Non-Banking Finance Company – Challenges & Remedies

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Abstract

Non-Banking Finance Company – Challenges & Remedies with specific reference to Satin Housing Finance Limited. This topic has been selected as I am working in the non-banking finance sector and the project will cover the detailed analysis of the issues and challenges being faced by a Non-Banking Finance Company (NBFC) and the remedies or corrective actions need to be taken by this sector. The current liquidity crunch issue in this sector which is prevailing and the reasons behind the same will be analyzed in details.

Currently NBFCs sector is facing liquidity crunch viz Dewan Housing Finance, Indiabulls and other housing finance companies. Based on financial experts and publically available financial informations, it has been prima facie observed and notified that this issue has been arose due to issuance of loans to their customers with longer term horizons whereas the fund in source was happened for short term horizon in comparison to fund deployment. Recent regulatory changes and guidelines by the regulator and the Government had made the sector uncomfortable due to sudden changes in the regulation and more corporate governance based guidelines. Now, NBFC need to disclose more information to regulator and inculcate transparency in the system.

Due to tension in the infrastructure sector, the roll over facility by the Bank to NBFCs had been suddenly stopped and this sector faced acute crisis. NBFC are still facing regulatory clarification in most of its business structure as compared to the Banking Sector.

This project will cover and discuss over the business structure of Satin Group majorly consist of three NBFCs viz Satin Creditcare Network Limited, Satin Housing Finance Limited and Satin Finserve Limited. It will cover the recent announcement and majors taken by the Government and the Regulator to take out this sector from depression.

Beside that the changes need to be inculcate in the business and practice of the NBFC, various funding options available to the NBFC in domestic market and international market and brief over the investment option available to NBFCs also be outlined.

Introduction- An Overview

India has financial institutions which are not banks but which accept deposits and extend credit like banks. These are called Non-Banking Financial Companies (NBFCs) in India.

NBFCs in India include not just the finance companies that the general public is largely familiar with; the term also entails wider group of companies that are engaged in investment business, insurance, chit fund, nidhi, merchant banking, stock broking, alternative investments, etc., as their principal business. All are though not under the regulatory purview of the Reserve Bank.

Non-Banking Financial Companies (NBFC) play a crucial role in the economy, offering their financial services in urban as well as rural areas; varying from granting loans for growth of new ventures to monetary advices like chit-reserves and insurance. They supplement the role of the banking sector in meeting the increasing financial needs of the corporate sector, delivering credit to the unorganized sector and to small local borrowers. Hence they become a very important part of our nation's Gross Domestic Product and alone count for 12.5% raise in Gross Domestic Product of the country.

Most people prefer NBFCs over banks on account of better efficiency and flexibility in meeting their financial requirements. Many of them experiment with their products too and therefore find a favour with the consumers. But, there is risk element attached to them as they are not fully regulated like banks.

The NBFC sector in India has undergone a significant transformation over the past few years. It has come to be recognised as one of the systemically important components of the financial system and has shown consistent year-on-year growth. NBFCs play a critical role in the core development of infrastructure, transport, employment generation, wealth creation opportunities, and financial support for economically weaker sections; they also make a huge contribution to state exchequer.

Making of NBFCs

According to RBI, the current definition of NBFC is "a company registered under the Companies Act, 1956/ 2013 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property. A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in instalments by way of contributions or in any other manner, is also a non-banking financial company called Residuary non-banking company."

Technically a NBFC has also been defined by RBI as " ….when a company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfills both these criteria will be registered as NBFC by RBI".

NBFCs differ from Banks on following grounds:

(a) NBFC cannot accept demand deposits; whereas banks can accept the same.

(b) NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself, whereas banks can do so;

(c) Deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in case of banks.

(d) An NBFC is not required to maintain Reserve Ratios (CRR, SLR etc.)

(e) An NBFC cannot indulge Primarily in Agricultural, Industrial Activity, Sale-Purchase and Construction of Immovable Property.

(f) Foreign Investment allowed up to 100% in NBFCs.

NBFCs play an important role in the Indian financial system by complementing and competing with banks and by bringing in efficiency and diversity into financial intermediation. The Reserve Bank's regulatory perimeter is applicable to companies conducting non-banking financial activity, such as lending, investment or deposit acceptance as their principal business. The regulatory and supervisory architecture is, however, focused more on systemically important non-deposit taking NBFCs (with asset size Rs. 5 billion and above) and deposit accepting NBFCs with light touch regulation for other non-deposit taking NBFCs.

Certain categories of entities carrying out non-banking financial activities are exempt from the Reserve Bank's regulation as they are being regulated by other regulators. They include housing

finance companies (HFCs), mutual funds, insurance companies, stock broking companies, merchant banking companies and venture capital funds (VCFs), which are often referred to as the 'shadow banking system.

After the announcement made the Finance Minister during the presentation of the Budget for the year 2019, the Housing Finance Companies (HFCs) will be now regulated by the Reserve Bank of India and it will be now called as NBFC-HFC.

The NBFC segment has evolved considerably over a period of time in terms of operations, heterogeneity, asset quality, profitability and regulatory architecture. The Reserve Bank has been working on consolidating the various categories of NBFCs. At present, there are 13 categories of NBFCs. The latest addition is the NBFC – Peer to Peer Lending Platform (P2P) and NBFC- Housing Finance Company.

Non-Banking Finance Company and its types

Section 45I (f) of RBI act, 1934

"Non-banking financial company" means –

- a "Financial Institution" which is a company;

- a Non·Banking Institution which is a company and which has as its Principal Business the receiving of deposits, deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
- such other Non·Banking Institution or class of such institutions, as RBI specifies. "Non·Banking Institution" · means a company, corporation or co·operative society.

So, NBFC is a financial institution which is into the business of lending or investment or collecting money under any scheme or arrangement. It excludes any institution which undertakes its principal business as agriculture activity, industrial activity, trading and purchase or sale of immovable properties.

It may also be mentioned that Mortgage Guarantee Companies have been notified as Non-Banking Financial Companies under Section 45 I (f)(iii) of the RBI Act, 1934.

Types of NBFCs

NBFCs are categorized a) in terms of the type of liabilities into Deposit and Non-Deposit accepting NBFCs, b) non deposit taking NBFCs by their size into systemically important and other non- deposit holding companies (NBFC-NDSI and NBFC-ND) and c) by the kind of activity they conduct. Within this broad categorization the different types of NBFCs are as follows:

I. **Asset Finance Company (AFC)** : An AFC is a company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60% of its total assets and total income respectively. **Investment Company (IC)**: IC means any company which is a financial institution carrying on as its principal business the acquisition of securities,

II. Loan Company (LC): LC means any company which is a financial institution carrying on as its principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

III. Infrastructure Finance Company (IFC): IFC is a non-banking finance company a) which deploys at least 75 per cent of its total assets in infrastructure loans, b) has a minimum Net Owned Funds of ₹ 300 crore, c) has a minimum credit rating of 'A 'or equivalent d) and a CRAR of 15%.

IV. Systemically Important Core Investment Company (CIC-ND-SI): CIC-ND-SI is an NBFC carrying on the business of acquisition of shares and securities which satisfies the following conditions:-

(a) it holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;

(b) 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;

(c) 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;

(d) 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.

(e) Its asset size is ₹ 100 crore or above and

(f) It accepts public funds

V. Infrastructure Debt Fund: Non- Banking Financial Company (IDF-NBFC) : IDF-NBFC is a company registered as NBFC to facilitate the flow of long term debt into infrastructure projects. IDF-NBFC raise resources through issue of Rupee or Dollar denominated bonds of minimum 5 year maturity. Only Infrastructure Finance Companies (IFC) can sponsor IDF-NBFCs.

VI. Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI): NBFC-MFI is a non-deposit taking NBFC having not less than 85% of its assets in the nature of qualifying assets which satisfy the following criteria:

a. loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding ₹ 1,00,000 or urban and semi-urban household income not exceeding ₹ 1,60,000;

b. loan amount does not exceed ₹ 50,000 in the first cycle and ₹ 1,00,000 in subsequent cycles;

c. total indebtedness of the borrower does not exceed ₹ 1,00,000;

d. tenure of the loan not to be less than 24 months for loan amount in excess of ₹ 15,000 with prepayment without penalty;

e. loan to be extended without collateral;

f. aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs;

VII. loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower **Non-Banking Financial Company – Factors (NBFC-Factors)**: NBFC-Factor is a non- deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring business should constitute at least 50 percent of its total assets and its income derived from factoring business should not be less than 50 percent of its gross income.

VIII. **Mortgage Guarantee Companies (MGC) -** MGC are financial institutions for which at least 90% of the business turnover is mortgage guarantee business or at least 90% of the gross income is from mortgage guarantee business and net owned fund is ₹ 100 crore.

IX. **NBFC- Non-Operative Financial Holding Company (NOFHC)** is financial institution through which promoter / promoter groups will be permitted to set up a new bank. It's a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators, to the extent permissible under the applicable regulatory prescriptions.

X. **NBFC- Housing Finance Company (NBFC-HFC)** is most recent addition of NBFC under the purview of Reserve Bank of India. Earlier it has been regulated by National Housing Bank but pursuant to the Finance Act, 2019, Housing Finance Companies will be now regulated by Reserve Bank of India. Till now the regulation and provision of National Housing Bank is there and will be subsequently replaced with the notified regulation of Reserve Bank of India.

Brief of Regulatory Environment

Non-Banking Finance Companies are basically regulated by Reserve Bank of India. Reserve Bank of India and Ministry of Finance is the regulator and controller of Non- Banking Finance Companies.

But this is not true for all Non-Banking Finance Companies, for example- Housing Finance Companies are being regulated by National Housing Bank (its wholly owned subsidiary of Reserve Bank of India).

On implementation of the Finance Act, 2019, now Housing Finance Companies are being regulated by Reserve Bank of India and supervise by National Housing Bank.

Now, coming to the topic about regulatory environment, then we can see it in broader term as what are the regulation applicable over Non-Banking Finance Companies viz, Acts, Directions, Regulations, Rules, Circulars, Notifications, and others.

As my scope of study is Satin Housing Finance Limited, hence we will discuss the regulator environment with respect to applicable laws and regulations over it. Though the regulatory for Housing Finance Companies are also RBI and the provisions are almost same as of NBFCs. Hence, the scope of study is around the NBFCs only. We will study the same in broader term.

Evolution of Regulatory Framework for NBFCs

Over the past several decades, NBFCs have emerged as important financial intermediaries, particularly for the small-scale and retail sectors, in underserved areas and unbanked sectors. NBFCs have turned out to be growth engines in an arena where increased importance is assigned to financial inclusion. The growing importance of the NBFC segment in the Indian financial system has led to a changing landscape of the NBFC framework. The evolution of the regulatory framework for NBFCs in India has gone through a cyclical phase–from simplified regulations to stringent and extensive regulations and finally towards rationalisation as part of the recently revised NBFC regulatory framework.

In 1964, Chapter III B of the Reserve Bank of India (RBI) Act, 1934, was introduced to regulate deposit accepting NBFCs. With NBFCs emerging as an important segment deeply connected with entities in the financial sector, coupled with failures of large NBFCs, a more comprehensive and enhanced framework was put into place by the RBI in the years 1996 and 1997. This included introduction of entry point norms (EPNs), stricter and more detailed regulations with respect to acceptance of deposits with an objective to have a focussed supervision of deposit-accepting NBFCs, mandatory registration of all NBFCs with the RBI (irrespective of their holding of public deposits) for commencing and carrying on business, maintenance of a portion of deposits in liquid assets, creation of a reserve fund, etc. In 1999, the capital requirement for a fresh registration was enhanced from 25 lakh INR to 200 lakh INR. Furthermore, in 2006, in order to bridge the gapbetween banks and NBFCs, non-deposit accepting NBFCs were further classified into systemically important NBFCs and non-systemically important NBFCs based on their asset size. Certain prudential norms were imposed on such NBFCs. Also, the focus of RBI shifted from deposit- accepting NBFCs to non-deposit accepting NBFCs. The true magnitude of the risks that the shadow banking sector at the global level could proffer was clearly visible in the aftermath of the global financial crisis of 2008. In the Indian context, NBFCs are considered similar to shadow banks, although they are still subject to regulatory supervision. The light-touch regulations on shadow banks gave rise to high leverage and sub-credit assets. The resultant liquidity crunch got further transferred to the banking system due to its interlinkages with the shadow banking sector. This gave rise to the need for a collective effort to preserve financial stability and one of the key issues highlighted by the G-20 leaders at the November 2010 Seoul Summit was 'strengthening regulation and supervision of shadow banking'. The Financial Stability Board (FSB) has been constantly working towards strengthening the oversight and regulation of the shadow banking system to mitigate the risks arising therefrom.

Recent changes in the Regulatory Framework

A comprehensive review of the NBFC regulations was conducted by the RBI in 2014. The revised regulatory framework is designed to focus supervisory attention to those NBFCs which genuinely can pose risks to the financial system and bring operational freedom to smaller NBFCs. The foremost step in this direction was the revision in the threshold for systemic significance from 100 crore INR to 500 crore INR. Under the new regulatory framework, non-deposit accepting NBFCs with total assets less than 500 crore INR are considered as not being systemically important and subject to a light touch regulation. Those with total assets above 500 crore INR are considered as systemically important non-deposit accepting NBFCs and have been subjected to a more stringent set of regulations

Non-systemically important non-deposit accepting NBFCs (NBFCs-ND) Limited prudential norms

Capital adequacy norms and credit concentration norms have been done away with for all NBFCs- ND. This change will bring greater operational flexibility to over 11,500 NBFCs, who have an asset size of more than 100 crore INR but less than 500 crore INR, as they were earlier subjected to these norms.

The regulations are further customised depending on whether the NBFC-ND has access to public funds and/or has a customer interface.

In order to ensure that the NBFCs-ND do not become over-reliant on leverage and have their skin in the game, they are required to ensure a leverage ratio of 7 (i.e. total outside liabilities to not exceed seven times their owned funds).

Under the earlier NBFC prudential norms, 'public funds' were defined to include funds raised either directly or indirectly through public deposits, commercial papers, debentures, intercorporate deposits and bank finance. As a measure of further liberalisation, the definition of public funds has been amended to 'exclude funds raised by issue of instruments compulsorily convertible into equity shares within a period not exceeding five years from the date of issue'.

All other prudential norms such as asset classification, provisioning requirements, and accounting principles remain unchanged for NBFCs-ND.

Governance Requirements

Hitherto, all NBFCs were required to comply with governance requirements, such as the Fair Practices Code (FPC) and anti-money laundering, resulting in extra compliance burden. Under the new framework, only those NBFCs that have a customer interface are required to comply with such governance requirements.

NBFCs-ND with no public funds and no customer interface are not subject to any prudential norms and thus have complete regulatory freedom to conduct their business activities. This change should give a great fillip to NBFCs engaged in investment activity through their own funds. Given the spur of start-ups in the country, this single change could make NBFCs a very attractive vehicle for private equity (PE) investments.

Systemically important NBFCs (NBFCs-ND-SI) and deposit-accepting NBFCs (NBFCs-D) Prudential norms

While the regulatory framework for NBFCs-ND has been liberalised, the regulations for NBFCs- NDSI and for all NBFCs-D have been strengthened considerably. For these NBFCs, prudential regulations and conduct of business regulations both remain applicable whereas there is no prescribed leverage ratio.

About Capital Structure

The capital structure is the particular combination of debt and equity used by a company to finance its overall operations and growth. Debt comes in the form of bond issues or loans, while equity may come in the form of common stock, preferred stock, or retained earnings. Short-term debt such as working capital requirements is also considered to be part of the capital structure.

Key Points:

- Capital structure is how a company funds its overall operations and growth.
- Debt consists of borrowed money that is due back to the lender, commonly with interest expense.
- Equity consists of ownership rights in the company, without the need to pay back any investment.
- The Debt-to-Equity (D/E) ratio is useful in determining the riskiness of a company's borrowing practices.

Both debt and equity can be found on the balance sheet. Company assets, also listed on the balance sheet, are purchased with this debt and equity. Capital structure can be a mixture of a company's long-term debt, short-term debt, common stock, and preferred stock. A company's proportion of short-term debt versus long-term debt is considered when analyzing its capital structure.

When analysts refer to capital structure, they are most likely referring to a firm's debt-to-equity (D/E) ratio, which provides insight into how risky a company's borrowing practices are. Usually, a company that is heavily financed by debt has a more aggressive capital structure and therefore poses greater risk to investors. This risk, however, may be the primary source of the firm's growth.

Debt is one of the two main ways a company can raise money in the capital markets. Companies benefit from debt because of its tax advantages; interest payments made as a result of borrowing funds may be tax deductible. Debt also allows a company or business to retain ownership, unlike equity. Additionally, in times of low interest rates, debt is abundant and easy to access.

Equity allows outside investors to take partial ownership in the company. Equity is more expensive than debt, especially when interest rates are low. However, unlike debt, equity does not need to be paid back. This is a benefit to the company in the case of declining earnings. On the other hand, equity represents a claim by the owner on the future earnings of the company.

In order to optimize the structure, a company will decide if it needs more debt or equity and can issue whichever it requires. The new capital that's issued may be used to invest in new assets or may be used to repurchase debt/equity that's currently outstanding as a form of recapitalization.

Debt investors take less risk because they have the first claim on the assets of the business in the event of bankruptcy. For this reason, they accept a lower rate of return, and thus the firm has a lower cost of capital when it issues debt compared to equity.

Conclusion

The Company expects its Directors, officers and other employees to act ethically at all times and to acknowledge their adherence to the policies and codes adopted by the Company. The Directors, senior management and other employees of the Company shall endeavor to avoid any conflict of interest with respect to their dealings with the Company. A conflict of interest exists when benefits or interests of one person or entity conflict with the interests or benefit of the Company. If a Director has a potential conflict of interest in a matter under consideration by the Board or a Committee, such Director shall disclose his interest in accordance with the provisions of applicable laws and abstain from deliberations and voting on such matter. A Director who is interested in any proposed transaction shall not exercise any influence over other Board/Committee Members in any manner whatsoever and is restricted from casting his vote for the particular agenda. Officers and other employees must disclose the circumstances of any possible conflict of interest to his / her supervisor and the Whole Time Director and CEO, for a determination about whether a potential or actual conflict exists. If an actual or potential conflict is determined, the Company may take whatever corrective action appears appropriate according to the circumstances.

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