even have to certify whether the NBFC is in a position to meet the liabilities to depositors.

Interest on deposits

Ideally, the rate of interest on deposits should be determined by market forces. An NBFC should be left to decide what rate of interest it can afford. The deposits are usually unsecured. Each NBFC is in a different situation. The credit rating may be different. The credibility of management, the track record otherwise of the NBFC are further differences. A company in a stronger position may offer lower rate of interest while a company in a weaker position may offer higher rate. A maximum limit of interest may disable some companies in acceptance of deposits.

However, the Reserve Bank of India has laid down a maximum rate of interest on deposits at 12.50% per annum. Such interest can be compounded at monthly rests. This comes to approximately 13.24% per annum on an annualised basis.

Brokerage on deposits

The Reserve Bank of India has also laid down limits over brokerage that can be paid to brokers for sourcing deposits from their clients. Brokerage was often misused and reportedly even misused now by passing on a part of it to the depositors. If no limit is provided on brokerage, the NBFCs may misuse this to bypass the provisions relating to maximum interest to depositors.

Thus, a maximum rate of brokerage of 2% of the amount of deposits so collected has been laid down. This includes brokerage, commission, incentive, or benefit called by any other name.

Further, expenses may also be reimbursed to such brokers provided that they are duly supported by bills/vouchers and that such expense do not amount to more than 0.50% of the amount collected.

The brokerage and expense limits remain unchanged irrespective of the tenure of deposits.

Reporting requirements

There are various reporting requirement by deposit accepting NBFCs for deposits, liquid assets, etc. Further, certain disclosures also have to be made in the Directors' Report particularly on matters relating to unclaimed amounts of Public Deposits.

Advertisements/statements in lieu of advertisements for accepting Public Deposits

Depending on whether the Public Deposits are sought to be raised from the public by solicitation or privately, advertisement or statement in lieu of advertisement has to be issued/filed in prescribed manner containing the prescribed disclosures.

Credit rating

As a general rule (but for one exception for asset finance companies), a minimum investment grade credit rating from one of the designated credit rating agency is a pre-requisite for acceptance of Public Deposits.

Minimum period and maximum period of Public Deposits

Limits are provided over the maximum and minimum period for which Public Deposits can be accepted. To begin with, deposits cannot be accepted repayable on demand. Further, the minimum period for which deposits can be accepted is 12 months and the maximum period for which deposits can be accepted is 60 months.

Premature repayment is possible before the maturity period at the discretion of the NBFC but not earlier than 3 months from the date of deposit. However, if such premature repayment is after three months but before six months of the acceptance of the deposit then no interest shall be paid on such deposits. However, if the premature repayment is after such period of six months but before the maturity period, then the interest rate shall be 2% lower than the contracted rate.

Certain exceptions are provided for tiny deposits upto ₹ 10,000 as well as in case of death of the depositor.

Limits on deposits

Acting as intermediary for finance is the essence of an NBFC. Accepting deposits from outsiders who have savings and finding people to lend it to and keeping a spread in the process is how generally an NBFC operates. There is a risk of bad debts in the process and hence a cushion in the form of shareholders' funds is needed to absorb losses to some extent before the depositors suffer from such loss. From point of view of profitability of the NBFC, the higher the leverage ratio, the higher the profits to the shareholders since the spread on the amounts received and lent would go to them on the same amount of share capital. However, higher the

leverage, the higher would be the risk of the NBFC defaulting on depositors since the capacity to absorb losses reduces.

To ensure that NBFCs do not over leverage, limits have been provided on the extent to which NBFCs can accept deposits.

A fairly complex set of formula has been provided for this purpose and it would not be possible to go into great detail into this here. The limits on deposits and conditions thereon vary on account of several factors. One is the classification of the company – whether it is a loan/investment company or an asset finance company. Another is the net owned funds of the company since it is a multiple of this that the maximum amount of deposits that can be accepted has been laid down. The capital adequacy ratio under the Prudential Norms as prescribed is another factor. Yet another factor is the credit rating. Taking various combinations of the above, Public Deposits are allowed to be accepted generally as a multiple of the net owned funds.

Liquid Assets

NBFCs are required to maintain a certain portion of the deposits in the form of liquid assets in the prescribed form and invested in the prescribed form of assets. This also helps enable meeting of needs of repayment at maturity from time to time.

The amount of such liquid assets are 15% of its Public Deposits as at the end of the preceding quarter. These liquid assets are required to be maintained in approved securities. Further, they need to be unencumbered and also maintained in the prescribed manner.

If an NBFC violates the requirements of these provisions, there are certain penal and other consequences. The NBFC is required to pay penal interest on the shortfall in maintenance of the liquid assets. Further, a fine may also be levied on the NBFC.

Auditors responsibilities

The Auditors have several responsibilities with regard to acceptance of deposits by an NBFC.

Under Section 45MA(1) of the Act, they are required to inquire whether the NBFC has furnished to the Reserve Bank of India the statements, information, etc., as prescribed relating to deposits accepted by it. If such information, etc., has not been provided, the Auditors are required to make a report to the Reserve Bank of India giving the aggregate amount of deposits held by the NBFC.

Apart from the above specific requirement under the Act, the Directions to Auditors are even more detailed as to various aspects of deposits accepted by the NBFC. The responsibilities of reporting by the Auditors are quite comprehensive. For example, if deposits are accepted by the NBFC, the Auditors are required to inquire whether the NBFC is eligible. Further, they are to inquire whether the deposits are within the prescribed limits. Whether the liquid assets required to be maintained in respect of such deposits are duly maintained. And so on. Generally, the Auditors are required to check on compliance with prescribed Directions for every aspect of acceptance of deposits.

If there is any non-compliance, the Auditors are required to report such non-compliances to the Reserve Bank of India.

Non-compliance with any direction given or order made by the Reserve Bank of India under Section 45MA would result in a fine on the auditors upto ₹ 5,000. This is of course apart from the action that the Institute of Chartered Accountants of India may take against such auditor, in case of violation of the applicable Code of Conduct, etc.

Penal provisions for excessive acceptance, acceptance without registration, violation of Directions, etc.

There are serious penal consequences for violations of provisions relating to acceptance of deposits and related matters. Accepting deposits in contravention of the Reserve Bank of India Act generally, issuing any advertisement otherwise than in accordance with the prescribed provisions, etc., attract imprisonment upto three years and fine.

Merger/amalgamation etc., of deposit accepting NBFCs

In case of mergers/amalgamations of NBFCs or takeover of control of such NBFCs, concern arises about the existing depositors. Accordingly, Reserve Bank of India has laid down formal Directions providing for the compliances to be made in case of such mergers/ amalgamations/takeovers of NBFCs accepting Public Deposits.

These Directions apply where there is a takeover or acquisition of control of a deposit-taking NBFC or merger or amalgamation of such an NBFC with another entity or merger/ amalgamation of any other entity with a deposit taking NBFC.

In such cases, the deposit taking NBFC is required to take prior written approval of the Reserve Bank of India.

Recent report of expert Working Group recommending substantial amendments

The Reserve Bank of India had constituted a Working Group whose Chairperson was Ms. Usha B. Thorat, to study and report on changes in the regulatory framework relating to changes required. The Group gave their report dated 23rd August 2011. Very far reaching changes have been suggested. For a non-deposit accepting NBFC, registration is sought to be waived if the total assets are less than ₹ 50 crores. Further, if a NBFC is not accepting public funds in any form, whether by Public Deposits, inter corporate loans, bank loans, etc. an even higher limit of ₹ 1000 crores of total assets is proposed up to which the NBFC need not be registered. Another change proposed is that in case of all types of NBFCs, whether deposit taking or not, change of control in excess of 25% of the paid up capital of the company would require prior approval of the Reserve Bank of India.

Another important change suggested is the very definition of an NBFC. A Company would be an NBFC provided that at least 75% of its assets are financial assets and 75% of its income is sourced from financial assets. This would exclude several existing and new NBFCs, whether deposit accepting or not, from the whole legal framework relating to NBFCs. The limits on acceptance of deposits as a multiple of NOF is suggested to be reduced.

There are several other major and minor suggestions made. It will have to be seen when this report is implemented by the Parliament and/or the Reserve Bank of India and which of its recommendations are accepted.

Conclusion

The law relating to NBFCs is complex, gives a lot of discretion and powers to Reserve Bank of India and has serious consequences for violations. It covers even companies where the public interest may not be seriously affected. However, it is hoped that over a period of time, the entities to which this strict and complex set of laws apply become less and less.