SAMPADA

News and views on Non-Banking Financial Services

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Editorial:

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

The NBFC sector globally and in India is the centerpiece of attention again. Globally, the Financial Stability Board, an international body of banking regulators to ensure stability of the financial system, is examining so-called "shadow banking, that is, banking-like services which are not regulated as such, and we are of the view that this would include NBFCs too.

In India, the gap between banking and non-banking companies will get narrowed, as RBI has opened up its to allow banking licenses to NBFCs. In addition, the Usha Thorat panel has made important recommendations to narrow the regulatory arbitrage between NBFCs and banks.

Sampada, the newsletter continues to bring you to speed on what is happening on NBFC sector, not just in India, but globally. So, stay tuned.

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FULL-THROTTLE REFORM OF NBFC REGULATION CREATES SEVERAL POTENTIAL ISSUES

-By Vinod Kothari
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The report of the Working Group (WG) headed by Smt. Usha Thorat has done a wonderful job and put together a remarkable report which, if accepted, would make NBFC regulation sensible in the country. It is not for the first time that an attempt for a complete overhaul of the regulatory regime has been attempted. In 2003, the Finance Committee of the Parliament had made recommendations on a Financial Companies Regulation Bill[1] which has since never been acted upon. The Parliamentary Committee had also made sweeping suggestions – including the point that investment companies should be completely excluded from the regulatory ambit of NBFCs.
In fact, India is one of the few countries which are regulating investment companies and financial companies under the same regulatory regime, whereas the nature and business of investment companies may be totally different. It is for this reason that we have a mass of more than 12000 NBFCs registered and being regulated by the RBI. At the point when NBFC registration regime was first implemented, there were well over 37000 companies registered as NBFCs, since, going by the way the definition is laid down, even a husband-and-wife company investing self-owned funds into stock markets will be said to be an NBFC, where the RBI must step in to protect the shareholders from the shareholders.

De-registration based on size:

The WG has not gone into the question of what an NBFC is, and what business would make a company an NBFC. However, the WG has recommended de-registration of all non-depository companies with asset size of Rs 50 crores or below. This would prima facie be a great relief for smaller investment companies. But then, there are fall-out problems. For instance, the Motor Vehicles authorities in several Southern states have come up with rules that registration of a motor vehicle with endorsement of a hypothecation in the name of an NBFC will not be allowed, unless the NBFC is RBI-registered. So, as RBI de-registers NBFCs of less than Rs 50 crores in assets, smaller companies would practically be forced out of vehicles finance business.
There is a welcome measure introduced – to regulate NBFCs with asset size of less than Rs 1000 crores only if they have "public funds", including funds from banking channels.

Principality definition:

There is yet another significant change proposed – changing the definition of "principal" business for NBFC registration. We have commented on several occasions earlier that the administrative definition of the RBI capturing 50% of income and assets for NBFC definition is at best an issue of administrative convenience, and cannot be applied mechanically. The WG suggests that this threshold should be moved up to 75%, which is quite a welcome step. If 50% were the criteria, an entity formed as NBFC may effectively carry substantial amount of non-financial business, and still retain NBFC classification.

[1.] *http://164.100.24.208/ls/committeeR/finance/45.pdf*

It is notable that the Dodd Frank Act in the USA has put a threshold limit of 85% for a company to be regarded as non-bank financial company.

Pre-empting Basle III

The WG brings in a new concept of liquidity ratio – which is a part of Basel III recommendations. Basel III is still a few years away for banks in the world, but the WG has already introduced a liquidity ratio based on 30 days' cashflows. In principle, the stipulation is prudentially important, as it helps to maintain better asset liability management.
There is quite an important point that the WG makes – tax deduction for provisions made by NBFCs. Currently, NBFCs make provisions for NPAs as required by RBI directions, but they do not get any tax deduction for the same. A Supreme Court ruling had also declined such tax benefits. The WG suggests parity between banks and NBFCs in terms of tax deductibility – something that would require amendment of the Income-tax law.

Corporate governance:

Corporate governance has become the buzzword these days, and the WG report is also full of references to application of corporate governance and disclosure norms to NBFCs whether they are listed or not. This measure is also welcome.

This article can be viewed at http://www.microfinancefocus.com/full-throttle-reform-nbfc-regulation-creates-several-potential-issues

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Full-throttle Reform of NBFC Regulation creates several potential issues

In column India top

By Vinod Kothari,

Microfinance Focus, August 30, 2011: The report of the Working Group (WG) headed by Smt. Usha Thorat has done a wonderful job and put together a remarkable report which, if accepted, would make NBFC regulation sensible in the country. It is not for the first time that an attempt for a complete overhaul of the regulatory regime has been attempted. In 2003, the Finance Committee of the Parliament had made recommendations on a Financial Companies Regulation Bill[1] which has since never been acted upon. The Parliamentary Committee had also made sweeping suggestions – including the point that investment companies should be completely excluded from the regulatory ambit of NBFCs.

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His main areas of scholarship are international finance and capital markets, bankruptcy and commercial law where he brings the unique perspective of having been a leading practitioner as well as a scholar.

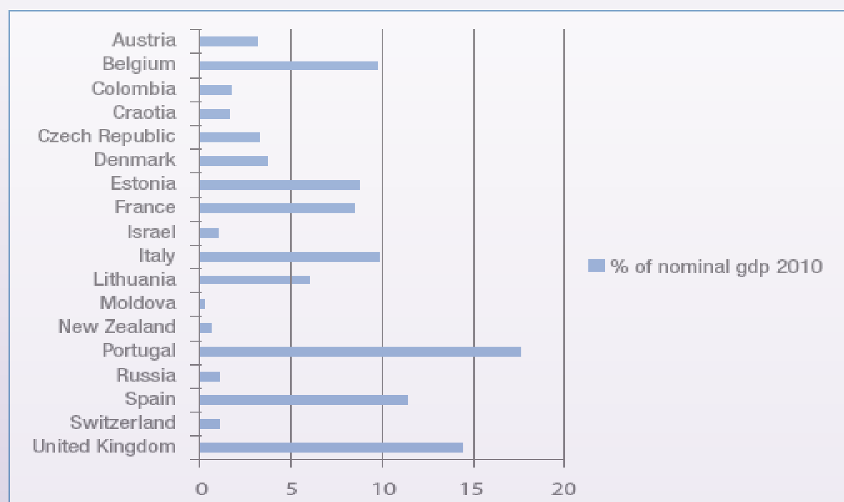
In his recent article "**Helping Microfinance Become Commercially Sustainable**", the prolific writer has separately argued that microfinance lending can benefit through securitization. It also states that to successfully securitize microfinance loans, the MFI originating the loans would have to transfer the loans to the SPV. That transfer will often have to constitute a sale. He highlights on the problem of the forms of securitization under commercial law and the ways by which securitization can be applied to microfinance.

VK

Credit Factoring or simply factoring is an asset backed means of financing (tripartite agreement between the buyer, seller and the factor), whereby the account receivables are assigned to a third party called factor for a discount, releasing the tied-up capital and providing financial accommodation to the Company. The origin of factoring goes back to 14th century in England. Earlier, factoring was confined to textile and garment industries, but later was spread across various industries and markets. Factoring has been defined as:

> "Credit factoring may be defined as a continuing legal relationship between a financial institution (the "factor") and a business concern (the "client") selling goods or providing services to trade customers (the "customers") whereby the factor purchases the client's book debts either without or with recourse to the client, and in relation thereto controls the credit extended to customers and administers the sales ledger."

Though Europe provides largest volumes globally, factoring in Asia has been growing rapidly in the last few years. The penetration rate[1] of factoring in various countries is as below:



The purport of factoring is to assign the account receivables to be able to a) instantly convert receivables into case, that enable the companies to have funds to finance the day to day operations of the company, b) helps in efficient collection of the receivables and protection against bad debts, c) outsourcing sales ledger administration and d) availing credit protection for receivables

Typically in a factoring transaction, a seller gets a prepayment limit from the factor, then enters into a transaction with the buyer and submits the invoice; notice to pay etc to the factor. The factor makes upfront payment to seller, as a percentage of invoice value based on criteria, such as, quality of receivables, number and quality of the buyers and your requirements (80% - 95% of invoice value) and maintains the sales ledgerof the seller and collects payment from buyer. The balance payment is made to the seller, net of charges. The seller is not be required to open an LC or a bank guarantee. The cost to the seller in factoring is the service fees, which is dependent on a) sales volume, b) number of customers, c) number of invoices and credit notes and d) degree of credit risk in the customer or the transaction.

[1] IFG, March, 2011 Newsletter, http://www.ifgroup.com/files/images/data/020110331145023newsletter

ARTICLE

LEGAL ISSUES ON FACTORING BUSINESS IN INDIA

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Factoring and Bill Discounting

There is a very thin line of difference between factoring and bill discounting. Bill discounting unlike factoring is always with recourse to the client, whereas factoring may be with recourse or without. Generally there is no notice of assignment given to the customer in case of bill discounting and collections are done by the lender, unlike factoring, where debt collection is done by the factor. Factoring can be called a financing and servicing function, whereas, bill discounting function is purely financial.

Types of Factoring

On the basis of geographical distribution

1. Domestic Factoring
    a. Sales bill factoring
    b. Purchase bill factoring
2. International Factoring – As international trade continues to increase, international factoring is being accepted as vital to the financial needs of the exporters and is getting the necessary support from the government, specifically in the developing countries to stimulate this mode of funding.
    a. Export factoring – It is seen as an alternative to letter of credit, as the importers insist on trading in open account terms. Export factoring eases the credit and collection troubles in case of international sales and accelerates cashflows and provides liquidity in the business.

On the basis of credit risk protection

- On recourse basis, wherein the factor can recover the amount from the seller, in case of non-payment of the amount to the factor. Thus, though the receivables have been assigned, the credit risk remains with the client.
- On non-recourse basis also called *old line* factoring, wherein the risk of non-payment of invoices is borne by the factor. However, the factor only bears credit risk in such transactions. In case non-payment is due to any other reason other than financial incapacity, the factor

Other types:

- Advance factoring: In case of advance factoring, the factor provides financial accommodation and non-financial services. The factor keeps a margin while funding, which is called the client's equity and is payable on actual collection.
- Maturity factoring: Here, the factor makes payment on a due date. This sort of funding is resorted to by clients who are in need of non-financial services offered by the factors.
- Supplier guarantee factoring: Also known as drop shipment factoring. This sort of factoring is common where the client acts as a mediator between the supplier and the customer.

Overview of factoring in India:

India's factoring turnover in 2009 was around Euros 2500 Million in domestic and Euros 2650 million in total as compared to a total of Euros 1,283,559 million worldwide[2] and the turnover over the last 7 years has seen a tremendous growth and steep downfall as well; while that of Asia has risen 219% from 2004 to 2010 and is valued at $637 billion. Some of the challenges faced by the factoring companies in India are a) there was no specific law for assignment of debt, b) there was no recovery forum available to the factoring NBFCs such as DRT or under Sarfaesi Act, c) Lack of access to information on credit worthiness and d) assignment of debt involves heavy stamp duty cost.

UNICITRAL laws on assignment

The United Nations Convention on the Assignment of Receivables in International Trade was adopted to facilitated availability of credit and capital. Article 2 of the Convention defines Assignment as –

> *"Assignment" means the transfer by agreement from one person ("assignor") to another person ("assignee") of all or part of or an undivided interest in the assignor's contractual right to payment of a monetary sum ("receivable") from a third person ("the debtor"). The creation of rights in receivables as security for indebtedness or other obligation is deemed to be a transfer;*

The definition covers both the creation of security rights in receivables and the transfer of full property in receivables, whether or not for security purposes. Further, the Convention defines receivables as contractual right to payment of a

[2] *Data from Factors Chain International* http://www.factors-chain.com/?p=ich&uli=AMGATE_7101-2_1_TICH_L1403780046

monetary sum and includes parts of and undivided interests in receivables. Also included are loan receivables, intellectual property licence royalties, toll road receipts and monetary damage claims for breach of contract, as well as interest and non-monetary claims convertible to money. The term does not include a right to payment arising other than by contract, such as a tort claim or a tax refund claim. The Convention generally does not apply to domestic assignments of domestic receivables, but some of the clauses as stated are relevant adaption and include the following:

- Notice of assignment of receivables is required to be given to the debtor and is effective when received by the debtor. An assignment does not affect the rights and obligations of the debtor, without the consent of the debtor.
- The assignee may not retain more than the value of its rights in the receivables.
- The assignor makes representation that the debtor shall not have the right of set-off.
- The law of the State in which the assignor is located governs the priority of the right of an assignee in the assigned receivable over the right of a competing claimant.
- The Annex to the convention states that the
    - Right of an assignee in an assigned receivable has priority over the right of an insolvency administrator and creditors who obtain a right in the assigned receivable by attachment, judicial act or similar act of a competent authority.
    - The registration system should be operative to register details with regard to the assignor, assignee and brief description of the assigned receivables and may be with regard to existing or future receivables.
    - The priority of the right of an assignee in the assigned receivable is determined by the order in which notification of the respective assignments is received by the debtor.

As the Convention is a model law, it does not contain a uniform substantive law rule as to the formal validity of the assignment, but is indicative of the aspects to be covered in assignments.

The Regulation of Factor (Assignment of Receivables) Bill, 2011

In order to revive the business and render liquidity specifically to the small and medium enterprises, the Finance Minister in the last Parliament session had tabled a pilot bill to bring the factors business in India under regulation.
While the intent of the Bill may be to stimulate the growth of factoring business in India, but a close look at the Bill does not enumerate so. The Bill is a regulation Bill, but the much need is for a Bill to promote factoring and not so much to regulate. Some of the highlights of the Bill are as mentioned below:

- The Regulation of Factor (Assignment of Receivables) Bill, 2011, the name makes it unclear whether the Bill is for regulating assignment; factoring or both. Further it should have been a regulation of factor's' and nor factor, to be more appropriate.
- Section 2 (a) of the Bill defines *assignment means transfer by agreement, of **undivided interest** of any assignor in **any receivables** due from any debtor…*The definition talks about undivided interest to be assigned only and does not consider assignment of fractional interest within its ambit. This would mean that any assignment of fractional interest would not be covered under this definition. Further whether the assignment could be in terms of money, in terms of time or rate of interest is not clear from the definition.
- The definition of receivables, in Section 2(p) of the Bill includes futures receivables as well, which is in line with international laws.
- Section 3(1) of the Bill says –

    No Factor shall commence or carry on the factoring business unless it obtains a certificate of registration from the Reserve Bank to commence or carry on the factoring business under this Act.

    The definition should have said *no '**person**' shall commence or carry on the factoring business* rather than using the term factor. A person shall only become a factor after obtaining a certificate of registration from the Reserve Bank as the section suggests. However the section already terms such person as factor, making the definition circular.
- Section 3(3) of the Bill states every company carrying or commencing factoring business to be registered with RBI, and such companies would be classified as NBFCs and all the provisions applicable to NBFCs would be applicable here as well. Section 3(4) requires existing NBFCs to take a fresh certificate of registration, if they are principally engaged in the business of factoring. However the question to be considered is whether companies

carrying out the business of factoring can be classified as NBFCs as per the definition provided in Section 45I(c) and Section 45I (f) of the Reserve Bank of India Act, 1934. The definition of a financial institution as stated in the Act is:

1[(c) ''financial institution'' means any non-banking institution which carries on as its business or part of its business any of the following activities, namely:–

(i) the financing, whether by way of making loans or advances or otherwise, of any activity other than its own:

XXX

4[(f) ''non-banking financial company'' means–

(i) a financial institution which is a company;

(ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;]

Section 45I (c) requires the companies to carry on the business of financing, apart from other businesses listed to be classified as a non banking financial company. The question for consideration here is whether factoring business, is a business of financing or insurance. We have discussed this issue in detail below.

- Section 7(3) states that in case the receivables are encumbered to any creditor, the assignee shall pay the consideration for such assignment to the creditor to whom the receivables have been encumbered. In case of fixed charge created over assets, the provisions of this section are well thought, as, if the consideration was paid to the assignor, it would have resulted in double funding. However in case of floating charges, this would render several difficulties for the assignor. Most companies have fixed and floating charges created over their assets, the assets on which floating charge is created are regularly rotated in business and are only crystallized in case of default or non-payment, thus it would be difficult to crystallize the assets by the factor and the creditor to whom assets are encumbered and floating charge is created.
- Section 8 of the Bill requires the notice of assignment to be given to the debtor, without which the assignee shall not be entitled to demand payment of the receivables from the debtor. However Section 7(2) of the Act, makes Section 8 redundant, as it states that on execution of agreement in writing for assignment of receivables, the assignee shall have '*absolute right to recover such receivable and exercise all the rights and remedies of the assignor whether by way of damages or otherwise, or whether notice of assignment as provided in sub-section (1) of section 8 is given or not.*' This is not on line with the proviso to Section 130 (1) of the Transfer of Property Act, 1882 which mandates that the assignee will be able to entitle to recover or enforce the debt when the debtor is made party to the transfer or has received express notice of such an assignment and also as stated in the UNCITRAL model law on assignment.
- Section 8, 9 and 10 provide for the requirements of notice of assignment. The intent of Section 11 seems that even in case notice of assignment is not provided the debtor would not be absolved from his duties to make payment. However the section is worded as '***till notice is served** on the debtor, the **rights and obligations** in its contract with the assignor, **shall remain unchanged, excepting the change of the party to whom the receivables are assigned** which may become entitled to receive the payment of the receivable from the debtor;*' this means whether or not notice for assignment is provided the rights and obligations of the debtor towards the assignee would remain unaffected. If so was the intent of the Section, then there was no need for any notice of assignment to be given to the debtor, as by the virtue of this section read with section7(2), the assignee would have all the right on receivables as that of the assignor. The UNCITRAL model law on assignment requires that notification of assignment of debt is to be given by either the assignor or the assignee, the assignee may not retain more than the value of its right in the receivable and notification of the assignment or a payment instruction is effective when received by the debtor. However, until the debtor receives notification of the assignment, the debtor is entitled to be discharged by paying in accordance with the original contract.
- Import factoring is not permitted as per Section 31(1) of the Bill
- Further recourse to the assignor is not permitted under the Bill.
- The proposed law provides for compulsory registration of every transaction of assignment of receivable with the Central Registry to be set up under the SARFAESI Act within a period of 30 days.

True sale or mere financing?

The factoring business in India was carried out on both with recourse and without recourse basis prior to the Bill. The question for consideration is whether factoring is an agreement of true sale or mere mode of financing in the garb of transfer of receivables. In one of the landmark judgment's of Major's Furniture Mart, Inc v. Castle Credit Corporation, 602 F.2d 538; 1979 U.S. App. LEXIS 13808; 26 U.C.C. Rep, the question in consideration in the case was whether the transaction was a true sale or mere financing. Major's was into retail sale of furniture and Castle into the business of financing such dealers as Major's. Under an agreement, Major's had sold its receivables to Castle, with full recourse against Major's. The Court held the assignment of receivables by the furniture seller to the factoring company a case of financing and not assignment, as the factor had full recourse on the seller and the factor only paid a part of the total debt factored by him.

In another case of Endico Potatoes, Inc., and others vs. CIT Group/Factoring, Inc., Second Circuit Nos. 1751, 1961 Decided: October 2, 1995, in case of a factoring transaction, the court opined:

> "Resolution of whether the "contemporaneous transfer," as CIT describes Merberg's assignment of accounts receivable to CIT and CIT's loan advances to Merberg, constitutes a purchase for value or whether the exchange provides CIT with no more than a security interest, depends on the substance of the relationship between CIT and Merberg, and not simply the label attached to the transaction. In determining the substance of the transaction, the Court may look to a number of factors, including the right of the creditor to recover from the debtor any deficiency if the assets assigned are not sufficient to satisfy the debt, the effect on the creditor's right to the assets assigned if the debtor were to pay the debt from independent funds, whether the debtor has a right to any funds recovered from the sale of assets above that necessary to satisfy the debt, and whether the assignment itself reduces the debt.
>
> Major's Furniture Mart, Inc. v. Castle Credit Corp. , 602 F.2d 538, 543-46 (3d Cir. 1979); Levin v. City Trust Co. , 482 F.2d 937, 940 (2d Cir. 1973); Hassett v. Sprague Electric Co. , 30 B.R. 642, 647-48 (Bankr. S.D.N.Y. 1983); In re Evergreen Valley Resort, Inc. , 23 B.R. 659, 660-61 (Bankr. D. Me. 1982). The root of all of these factors is the transfer of risk. Where the lender has purchased the accounts receivable, the borrower's debt is extinguished and the lender's risk with regard to the performance of the accounts is direct, that is, the lender and not the borrower bears the risk of non-performance by the account debtor. If the lender holds only a security interest, however, the lender's risk is derivative or secondary, that is, the borrower remains liable for the debt and bears the risk of non-payment by the account debtor, while the lender only bears the risk that the account debtor's non-payment will leave the borrower unable to satisfy the loan.

In a more recent case[3] of Re: Qualia Clinical Service, Inc v. Inova Capital Funding, LLC; Inova Capital Funding, Inc, the bankruptcy appellate panel for the eighth circuit found that the invoice purchase agreement was clearly and unambiguously a financing arrangement. The court made that finding on the terms of the agreement itself. In particular, the court noted that, the recourse provisions contained in section 7.02 of the agreement, which shift all collection risks to Qualia.

> "….. "The question for the court then is whether the Nature of the recourse, and the true nature of the transaction, are such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing transaction or to a sale."
>
> This agreement, which shifts all risk to Qualia, is a disguised loan rather than a true sale. Where the "seller" retains "virtually all of the risk of non-collection," the transaction cannot properly be considered a true sale.

If the assignment alone did not reduce the obligation of the assignor towards the assignee and the assignee at any given point of time, directly demand the money from the assignor, there is no transfer of risk. If the primary risk of customer's non-payment remained with the assignor, then it cannot qualify as a true sale.

[3] *http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202482639423&slreturn=1&hbxlogin=1*

FIRST PRIVATE NBFC NOTIFIED AS PUBLIC FINANCIAL INSTITUTION

The Central Government has notified L&T Infrastructure Company Limited as a Public Financial Institution (PFI) under section 4A (2) of the Companies Act, 1956. It is one of the first private Non Banking Financial Company (NBFC) to be notified as a Public Financial Institution. Notification No. S.O.1355 (E), dated 10-6-2011

Other NBFC falling under this category are as follows:

- Gujarat Industrial Investment Corporation Limited
- Andhra Pradesh Industrial Development Corporation Limited
- Karnataka Urban Infrastructure Development and Finance Corporation Limited

NBFCs are not covered under the SARFAESI Act, 2002 but by virtue of being classified as a PFI u/s 4A of the Companies Act, 1956, they get covered under the definition of financial institution for the purpose of SARFAESI Act, 2002.

Prior to the amendment, the Central Government notified institutions as PFIs if it satisfied any of the following conditions stated under 4A (2):

(i) It has been established or constituted by or under any Central Act;
(ii) Not less than 50% of the paid up share capital of such institution is held or controlled by the Central Government.

Recently, Ministry of Corporate Affairs has laid down guidelines for declaring financial institution as Public Financial Institution under Section 4A of the Companies Act, 1956 vide General circular no. 34/2011 dated 2-06-2011. Hence every financial institution applying for declaration as PFI shall fulfill the following criteria:

- It should be established under a Special Act or Companies Act being Central Act
- The net worth of the Company should be rupees one thousand crore
- Their main business should be infrastructure or industrial financing
- It must be in existence for at least 3 years also their income from industrial/infrastructure financing should be exceeding 50% of their income
- The company is registered as Infrastructure Finance Company with RBI or as an Housing Finance Company with National Housing Bank
- In the case of CPSUs/SPSUs, no restriction shall apply with respect to financing specific sectors and net worth.

RBI ISSUES DRAFT GUIDELINES FOR LICENSING OF NEW BANKS IN THE PRIVATE SECTOR

The RBI released on its website on 29th August 2011, the Draft Guidelines for Licensing of New Banks in the Private Sector. These guidelines have been prepared taking into account the experience gained from the functioning of the banks licensed under the guidelines of 1993 and 2001. It has also considered the feedback and suggestion received in response to the discussion paper.

Few highlights of the guideline are as follows:

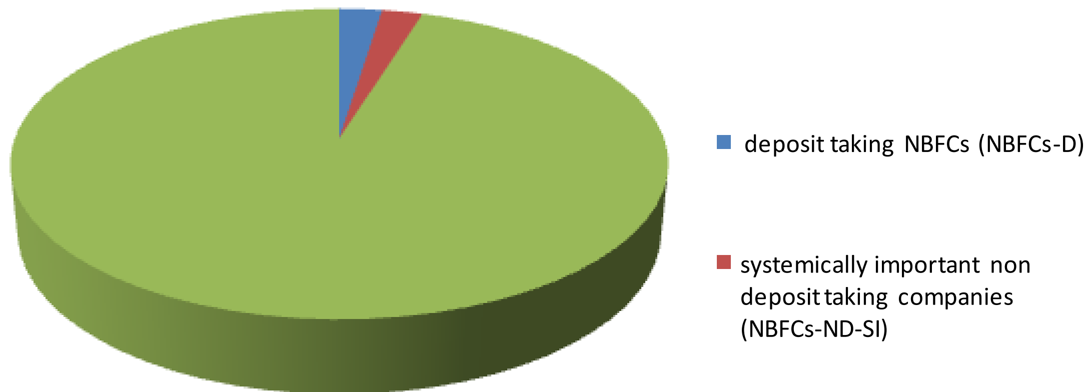
- Entities/groups in the private sector which are owned and controlled by residents, with diversified ownership, sound credentials and integrity and having successful track record of at least 10 years will be eligible to promote banks.
- New banks will be set up only through a wholly owned Non-Operative Holding Company (NOHC) to be registered with the Reserve Bank as a non-banking finance company (NBFC) which will hold the bank as well as all the other financial companies in the promoter group.
- Minimum capital requirement will be 500 crore.
- Aggregate non-resident shareholding in the new bank shall not exceed 49% for the first 5 years after which it will be as per the extant policy.
- At least 50% of the directors of the NOHC should be independent directors.

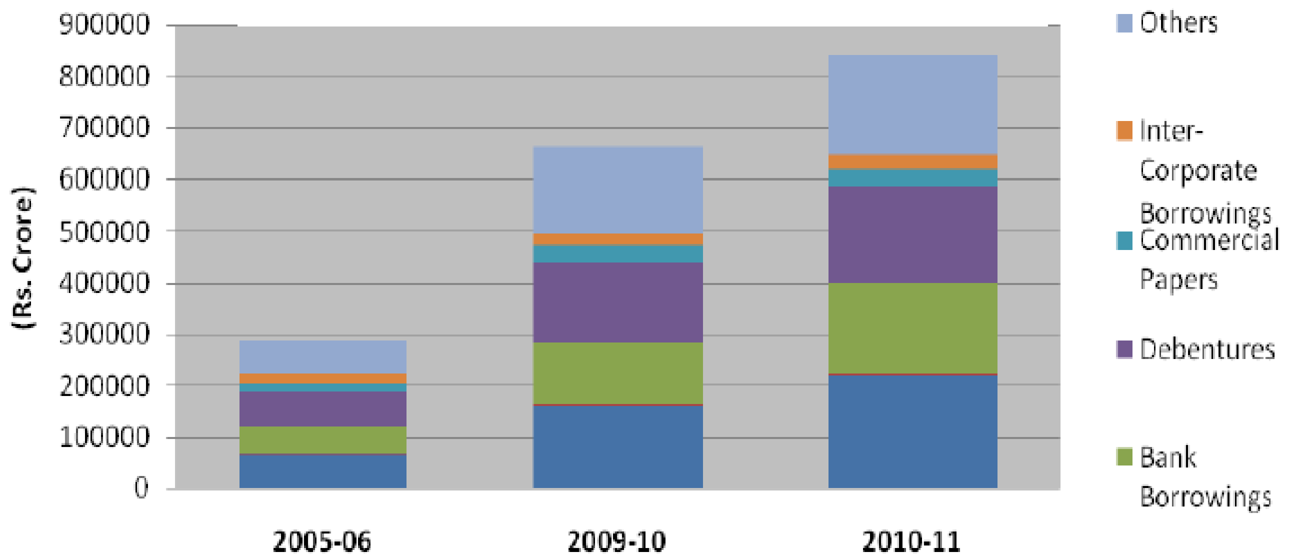
FIDC DEMANDS RESTORATION OF THE PRIORITY SECTOR

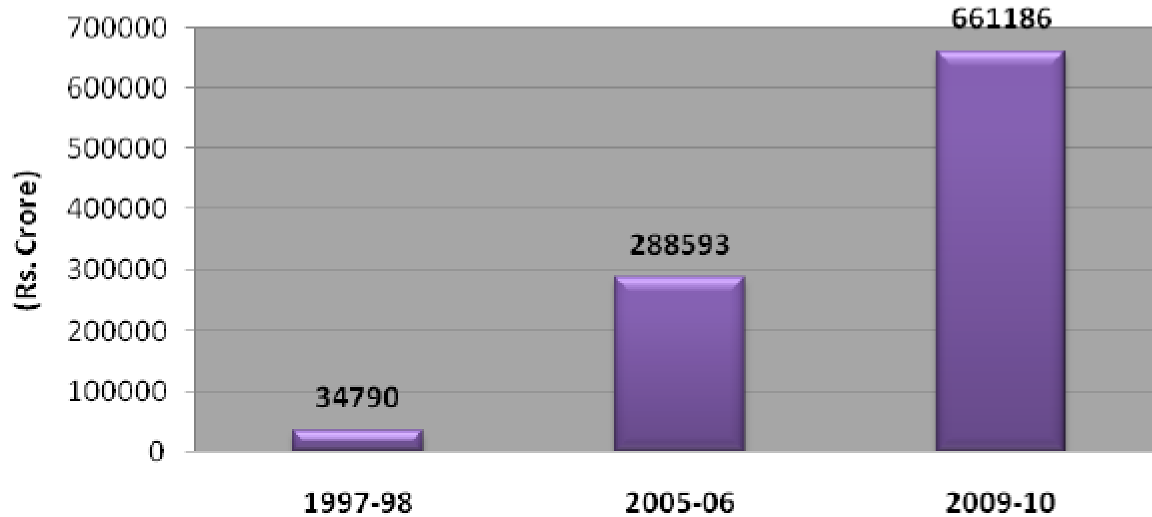
Bank loans to NBFCs rose to 55% in financial year 2011 also the overall credit growth in the economy was 20%, hence under such circumstances the RBI removed the priority sector tag. RBI is of the concern that such removal pushes up the cost of funds for these companies and puts pressure on their operating margins. It is contested that the money being lent by NBFCs are concentrated in a few high risk sectors like capital markets and real estate.

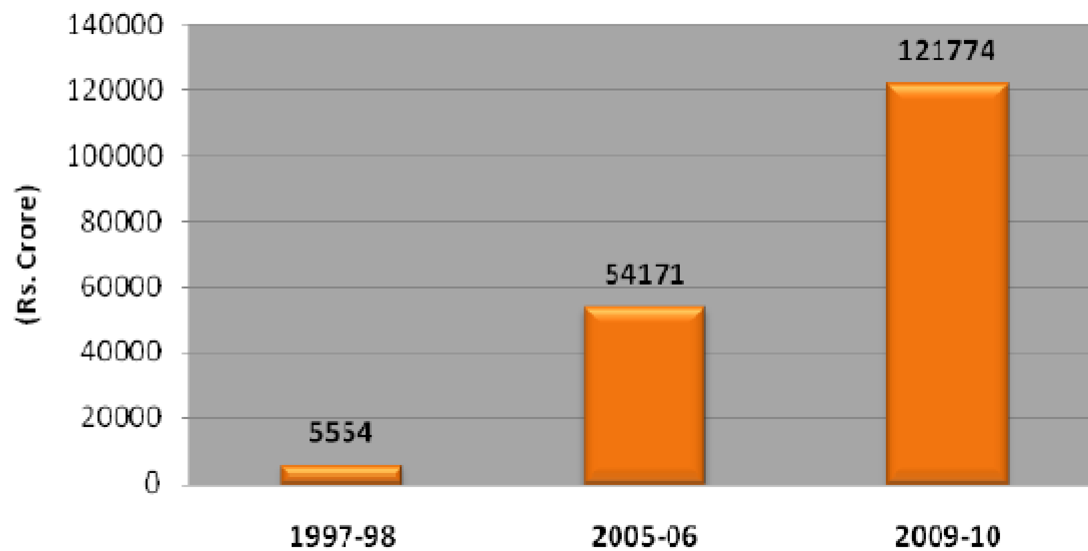
Finance industry development council (FIDC), the self-regulated body of non-banking finance companies, has petitioned the Reserve Bank of India seeking restoration of the priority sector tag for bank loans to NBFCs. A formal letter was written to the RBI governor saying "The step taken by RBI in its annual monetary policy disallowing banks from classifying loans given to NBFCs as priority sector loans would significantly curtail credit flow to the priority sector which would in turn curtail growth." Under priority sector loans, borrowers (read NBFCs) get 1-2% discount on market rates. It is popularly known as interest rate subvention.

Snapshot of Present Growth in the NBFC sector









**Source*: Working Group on the Issues and Concerns in the NBFC Sector

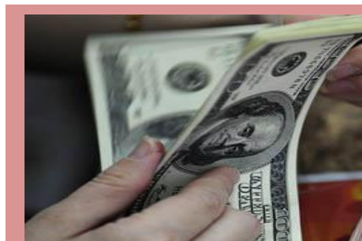
1. **What are the activities included in the definition of non banking financial companies?**

   The activities included in the definition of non banking financial companies which can be listed as financial business are as follows:
   - Financing, whether by giving loans, advances or otherwise
   - Acquisition of shares, stocks or securities
   - Hire purchase
   - Management of chits, kuries, etc
   - Money circulation schemes

2. **What are Core Investment Companies (CICs)?**

   Core Investment Company means:
   A NBFC carrying on the business of acquisition of shares and securities which satisfied the following conditions:-
   - at least 90% of its Total Assets are in the form of investment in equity shares, preference shares, debt or loans in group companies;
   - its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its Total Assets;
   - it does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;
   - it does not carry on any other financial activity referred to in Section 45I(c) and 45I(f) of the RBI act, 1934 except investment in bank deposits, money market instruments, government securities, loans to and investments in debt issuances of group companies or guarantees issued on behalf of group companies.

All you want to know about NBFCs



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3. What are IFCs?

An IFC is defined as non deposit taking NBFC that fulfills the criteria mentioned below:

- a minimum of 75 per cent of its total assets should be deployed in infrastructure loans as defined in Para 2(viii) of the Non Banking Financial (Non Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;
- Net owned funds of Rs. 300 crore or above;

4. If the principal business is industrial or trading, can it be classified as an NBFC?

If principal business is industrial, trading, etc., the company will not be an NBFC. RBI circulars have specified majority of assets and majority of income as the criteria for defining NBFC.

4. Can NBFCs carry out non-financial activities?

Yes, NBFCs can carry out non-financial activities to the extent that the non-financial business does not become "principal" business of the NBFC.

5. Can NBFCs make investments overseas?

Foreign investments overseas may be either in form of shares of a joint venture company or a wholly owned subsidiary (referred to as overseas direct investment or ODI), or portfolio investments in overseas stocks. ODI by NBFCs is permitted in financial sector entities in the foreign countries, subject to registration with appropriate regulatory bodies of the host country. The precondition is that the investing company must have made profits for 3 years. The limit of investment is 400% of net worth of the investing company.

6. Can NBFCs be owned by non-residents?

Yes, NBFCs can be owned by non-residents but these NBFCs cannot carry out investment activity. Foreign direct investment rules regulate foreign investment in NBFCs. Investment activity is not permitted in the list of permitted that NBFCs can carry out. This does not imply that such an entity cannot make any investments at all – investments can only be incidental. Step down subsidiaries can be floated by NBFCs with foreign capitalization of USD 50 million or above. There are minimum capitalization norms depending on the percentage of foreign holding envisaged. Upto 51%, it is USD 0.5 million, 51% - 75% - it is USD 5 million, and for 100% foreign owned entities, it is USD 50 million. Minimum capitalization refers to the capital brought by foreign investors – it is not the total paid up capital of the NBFC nor the par value of the shares.

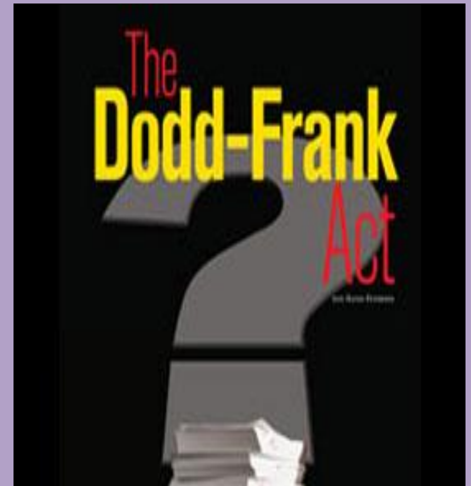
7. Can NBFCs do financial business in LLP?

There is no bar at all in doing financial business in an LLP. In fact, LLP is an incorporated body. Even the restriction in sec 45S of the RBI Act is not applicable in case of an LLP.

Comparing US and Indian definition of Non Banking Financial Company

Under the Dodd-Frank Act, a Non Bank Financial Company means a "*company predominantly engaged in financial activities*" and includes "*U.S. nonbank financial company and a foreign nonbank financial company".*

The Act states that in order to be classified as a Non Bank Financial Company the "consolidated annual gross financial revenues" of the company in either of its two most recently completed fiscal years should represent 85% or more of the company's consolidated annual gross revenues in that fiscal year; or the "consolidated total financial assets" of the company as of the end of either of its two most recently completed fiscal years represent 85% or more of the company's consolidated total assets as of the end of that fiscal year. Incase of Indian NBFCs the income from financial revenue should be more than 50%. Recently, the Working Group (WG) headed by Smt. Usha Thorat came up with a constructive suggestion of moving this threshold limit to 75%. However, there would still persist a difference of 10% as compared to the U.S. classification of nonbank financial company.



Also, in order to be defined as a "U.S. nonbank financial company" a company must be incorporated or organized under the laws of the United States or any State and be predominantly engaged in financial activities. It does not include

> *- any entity that is a bank holding company, a Farm Credit System institution, a national securities exchange (or parent thereof), clearing agency (or parent thereof, unless the parent is a bank holding company), a security-based swap execution facility, or security-based swap data repository registered with the Commission, or a board of trade designated as a contract market (or parent thereof), or a derivatives clearing organization (or parent thereof, unless the parent is a bank holding company), a swap execution facility, or a swap data repository.*

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A U.S. subsidiary of a bank holding company is excluded from the definition of a U.S. nonbank financial company. The term "foreign nonbank financial company" does not include a bank holding company or a company that is regulated in the U.S. as though it were a bank holding company. A non-U.S. subsidiary of a bank holding company or a non-U.S. bank that is treated as a bank holding company is excluded from the definition of a foreign nonbank financial company.

On the other hand, A Non-Banking Financial Company (NBFC), as per the Reserve Bank of India, is a company registered under the Companies Act, 1956 and covers within its ambit, the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property. Activities such as Agriculture, Industrial activity, Purchase or sale of any goods (other than securities) or services, Purchase, construction or sale of immoveable property are excluded.

On the meaning of “Deposit” for Deposit Regulations

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As greed overtakes caution, time and again, investors put in money into transactions which are in fact deposits, but structured to avoid deposit regulations. Regulation on Acceptance of Deposits is an important, and indeed, a very touchy part of Indian corporate laws. Not too many countries in the world allow non-banking companies to accept deposits. In fact, history has it that it was for avoiding short-term working capital crisis with cotton mills in Bombay that government allowed, as a temporary measure, acceptance of deposits by non-banking companies. Since then, regulated deposit acceptance has been a part of Indian corporate laws. Whole waves of NBFCs accepting deposits and depositors losing their life savings have been a part of the scenario – leading to Parliamentary committee reports etc. However, in some form or the other, acceptance of deposits keeps coming back into news.

This article discusses a very commonly known yet very important aspect – what exactly is the meaning of “deposit”? We get into case laws to find that even where a transaction is not structured as a deposit; it may still be a deposit in substance.

The term “Deposit” simply means money given/taken in advance to execute a monetary transaction. Any receipt of money whether in form of loan or deposit is to be construed as deposit. Generally money-for-money transactions are treated as deposits. A transaction may not be structured as a loan or a deposit but will still be considered as deposit if the transaction is of money for money and hence, in substance, a deposit only.

Deposit within the meaning of RBI Regulations:

The term ‘deposit’ has been defined separately for banking and non-banking companies in the RBI Directions. Banks accept deposits offer lower rate of interest repayable on demand like a current account while on the other hand, a non banking financial company accepts deposits repayable after a fixed term and attract a larger investor base on the lure of high rates of interest.

Acceptance of deposits by non-banking financial companies may amount to eroding the distinction between banks and non-banking companies. Banking companies are tightly regulated and supervised by RBI, in accordance with international solvency guidelines and for the non banking companies, RBI issues various guidelines from time to time. As receipt of deposits by non-banking companies involves public money and acceptance of public money by unregulated non-banking companies may cause loss of public money, there are strict controls on acceptance of deposits.

Section 45I(bb) of The Reserve Bank of India Act, 1934 defines deposit as:

> "deposit" includes and shall be deemed always to have included any receipt of money by way of deposit or loan or in any other form. The following are not deposits as per the Act:

i. amounts raised by way of share capital;
ii. amounts contributed as capital by partners of a firm;
iii. amounts received from banks and financial institutions
iv. amounts received by way of security deposit or advance against orders
v. any amount received from a registered money lender
vi. any amount received by way of subscriptions in respect of a chit.

Paragraph 2(i)(xii) of the Non-Banking Financial Companies Acceptance of Public Deposit (Reserve Bank) Directions, 1998 has

Money received from any other company

- In form of inter-corporate deposits: exempted
- In form of debentures issued to other corporate: exempted only if such debentures are not transferable.

Deposits and Advances:

The term deposit is a broader term and includes loans and advances also within its ambit. An advance given for a particular purpose cannot be treated as deposits. A mere monetary advance given without any purpose but intended to be refunded, with or without interest, would still be a deposit.

Deposits and Loans:

For the purpose of NBFC directions, it does not matter whether the transaction is a deposit or a loan, as both are covered by the sweep of the Regulation. However, the transaction has to be either a loan or a deposit in order to fall under the Regulation. Hence, it is important to understand the meaning of the two terms.

Both loans and deposits are financial transactions. A quick guide for understanding the difference between the two is – if the person having money approaches the depositee, it is a case of deposit. If a person not having and therefore, needing the money, it is a loan. In real life, every contract is struck with mutual needs – hence, the distinction is practically both invisible as also unnecessary.

In the case of *Govind Chintaman Bhat v. Kachubhai Gulabchand, AIR 1924 Bom 28*, the Bombay High Court cleared the difference between the terms 'loan' and 'deposit' holding the following view:

> "Ordinarily when A hands over money to B on the understanding that it is not a gift but has to be repaid when demanded, that would be considered in law "a loan" and when the plaintiff seeks to prove that the money so handed over was "a deposit", the onus would lie upon him to prove that there are additional circumstances which turned the "loan" into a "deposit". There is no distinction in the Act between the money lent and money deposited with regard to the agreement to re-pay. So that it is not the agreement that the money should be payable on demand that distinguishes a deposit from a loan. There must be something further proved, and it is not possible to define exactly what that something further must be. It has sometimes been suggested that facts must be proved which create a sort of fiduciary relationship between the lender and the borrower. It cannot be said that that is always necessary."

While giving some test rules for deciding whether an amount deposited is in nature of loan or deposit, the Apex court in *V.E.A. Annamalai Chettiar v. S. V. V. S. Veerappa Chettiar, AIR 1956 SC 12*, expressed that whether a transaction is a transaction of loan or deposit does not depend merely on the terms of the document but has got to be judged from the intention of the parties and all the circumstances of the case. Even though the transaction is a transaction of deposit the deposit can be coupled with an agreement that it will be payable on demand. Such an agreement can be express or implied and if an express agreement in that behalf is recorded in the document that transaction of deposit cannot be thereby converted into a transaction of loan.

However, what is the meaning of loan, and what is the meaning of deposit, does matter as both are covered under the definition of 'deposit' as prescribed by the RBI Regulations. Nevertheless what is neither loan nor deposit will not be covered. Conversely, what is either loan or deposit will get covered and will be regarded as deposit under RBI Regulations.

Loan-in- substance: covered by deposit regulations

As already said above, a loan and a deposit have different meaning but the definition of 'deposit' under RBI Directions includes a loan also and as a loan includes a transaction which is nothing but in substance a loan, hence a loan in substance is also to be construed as deposit within this ambit. For this reason, it is important to look into a transaction in depth to know whether the transaction is a loan in substance or not.

In his Judgment in *Fateh Chand Mahesri v. Akimuddin Chaudhury* (http://www.indiankanoon.org/doc/713784/), Mitter J. observed as follows:

> "If in a transaction there is no actual advance but only a notional advance -- what a Court of law would deem to be an advance -- with a view to earn interest, the transaction would be regarded as loan for the purpose of the Act. A renewed bond where interest is capitalised would thus be a loan although at its execution no money is actually advanced. In order to determine the question whether a particular transaction amounts to a loan the substance and not the form must be looked to and the facts and circumstances attending it must be taken into consideration. If the conclusion be that it was really an interest bearing investment it would be a loan."

In *Nirode Barani Debya v. Sisir Kumar Mukherjee AIR 1942 Cal 616*, the petitioners predecessors-in-interest owed some money to the opposite party on account of the price of the sale of some land. The purchase money was discharged partly in cash and partly by a promissory note. The note was renewed from time to time and the last renewal was by the petitioners themselves. The question was whether the last promissory note represented in substance a loan transaction. Henderson J., who delivered the judgment in this case observed as follows:

> "The real nature of the present transaction was that the purchase money was paid partly in cash and partly by the hand-note. If the real cause of action in the present case were merely the unpaid purchase money with a reasonable rate of interest, it would have been paid off long ago. It is not the case of the seller being willing to take part payment but the case of a seller insisting upon full payment partly in cash and partly in something else. I am, therefore, of opinion that this transaction was in substance a loan."

In both the above cases, judgment proceeded on the basis that the original debt was not a loan and was only a part of unpaid purchase money but the parties had treated the purchase money as paid off in its entirety and the amount equivalent to the unpaid purchase money as being due by the purchaser to the vendor by way of a loan. On such a basis, the transaction may in substance be a loan.

In *Radha Kissen Chamria And Ors. vs Keshardeo Chamria And Anr. AIR 1957 SC 743*, Apex Court rejecting the plea of the appellants of their being made to pay in respect of "loan", discussed the nature of transaction which was not in substance a loan. The Supreme Court held that the purchasers could not claim any benefit under Section 30 inasmuch as they were neither borrowers nor were they being made to pay in respect of a "loan" as those terms were defined in the Act; the fact that under the compromise decree, the moneys were payable in a number of instalments instead of at once would not show that the price had become a loan, nor was there anything to show that the parties had treated the purchase money as paid off in its entirety and the amount equivalent to the purchase money as being due by the purchasers to the vendor by way of a loan on which basis the transaction might in substance be a loan. The judgment says:

> "It may be that when money is due from one party to another not on an advance actually made but on other accounts a debt comes into existence but, as said by Sen J., in this very case a debt is not necessarily a loan. The parties, however, may agree to treat the money as a loan and then the transaction may in substance be a loan for the purpose of the Bengal Money Lenders Act. But there is no such agreement here. There is nothing to show that it had been intended that the original character of the moneys, namely, as unpaid price had been changed into a loan…".

Loan in substance - if there exists a relationship of debtors and creditors:

Through various rulings and judgments of different courts, it has become a well settled law that if in a transaction, there exists a relationship of debtors and creditors between the parties, the transaction is in substance a loan.

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The observation of Their Lordships in paragraph 10 in *Manindra Nath Bose Vs. Narendra Krishna Mitra & Anr.1980(2) CLJ 70* is quoted hereunder:-

> "10. .... There is, however, no such statutory requirement in the matter of a loan and there the rule of substance prevails over form and a transaction which is in form not a loan for example, a purported sale with an agreement of resale or reconveyance as in the case before us but is so in substance will be held to be a loan and would certainly come within the definition of "loan" as contained in S 2(12) of the Bengal Money-Lenders Act."

It was held that even though invalid as a mortgage the transaction may still be a loan in substance, so as to be a loan within the meaning of Section 2(12) of the Bengal Money-lenders Act.

In *Banku Behari Chandra Vs. Sm. Kalyani Debi AIR 1967 Cal 351*, it has been held that a transaction intended to be a mortgage, but evidenced by a sale deed and a separate agreement to repurchase or reconveyance, though cannot, in law, be a mortgage in view of proviso to Section 58C of the Transfer of Property Act, it may still amount to a "loan in substance" so as to fall within the definition of loan under Section 2(12) of the Bengal Money Lenders Act.

Same kind of stand was taken in *Abubakar Abdul Inamdar & Others Vs. Harun Abdul Inamdar & others AIR 1996 SC 112*, *Smt. Chandana Roy & Ors vs Sri Gobordhan Prosad Kundu* (http://www.indiankanoon.org/doc/1569674/)

Further, in all these judgments, this has been clarified that in order to prove the alleged transaction being loan in substance, it is not necessary to show that the lender has money lending business. Even a single transaction is sufficient to prove that the transaction is loan in substance and not out and out sale.

In order to prove the alleged transaction being loan in substance, it is not necessary to show that the lender has money lending business. Even a single transaction is sufficient to prove that the transaction is loan in substance and not out and out sale

Money for money transactions treated as deposit

If there is money for money transaction, it will come under the definition of deposit whether such transaction does not amount to legal loan or deposit. Some of these transactions are:

Share application money lying un-allotted for long time

The share application money received from the subscriber for which share have not been allotted for long, whether the company pays interest or not, if the facts indicate that the applicant withdraws the application money from time to time, and re-deposits it – it is nothing but a loan in substance and hence deposit.

Advances received

If money is received as advance against any purpose, it is an advance and not a deposit. However, advances received without any purpose will amount to deposit.

Subscription money received for issue of preference shares

Some companies receive money by way of subscription against preference shares and later refund it. Since preference shares are not redeemable at all, such money received as subscription is to be regarded as deposit.

Does deposit necessarily carry interest?

No, it is not necessary that a deposit should every time backed by an interest rate. Money may be deposited with or without interest but payable on demand shall be a deposit. However, banks cannot accept interest free deposits other than in current account.

Facts about MONEY!!

1. The most successful investor was Noah. He floated stock while everything around him went into liquidation.
2. The most successful female investor was Pharaoh's daughter. She went to the Nile bank and floated a prophet.
3. A long term investment is a short term investment that failed.
4. Always play with other people's money.
5. The market is weird. Every time one guy sells, other one buys, and they both think they are smart.
6. If you can count money, you don't have a billion dollars.
7. Money is always there but the pocket changes.
8. Never talk about money who have much more or much less than you.
9. Time is more valuable than money. You can get more money but you cannot get more time.
10. If you want to know what God thinks about money, think about the people he gives it to.

FEEDBACK OF OUR FIRST EDITION OF SAMPADA

"this is a very useful newsletter. I would love to receive it regularly"
- Mr. Sunil Kanoria, Srei Infrastructure Finance Ltd

"I have gone through the issue and find it most informative…an excellent discussion of relevant topics."
- Shreyans Kasliwal, Kamal Autofinance Ltd

"Good initiative…"
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