

# SAMPADA

## News and views on Non-Banking Financial Services



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## **Editorial:**

It is a pleasure to present our first issue of Sampada –a news and viewsletter on Non Banking Financial Companies.

The NBFC sector is buzzing with activity – the growth rates are substantially higher than those in the banking sector. Besides, with the growing economy needing more capital equipment, NBFCs are poised for a bullish time.

**Sampada**, the newsletter focuses on recent developments, topics of interest, regulatory news and so on. Every issue would be worth reading, preserving and circulating.

You would be happy to ensure that you and your colleagues do not miss a copy – please register at [www.vinodkothari.com/maillinglist.htm](http://www.vinodkothari.com/maillinglist.htm)

We would be obliged for your feedback.

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The recent Supreme Court ruling in *Booz Allen and Hamilton inc vs SBI Home Finance Ltd and others* [2011 (5) SCALE 147] sets severe limitations on rights of arbitrators. Housing finance companies are immediately affected, as it was common practice among housing finance companies to use the arbitration route for getting mortgage foreclosures. However, it would be myopic to believe that the implications of the Supreme Court ruling are limited to mortgage foreclosures only. In fact, as the ruling gets into the very issue of what is an arbitrable matter, the practice, very commonly used in the finance industry, to use arbitration awards as the device to order repossession of assets, may also coe for serious question.

### WHAT WAS THE CASE ALL ABOUT?

The history of the case involves several facts that may be not be relevant to our analysis here. Hence, we focus only on the relevant facts. Booz Allen (BA) was using flats which were acquired on leave and license basis from the owners of the flats. The owners of the flats, in turn, had taken a loan from SBI Home Finance (SHF). The owners defaulted on payment of the loan. Hence, SHF sought to foreclose the mortgage and evict BA. BA's contention was that BA had paid a huge security deposit while entering into the leave and license agreement. One of the owners who has given the property on leave and license basis had already become a sick company and was before BIFR.

Several issues were taken to courts at various levels, of which the key issue is – whether the arbitrator could pass an award for foreclosure of the mortgage? It is a different issue that any foreclosure would be highly inequitable for BA, as BA has paid a huge amount, may be almost the market value of the property, as security deposit against the leave and license agreement. However, that is the risk that anyone acquiring a property on leave and license basis anyway takes.

### WHAT IS AN ARBITRABLE MATTER?

Where a judicial proceeding is commenced in a matter which is subject matter of an arbitration agreement, the judicial forum is bound, by sec 8 (1), to refer the matter for arbitration by the arbitral tribunal. This provision implies that if the matter is an arbitrable matter, and is covered by the arbitration agreement, the matter must be decided by arbitration rather than by adjudication. The underlying crucial issue for this provision is – what exactly is an arbitrable matter, or what are the limits to arbitrability? The limit to arbitrability is a very significant topic in law relating to arbitration, and has been discussed world-over, including at the UNCITRAL itself. Courts in several jurisdictions have rendered rulings on arbitrability. Over a period of time, several exceptions to arbitrability have emerged. For instance, matters pertaining to public policy are non-arbitrable. Recently, a Singapore Supreme Court ruling went at length to define the limits of arbitrability where one of the parties is insolvent company. The Supreme court ruling in *Booz Allen* itself says: "The well recognized examples of non-arbitrable

## The limits on arbitrability: **SC ruling limits arbitrators' rights on mortgages, potentially even hypothecations**

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disputes are : (i) disputes relating to rights and liabilities which give rise to or arise out of criminal offences; (ii) matrimonial disputes relating to divorce, judicial separation, restitution of conjugal rights, child custody; (iii) guardianship matters; (iv) insolvency and winding up matters; (v) testamentary matters (grant of probate, letters of administration and succession certificate); and (vi) eviction or tenancy matters governed by special statutes where the tenant enjoys statutory protection against eviction and only the specified courts are conferred jurisdiction to grant eviction or decide the disputes." Clearly, if the matter is non-arbitrable, an arbitrator cannot rule in the matter. The moot question in the present case was, whether the right to foreclose a mortgage, was an arbitrable matter, and whether the arbitrator could pass an award for mortgage foreclosure.

### PERSONAL RIGHTS AND REAL RIGHTS

Citing from Russell on Arbitration, and the ruling of Supreme Court in *Chiranjilal Shrilal Goenka vs. Jasjit Singh and Ors.* 1993 (2) SCC 507, the court in the present case drew an important exception to arbitrability – real rights are not arbitrable, personal rights are. This brings us to an important point – what are real rights, as opposed to personal rights? Salmond in his class treatise *Jurisprudence*, in chapter XI, has discussed at length real and personal rights. "A real right corresponds to a duty imposed upon persons in general whereas a personal right corresponds to a duty imposed upon determinate individuals. A real right is available against the world at large; a personal right is available only against particular persons. The distinction is one of great prominence in the law". For example, a right to the peaceable occupation of one's farm is a real right, for all the world is under a duty towards him not to interfere with it. But if he grants a lease of the farm to a tenant, then his right to receive the rent from such tenant is personal; for it avails exclusively against the tenant himself. For the same reason a right to the possession and use of the money in one's purse is real; but my right to receive money from some one who owes it to him is personal.

Why is the distinction between real and personal rights relevant for matters of arbitration? Since real rights affect the world at large, an arbitrator giving a ruling on real rights is likely to affect the interests of third parties too, which an arbitrator is incompetent to do.

### IS REPOSSESSION OF AN ASSET A PERSONAL RIGHT OR REAL RIGHT?

In the NBFC sector in the country, repossession of assets is very commonly based on an award of arbitrator. The question would be – is repossession of an asset pursuant to a default on a loan an arbitrable matter? The Supreme Court's ruling in *Booz Allen* is not on the issue of mortgage foreclosure alone. It is not merely because a special procedure is laid down in Civil Procedure Code for foreclosure of mortgages that the SC was persuaded to hold a mortgage foreclosure to be beyond the scope of an arbitration award. Most commentators commenting on the ruling have assumed that the impact of the ruling is limited to mortgage foreclosures. However, that would be myopic. The underlying rationale in the ruling of the Apex court clearly lay enforceability of real rights through arbitration agreements.



**Supreme Court of India**

A right to recover money under a loan is a personal right, but the question is, is the right to seize an asset on default of a loan a personal right? An asset is a real right, not a personal right. A right of repossession is taking away the real right of the person owning the asset. Taking the SC ruling forward, it may be possible to contend that even repossession of assets would fall under the same category as enforcement of a mortgage. One of the reasons why the enforcement of a mortgage is not an arbitrable matter is that a court passing a decree on a mortgage deals not only with the rights of the mortgagor and mortgagee, but also of several third parties such as puisne/mesne mortgagees, persons entitled to equity of redemption, persons having an interest in the mortgaged property, auction purchasers, persons in possession. An arbitral tribunal will not be able to do so. The same argument may apply to other physical asset such as a commercial vehicle, an earth moving equipment, etc.

### CONCLUSION

The Apex court ruling in *Booz Allen* is a milestone in the law of arbitration and the limits on arbitrability. At the same time, it exposes the weak links that abound pertaining to enforcement of security interests on variety of assets. The SARFAESI Act made a change in respect of banks, but that Act itself, and more particularly the relation of that Act to several other competing laws such as Sick Industrial Companies Act, is mired in controversy. A system that expects for a law to be created by judges is an unfortunate system. Laws are to be created by the lawmakers. Where lawmakers leave gaping holes that is where courts come and lay the law. But surely enough, courts are not the best institutions to lay the law, because till the time it is settled by judiciary, the subjects would have passed through a great period of uncertainty.

To view the same article on our website- <http://www.india-financing.com/sc%20ruling%20on%20booz%20allen%20limits%20arbitrators%20rights.pdf>



JULY 2011

## “Supreme Court ruling in *Booz Allen and Hamilton inc vs SBI Home Finance Ltd and others* sets severe limitations on rights of arbitrators”

**Analytical Speaking**  
VINOD KOTHARI & COMPANY

The limits on arbitrability:  
SC ruling limits arbitrators' rights on mortgages, potentially even hypothecations

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Check at: [www.india-financing.com/sc%20ruling%20on%20booz%20allen%20limits%20arbitrators%20rights.pdf](http://www.india-financing.com/sc%20ruling%20on%20booz%20allen%20limits%20arbitrators%20rights.pdf)

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Finally, the Microfinance Institutions (Development and Regulation) Bill has been put up on the website of the Ministry of Finance. Though titled as "Development and Regulation Bill, as would be expected, the stance of the Bill is more on regulation, than on development. Also, as would be expected, the Bill is full of drafting problems and language inconsistencies, though it has had the benefit of the Malegam Committee's recommendations.

#### **Overview of the Bill and its major drafting problems:**

For starters, the Bill provides a mandatory registration. Clause 10 is the most important provision that provides that no MFI shall either commence or carry on the business of micro finance services without registration with the RBI. The key words are – microfinance institution, and micro finance services. Micro finance institution (MFI) is defined in clause 2 (f) to mean any entity which is engaged in providing micro finance services. Therefore, whether incorporated or not, if any entity provides microfinance services, it needs to come under the regulatory ambit.

The definition of "microfinance services" becomes critical. Clause 2 (g) defines microfinance services to mean any of micro credit, collection of thrift (again a defined term – see later), remittance, pension or insurance services, or other notified services. First of all, the word "micro credit" itself is not defined. As the definition connects with the regulatory ambit of the law, and therefore, goes into the very core of the enactment, it would be fatal to have a loose definition. First of all, there is no monetary limit to the definition of micro credit provided in the law – that is, loans of what amount are "micro credit", and beyond what amount they cease to be micro credit. Neither is there a definition by reference to who the borrower is - that is, whether loans to rural or urban or both borrowers would be micro credit. Since the word "credit" is not defined (the word "financial assistance" is defined, but that has not been integrated with the definition of "credit"), there would be questions as to whether a micro leasing service will be a micro credit? If a seller sells an asset, and provides for payment of the price on instalment, would that amount to micro credit? There is a power with the government to notify services that may be included in the definition of "micro finance services", but unfortunately there is no power to notify what is the monetary limit of lending upto which a financing is micro credit.

As for existing MFIs, a time frame of 3 months has been allowed to make application for registration. It would not be unexpected that when the date of enforcement of the Act is notified, there would be a mad rush to the RBI for registration – the like of which was seen in 1988 when NBFCs were registered for the first time. In case of MFIs – all the more a reason for the rush, as the net worth required for MFIs is only Rs 5 lacs. Besides, MFIs exist in most remote parts of the country – currently, they may not even be on the radar as they might be unincorporated bodies. Now they will rush for registration – the RBI is surely going to have a tough time.

The Bill also brings in the concept of "thrift" services. Thrift is defined in clause 2 (p) to mean collection of time deposits. This seems to suggest that the RBI is inclined to permit MFIs to accept deposits too – a long-felt need. There is a mention in the marginal notes below section 14 about thrift services, but it seems that that provision actually fell through the cracks somewhere along the way, as there is no substantive provision in the law about thrift acceptance

Regrettably, the overlap between NBFCs and MFIs remains under the Bill. It would be most illogical to have a company carrying out microfinance business being regulated both as an NBFC and as an MFI. However, Clause 11 (3) and (4) clearly suggest that such overlap will continue – which is a regrettable waste of regulatory attention. In fact, the Bill mandates that an MFI that becomes systematically important (based on a number of borrowers - the number to be notified by the RBI) will have to convert itself into a company. Once it converts, it obviously becomes an NBFC also.

## **Micro Finance Institutions Bill:**

**A bunch of  
Conceptual and  
Drafting problems**

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The draftsmen of the Bill has obviously used the NBFC provisions of the RBI Act – as is clearly indicated by the flow of provisions and the requirements for creating a reserve, etc.

Every MFI will require an audit, and will have to file periodic returns with the RBI.

The RBI has been given the power to notify directions applicable to NBFCs – including limitations on annual percentage rate, margin, etc

#### Minor Drafting problems:

Minor drafting problems abound. Take, for instance, the very first definition in the Bill – that of “annual percentage rate” – the definition fails to say that it is referring to the annual rate. It just defines the annual percentage rate as the “aggregate rate”, and not “aggregate rate per annum”. The same is also the problem with the definition of “margin” or the reference to the cost of funds – it nowhere says that the cost is an annual cost.

#### Operational controls on MFIs:

Besides registration, audit and reporting requirements, there are important controls on the operations of MFIs. One of the important provisions is the mandatory disclosure of the annual percentage rate being charged on loans – this would be “distinctly and prominently” disclosed in the loan document and the sanction letter. It is a different issue that most MFIs do not have anything called a sanction letter.

The compliance of this requirement, and that of the maintenance of the “margin” – that is, difference between (a) the annual percentage rate and (b) the cost of funds and the cost of operations, will also have to be certified by the auditor. The certification may be really really tough – for example, at what point of time does the auditor test whether the margin was maintained? One has to understand that the cost of funds and the cost of operations are not static. Even if one may annualize the cost of funds, anyone with slightest sense of finance would know that the cost of operations cannot be annualized. Cost of operations is a fixed or semi variable function. The law does not even provide for how to express the cost of operations as a percentage – percentage of what? Even one takes the unwritten meaning and takes it to mean percentage of total assets, what all costs are taken as operational costs is unclear. Also, it is purely rudimentary understanding that at the beginning stage of business, an entity’s cost of operations is always higher, as cost of operations has an inherent economy of scale. The cost of operations is different at the start of the year, and at the end of the year. One understands cost of operations as a financial concept, but to think of putting that into a law and regulating entities based on it, and also expecting auditors to certify the compliance with that regulation, there would be too many definitional uncertainties.

The concept of control on margins, based on cost of funds and operational costs, is not, in fact, a drafting problem – it is a conceptual problem that even the Malegam Committee also had.

Does it surprise anyone that the approval of the RBI will be needed not just to get born or remain alive, but also to die? Clause 27 says that no one can even wind up MFI services without the approval of the RBI. So what if the Bill makes it difficult to sustain and one has to wind up?

#### Developmental agencies:

The Bill provides for a Microfinance Development Council, and Councils at State level. The Council’s role is purely advisory – to advise the government on matters concerning the development of the microfinance sector. The Council will not have any regulatory role. The State councils are also advisory – though they get into complex questions of whether microfinance is resulting into excessive indebtedness, whether recovery practices being adopted by the MFIs are fair etc. In essence the Councils provide a political safeguard to the government which has faced scathing criticism on account of borrowers’ suicides and similar issues.

The Bill also provides for ombudsman, microfinance development fund, etc.

Click on this link to view the same article-

<http://www.microfinancefocus.com/microfinance-institutions-bill-%E2%80%93-bunch-conceptual-and-drafting-problems>

#### DID YOU KNOW?

The Microfinance Institutions (Development and Regulation) Bill, unveiled recently, envisions a larger regulatory role for the Reserve Bank of India and proposes that all microfinance institutions with net-owned funds of over Rs.5 lakh register with it. The RBI will define and fix what the Bill calls “an annual percentage rate”, to be charged by private MFIs, and also set the range within which it can operate.

Microfinance Focus, July 7, 2011: Finally, the Microfinance Institutions (Development and Regulation) Bill has been put up on the website of the Ministry of Finance. Though billed as ‘Development and Regulation’ Bill, we would be expecting the thrust of the Bill to mean on regulation, then on development. Also, as would be expected, the Bill is full of drafting problems and language inconsistencies, though it has had the benefit of the Malegam Committee recommendations.

Original of the Bill and its major drafting problems

# Regualatory news

- **Opening of Branch-Subsidiary-Joint Venture-Representative office or Undertaking Investment Abroad by NBFCs-**  
July 1, 2011  
<http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=6563&Mode=0>
- **Bank Finance to Non-Banking Financial Companies (NBFCs)-** July 1, 2011  
<http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=6550&Mode=0>
- **KYC Guidelines – Anti Money Laundering Standards - PMLA, 2002 - Obligations of NBFCs-** July 1, 2011  
<http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=6575&Mode=0>
- **Returns to be submitted by NBFCs-**July 1, 2011  
<http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=6578&Mode=0>
- **Miscellaneous Instructions to NBFC-** July 1, 2011  
<http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=6593&Mode=0>

The Deputy Transport Commissioner, Thiruvananthapuram noted that due to the lack of specification being mentioned under section 51 (1) of the Motor Vehicle Act, 1988, by the registering authorities in relation to the type of agreement, difficulties have been arising in fixing up the tax liability in appeal cases.

There are three distinct transactions covered under section 51 of the said Act, i.e. Hire Purchase, Lease and Hypothecation Agreement and the registering authority while making entry in the certificate of registration shall clearly mention the kind of transaction involved in the agreement.

- In case of an endorsement under hire purchase, the property is transferred from the vendor to the hire purchaser, on down payment whereas the title to the property transfers only on the payment of final installment.
- In the case of hypothecation agreement the transferee is having a charge over the property. It is a transaction similar to pledge.
- In case of a lease agreement the lessee gets the possession of the property for certain period of time and the transaction is governed by the lease agreement.

Therefore, as the three transactions have distinct characteristics, the tax implication of the same is different in each case and in case the registering authority does not make a proper entry in respect of the kind of agreement, it shall be difficult to assess the tax liability. In case of lease transaction, VAT is payable on the lease rentals by the lessee whereas in case of hire purchase VAT is payable on the hire purchase rentals or installments by the hire purchaser. Hence, all the registering authorities have been directed to specify the nature of transaction at the time of registering and issuing the Certificate of Registration.

See for more:

[www.kerelamvd.gov.in/images/mvd/circulars/2011/1\\_11.pdf](http://www.kerelamvd.gov.in/images/mvd/circulars/2011/1_11.pdf)

**Directions to the registering authorities in case of granting certificate of registration under agreement of hire purchase, lease and hypothecation**



## Lending to Micro, Small & Medium Enterprises (MSME) Sector



RBI vide master circular RBI/2011-12/83 on Lending to Micro, Small and Medium Enterprises (MSME) sector, on 1<sup>st</sup> July, 2011 which consolidates the instructions issued by the RBI up to June 30, 2011. The circular clearly excludes NBFCs in the priority sector categorization. Similar provisions have been mentioned in the master circular on priority sector lending on 5<sup>th</sup> July, 2011

[http://rbidocs.rbi.org.in/rdocs/Content/PDFs/107ANNO05071\\_1.pdf](http://rbidocs.rbi.org.in/rdocs/Content/PDFs/107ANNO05071_1.pdf)

Further the master circular mentions that any loan sanctioned to NBFCs w.e.f 1<sup>st</sup> April, 2011 for on lending, against gold jewelry, investment made by banks in securitized assets originated by NBFCs where the underlying assets are loan where the underlying assets are loans against gold jewelry and purchase/ assignment of gold loan portfolio from NBFCs would not be eligible for priority sector lending

<http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=6553&Mode=0>

Nidhi Bothra reviews on the same regulation. See the article below.

## Opening of Branch/Subsidiary/Joint Venture/Representative Office or Undertaking Investment Abroad by NBFCs

With an aim to regulate the credit system to the advantage of the country, the Reserve Bank of India vide notification no. RBI/2010-11/566, dated June 14, 2011 stated that the NBFC requires the prior approval of the concerned regulatory authorities both in India and abroad, to make an investment in an entity outside India engaged in financial services activities.

RBI issued to all NBFCs wherein it was advised that all NBFCs desirous of making any overseas investment must obtain 'No Objection' (NoC) of the DNBS of Reserve Bank before making such investment, from the Regional Office of the Bank in whose jurisdiction the head office of the company is registered. The amount of investment in financial sectors shall not exceed 100% of Net Owned Funds(NOF) of the NBFCs. RBI intends to control the financial exposures of Indian NBFC's abroad.

<http://rbidocs.rbi.org.in/rdocs/notification/PDFs/CC140611EL.pdf>

Aditi Jhunjunwala reviews on the same regulation. See the article below.



The National Credit Council in 1968 had slated the need and role of commercial banks for financing the priority sector to bring about financial inclusion. In view to give effect to this effort, banks were required to allocate a certain proportion of their net advances to agriculture, micro and small enterprises, micro credit, educational loans and housing loans, classified as priority sector.

Investments by banks in securitised assets, representing loans to various categories of priority sector, on lending to NBFCs were made eligible for meeting these targets, however it seems that banks in the garb of lending, achieving their priority sector targets are nothing but extending credit to NBFCs. In the monthly report on Sectoral Deployment of bank credit, February, 2011 credit growth to NBFCs at 46.4 per cent on a y-o-y basis in February 2011 was significantly higher than the growth of 19.8 per cent during the corresponding period of the previous year. On a financial year basis, credit to NBFCs increased by 39.9 per cent as compared with 9.7 per cent during the corresponding period of previous year. The ministry had apprehensions that the funds classified as priority sector lending were misused. Hence, by a notification, RBI, earlier during the year said that bank loans to NBFCs would not qualify for priority sector lending.

In the master circular on Lending to Micro, Small and Medium Enterprises (MSME) sector, on 1<sup>st</sup> July, 2011 and in master circular on priority sector lending on 5<sup>th</sup> July, 2011 NBFCs are clearly excluded from priority sector categorization and investments by banks in securitized assets and purchase of loan assets originated by *banks and eligible financial institutions* have been made eligible for priority sector lending. Since financial institutions cannot be taken to be NBFCs, RBI has been very clear in its intent on keeping NBFCs away from priority sector and this circular comes as a big blow to the growth of the sector.

Further the master circular mentions that any loan sanctioned to NBFCs w.e.f 1<sup>st</sup> April, 2011 for on lending, against gold jewelry, investment made by banks in securitized assets originated by NBFCs where the underlying assets are loan, against gold jewelry and purchase/ assignment of gold loan portfolio from NBFCs would not be eligible for priority sector lending.

Though NBFCs have been playing a complimentary role to the banks, in our view, the very idea of priority sector lending is a breeding ground for manipulation. Several gold loans, auto vehicle loans provided by NBFCs have been classified as priority sector and funded by banks, defeating the very essence of financial inclusion. If the government's concern was to channelize the funds to such finance deprived sectors, it could think of incentivizing banks for financing such sectors. The ministry should take a relook at the priority sector lending norms itself.

This article can be viewed at-

<http://www.india-financing.com/RBI%20rules%20out%20NBFCs%20from%20priority%20sector.pdf>

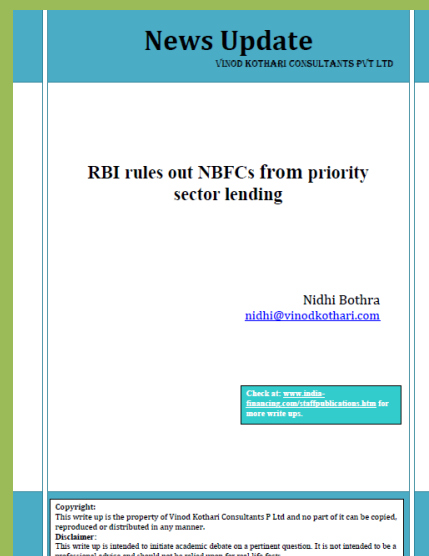
## No, no Non Banking Finance Companies

– RBI denies priority sector to NBFCs origination

--By Nidhi Bothra

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# RBI Gets Stringent on Overseas Business of NBFCs: Regulator puts restrictions on overseas subsidiaries and JVs of NBFCs

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In the recent past, NBFCs have had several pieces of bad news – here is one more. The RBI has put restrictions on overseas direct investment (ODI) in case of NBFCs. Compared to the previous regime which did not make distinction between NBFCs and non-NBFCs or non-banking non-financial companies (NBNFCs), the new directions limit the scope for overseas investment to 1/4<sup>th</sup> of what it earlier was. Besides, there is no scope for automatic approval for investment by NBFCs, as NBFCs will have to obtain prior no objection certificate of the RBI for making investments overseas.

The change above has come in form of Non-Banking Financial Companies (Opening of Branch/Subsidiary/Joint Venture/Representative Office or Undertaking Investment Abroad by NBFCs) Directions, 2011(Directions) on 14 June 2011<sup>1</sup>. Accordingly, no NBFC (both deposit taking and non-deposit taking) shall open any branch/subsidiary/Joint Venture/Representative Office or make any investment abroad, without the prior NOC of RBI. The directions prescribe specific and general conditions for such investment.

## Background

Overseas direct investment (ODI) is covered by general Master Circular on Direct Investment by Residents in Joint Venture (JV)/ Wholly Owned Subsidiary (WOS) abroad. Prior to the specific directions on NBFCs as per the Directions above, there was no separate set of guidelines applicable to NBFCs. Hence, NBFCs were covered by the Master Circular as in case of NBNFCs.

The Directions are not novel but the formalization of RBI's draft Guidelines for extending NOC for opening Branch/Subsidiary/Joint Venture/Representative Office or make any investment abroad issued in 2008. The Guidelines too prescribed for General and Specific provisions. In the precedent years NOC was granted on case to case basis in line with the draft guidelines. Though, nothing new, the Directions issued now are much more detailed and comprehensive in nature. Hence, it lays clear regulatory requirements for obtaining such NOC and making investment. The Directions are also in addition to those prescribed by Foreign exchange department (FED). The FED general conditions are contained in the Master Circular.

Further, as per the Master Circular dated May 3, 2010 RBI had clearly communicated its intent that any NBFC desirous of making any overseas investment is to receive NOC from DNBS of RBI. The said regulations were formulated as it was observed by the department that few NBFCs were making overseas investment without obtaining such regulatory clearances as specified. Any investment now made without such clearance is in contravention to the provisions of FEMA 2004 and attracts penal provisions.



### General Conditions

The Directions as mentioned above lay some General conditions for opening branch/subsidiary/Joint Venture/Representative Office or make any investment abroad. Some of them are:

- No investment is permitted in non-financial sectors
- No direct investment allowed in activities prohibited by FEMA or in sectoral funds
- Investment allowed only in entities having their core activities regulated by financial sector regulator in host jurisdiction or country
- Aggregate overseas investment not to exceed 100% of their NOF, i.e. Aggregate investment < 100% NOF
- Investment in single entity, including step down subsidiaries < 15% of NBFC's owned fund. The same to be by way of equity or fund based commitment
- CRAR requirement post investment
  - For deposit taking NBFC, should not be less than applicable as per Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank Directions, 2007; as amended from time to time
  - For non-deposit taking NBFCs (other than NBFC-ND-SI), investment in subsidiary abroad should not be less than 10%; as modified from time to time
  - For NBFC-ND-SI should not be less than applicable as per Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank Directions, 2007; as amended from time to time
- Level of Non-Performing Assets < 5% of net advances
- There should be profit incurred by NBFC in the last three years along with a satisfactory performance
- NBFC to also comply with regulations of FEMA 1999
- Compliance with the KYC norms
- Depending on the %age of investment in overseas entity, any SPV set up abroad or acquisition abroad to be treated as investment/subsidiary/joint venture
- Compliance of the Direction to be certified annually from the statutory auditors and to be submitted to the Regional Office of DNBS
- Quarterly return in the prescribed format is also to be submitted to the Regional Office of the DNBS and Department of Statistics and Information Management. Such return contains various disclosures in terms of CRAR, NOF, amount of remittances, cumulative investment, financial details etc.

### Specific Conditions

The Directions no more permit NBFCs to open branches abroad. However, existing branches shall be permitted to continue subject to the compliance of the conditions specified in the Directions. Some of the important specific conditions are:

- In case of opening a subsidiary /joint venture abroad, the parent NBFC not permitted to extend any implicit or explicit guarantees to or on behalf of such subsidiary/joint venture
- Liability of the NBFC in the proposed overseas entity to be restricted to its either equity or fund based commitment. The same to be disclosed in the subsidiary's/joint venture's Balance Sheet
- The subsidiary/joint venture should not be shell companies. However, activities such a financial consultancy and advisory services with no significant assets are an exception
- The subsidiary/joint venture should not be used as a vehicle for raising resources for creating assets in India
- The parent NBFC to obtain periodical reports/audit reports about the business activity undertaken by the subsidiary and such reports to be made available to RBI and its inspecting officials
- NBFC shall set a representative office abroad for the purpose of liaison work, market study and research and not for any activity involving outlay of funds, provided it is subject to regulation in the host country

The Directions are effective from the date of their issue. The Directions have been issued for the purpose of enabling the banks to regulate the credit system to the advantage of the country. The violation of these Directions shall invite penal action under provisions of RBI Act, 1934.

### Investments by and in NBFCs and NBNCs

A comparative statement on investment abroad by a NBFC and a Non-NBFC, into an NBFC and NBNC, is shown by the Table below:

Investing Co →	<b>NBFC</b>	<b>NBNC</b>
Investee Co ↓		
<b>NBFC</b>	Investment not to exceed 100% of NoF	Investment to be subject to the conditions in Regulation 7 in terms of registration and all other provisions as applicable to NBFCs
<b>NBNC</b>	Investment Prohibited	No Prohibition

A comparative statement of the restrictions and permissions in case of investment abroad as referred in the above statement is briefed in the table below:

PARTICULARS	Investment by NBFCs	Investment by NBNC
<b>Amount of Investment allowed</b>	Aggregate overseas investment not to exceed 100% of the NoF	<ul style="list-style-type: none"> <li>• Upto 400% of the net worth. The limit includes-               <ul style="list-style-type: none"> <li>-Contribution to capital</li> <li>-Loan Granted</li> <li>-100% of the guarantees other than performance guarantee</li> <li>-50% of performance guarantee                   <ul style="list-style-type: none"> <li>• Investment by Proprietorship/unregistered partnership exporter firm</li> </ul> </li> <li>-Amt of investment not exceeding 10% of av. Export realization or 200% of its net owned fund</li> </ul> </li> </ul>
<b>Extension of Guarantees</b>	NBFCs opening subsidiary abroad cannot extend guarantees	The Indian party is allowed to extend CG also to their first level step down by their JV/WOS abroad, under Automatic Route, within the limit specified
<b>Investment in single entity and group company</b>	Investment in single entity including step down not to be more than 15% of NBFCs own funds	No such limit prescribed
<b>Method of Funding</b>	-Equity -Fund based Commitment	-Capitalization of exports -swap of shares -Proceeds of ECB/FCCBs -In exchange of ADRs/GDRs -balance held in EEFC account -proceeds of foreign currency raised through ADR/GDR -Drawal of foreign exchange from AD bank in India (Para B.3)
<b>Mode of Investment</b>	No such route prescribed so do the general guidelines prevail?	Under-Automatic Route Approval Route
<b>Requirement of CRAR</b>	<p>For <b>NBFC-D</b>- not less than 12% (such ratio shall not be less than 15% by March 31, 2012)</p> <p><b>For NBFC-ND-SI</b>-15% (was 12% until 31.3.2010 and should have been 15% by 31.3.11)</p> <p><b>For NBFC-ND</b>-(other than NBFC-ND-SI) should not be less than 10%</p>	No such requirement except in case of investment in Financial sector, which is guided by the Prudential norms of the regulatory authority concerned.
<b>Operational Limits</b>	NBFC to maintain required level of NoF after accounting for investment-Sec 45-IA	No such requirement
	NBFCs liability in the proposed	Guarantees are allowed

	overseas entity restricted to equity or fund based commitment. Non-fund-based support, for example, guarantees and derivatives are not allowed.	
<b>Whether approval of the RBI required or automatic investment?</b>	Investing company to get NoC from DNBS, RBI prior to making of investment	No such requirement except in case of investment in financial sector, where prior approval is required
<b>Branch restrictions</b>	NBFCs not to open a branch abroad	Making investment in foreign entity engaged in real estate or banking business subject to prior approval of RBI
<b>Level of NPAs</b>	Not exceeding 5% of net advances	No such requirements
<b>Writing off capital</b>	No such provision; however, we are of the view that the restrictions applicable to non-financial companies will apply here too	Indian party setting up WOS/JV may write off the capital or other receivables subject to limit of 25% in case of listed companies under automatic route, and 25% in case of unlisted companies under approval route, subject to reporting to RBI
<b>Disinvestment</b>	No such mode prescribed. However, we are of the view that the procedure applicable to non-financial companies is applicable	Modes of disinvestment are transfer, write off, hedging

The above article can be viewed at <http://india-financing.com/Article%20RBI%20Gets%20Stringent%20on%20Overseas%20Business%20of%20NBFCsregulator%20puts%20restrictions%20on%20investment%20abroad.pdf>



# What is an NBFC?

The financial sector in any economy consists of several intermediaries. Apart from banking entities, there are investment intermediaries (such as mutual funds, hedge funds, pension funds, and so on), risk transfer entities (such as insurance companies), information and analysis providers (such as rating agencies, financial advisers, etc), investment banks, portfolio managers and so on.

All such entities that offer financial services other than banking, may be broadly called non-banking financial institutions. What is banking? Banking is commonly understood to mean taking of deposits withdrawable on demand or notice - that is, banks can hold people's deposits and promise to pay them on demand. There are varieties of other entities that may accept deposits - hence, acceptance of deposits is not the essence of banking.

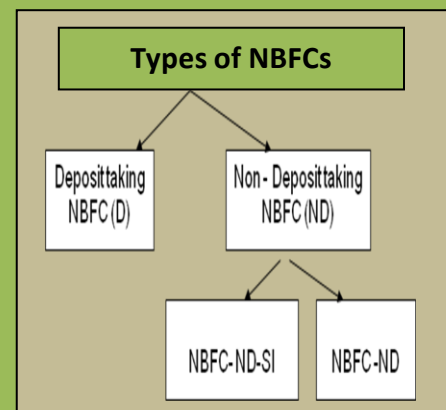
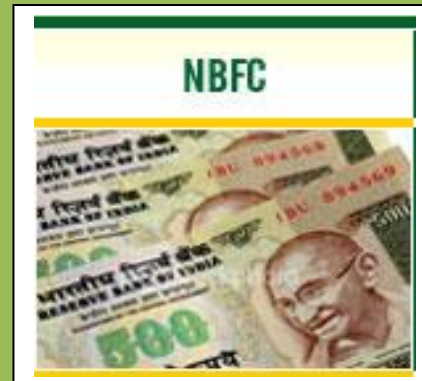
In India, the term "non-banking financial companies" acquires a new meaning, and a huge significance. The meaning of the term is such entities which are not banks, and yet carry lending activities almost at par with banks. They may also accept deposits - however, these deposits are term deposits and not call deposits.

The significance of non-banking financial companies in India lies in the massive capabilities of NBFCs - short of acceptance of call deposits and remittance function, NBFCs can virtually do everything that a bank can. Compared to this disability, the ease of entry and lightness of regulation applicable to NBFCs makes it a tremendous focus of interest, particularly for foreign investors wanting to enter India's financial sector.

For instance, it is possible to hold 100% foreign ownership of NBFCs, while in case of banks, there are serious caps.

It is possible to either start an NBFC or buy one of the 17000-odd companies many of which are formed for sale. On the other hand, getting a banking license requires a real penance.

For articles and presentations on NBFCs log on to <http://www.india-financing.com>



# Money Pros & Cons

- Money can't buy you happiness but it does bring you a more pleasant form of misery. — Spike Milligan
- Whoever said money can't buy happiness simply didn't know where to shop
- Money can't buy friends, but you can get a better class of enemy.
- A bank is a place that will lend you money if you prove that you don't need it.
- Money is better than poverty, if only for financial reasons
- The hardest thing in the world to understand is income tax. — Albert Einstein
- Finance is the art of passing currency from hand to hand until it finally disappears.
- Money can't buy you happiness
- Fear of not being able to teach their children to appreciate the value of a rupee
- Balancing family and business: it's hard to spend time with your children if you're busy running the family empire 7 days a week



*Do you think 'the pros and cons of being wealthy' are in balance? What do you choose?*