FIDC

Finance Industry Development Council

(A body incorporated as a Self Regulatory Organisation for Registered NBFCs – AFCs)

101/103, Sunflower, 1st Floor, Rajawadi Road No.2, Ghatkopar (East), Mumbai – 400 077 (India)

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April 29, 2014

To
Mr. Naved Masood,
Secretary,
Ministry of Corporate Affairs,
Shastri Bhavan,
Dr. R. P. Road,
NEW DELHI 110 001.

Sir,

SUB: Issues and concerns of NBFC Sector on the provisions contained in the Companies Rules, 2014, notified by the Ministry of Corporate Affairs (MCA) relating to issuance of Debentures.

As you are aware, the Asset Financing NBFCs (NBFC-AFCs) registered with Reserve Bank of India have joined hands and formed a Self Regulatory Organization (SRO) under the name of **Finance Industry Development Council (FIDC).** NBFC-AFCs have been recognized for their role in credit delivery in remote corners of India and have carved a niche for themselves in the semi-rural and rural segments of the country. NBFC-AFCs are also playing a vital role in furthering the cause of Financial Inclusion and in credit dispensation to the poor states/credit starved areas for over 6 decades.

Ever since the amendments made in the year 1997 to The Reserve Bank of India Act, 1934, NBFCs have been regulated by RBI. Both the liabilities and the asset side of the NBFCs' balance sheets are well regulated by RBI. However, some of the Rules notified under The Companies Act, 2013, namely, The Companies (Share Capital and Debentures) Rules, 2014 and Companies (Prospectus and Allotment of Securities) Rules, 2014 issued w.e.f. 01.04.2014 have come as a great shock to the NBFC sector, as the provisions therein shall have a grave impact on issue of Secured Debentures by NBFCs, which is one of the key avenues of fund raising. We would like to draw your kind attention to these provisions and the issues that arise, more so, since some of these provisions either ignore or are in contradiction to the prevailing RBI norms. There were specific exemptions given to NBFCs under The Companies Act, 1956 in matters relating to issue of Secured Debentures both through Private Placement and Public offer.

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1. Interpretation of term 'Specific movable property' as per Rule 18(1)(d)(i) of Companies (Share Capital and Debentures) Rules, 2014

As per Chapter IV, Rule 18 of the Companies (Share Capital and Debentures) Rules 2014, the Company shall not issue debentures unless it complies with certain conditions. One of such conditions mentioned in Rule 18(1)(d) of the Companies (Share Capital and Debentures) Rules 2014 is reproduced below :

The security for the debentures by way of a charge or mortgage shall be created in favour of the debenture trustee on –

*(i) any **specific** movable property of the company (not being in the nature of pledge) ; or*
(ii) any specific immovable property wherever situate, or any interest therein,

Typically, NBFCs do not own substantial immovable properties. The prevailing RBI norms for NBFCs discourage investments by NBFCs in the real estate. The prudential norms issued by the RBI restrict NBFCs (which are deposit taking) to invest in land or buildings, except for its own use, to an amount not exceeding 10% of their owned fund. Further, as per RBI norms, the issue of bonds/debentures secured by mortgage of any immovable property or secured by other assets are allowed, as they fall outside the scope of definition of public deposits. Hence, the Receivables under the loan disbursements made by them are charged by NBFCs, by way of hypothecation charge, to secure repayment of loans from Banks or to secure redemption of NCDs issued.

In case of issuance of NCDs by NBFCs, the repayment of principal amount of the NCDs, the interest due thereon and the cost, charges, fees, remuneration of debenture trustee and expenses payable in respect of the Issue are secured by creating first charge:

i. on identified immoveable property or
ii. on **specified Receivables** by way of Hypothecation Charge (of the amount equivalent to the amount of NCDs to be issued depending upon the asset coverage requirement) as may be decided mutually between the NBFC and the Debenture Trustee.

Hence, NCDs are primarily secured by creation of exclusive charge on specified Receivables by way of Deed of Hypothecation. A charge may also be created on an immovable property of a nominal value by way of mortgage.

The Receivables, on which hypothecation charge is created, represent the monies receivable under agreements for the loans disbursed by the NBFC to the borrower. The NBFC creates charge on these specified Receivables.

The specific list of Receivables with details of the agreements with the borrowers, names of the borrowers and amounts etc. are shared with the Debenture Trustee. Further, depending on the run down on the amount of these Receivables (which have been hypothecated as a security for the outstanding amount of NCDs), fresh Receivables of equivalent amount are added to the list of Receivables hypothecated on monthly/quarterly basis. It is also in the interest of asset financing NBFCs such as NBFCs financing commercial vehicles and servicing the Small Road Transport Operators to create Floating Charge on the Receivables so as to secure NCDs.

It is, therefore, requested that a clarification may be issued that the current practice of NBFCs securing the NCDs by way of a floating charge on specified Receivables is in line with the requirement of the said rule 18(1)(d) of the Companies (Share Capital and Debentures) Rules,2014.

2. Creation of Debenture Redemption Reserve(DRR) and Provision for Investing 15% of Debentures Maturing during the Year in Unencumbered Approved Securities

As per Rule 18(7) of Chapter IV of the Companies (Share Capital and Debentures), Rules, 2014:

The Company shall create DRR for the purpose of redemption of debentures, in accordance with the conditions given below –

(a) the debenture redemption reserve shall be created out of the profits of the company available for payment of dividend.

(b) The company shall create DRR equivalent to at least 50% of the amount raised through the debenture issue before debenture redemption commences.

(c) Every company required to create DRR shall on or before 30th day of April in each year, invest or deposit, as the case may be, a sum which shall not be less than 15% of the amount of its debentures maturing during the year ending on the 31st day of March of the next year, in unencumbered approved securities/bank FDs

Accordingly, for all **secured** debentures, **whether issued on and after April 01, 2014 by way of public issue or on private placement basis,** DRR is required to be created to the extent of at least 50% before debenture redemption commences. The company will also be required to invest before 30th April, the amount to the extent of at least 15% of the amount of debentures maturing during the year ending on the 31st day of March of the next year, in one or more of the prescribed methods.

The impact of the new provisions as mentioned above:

(i) Creation of DRR will directly impact distributable profits of the company.
(ii) Company's ability to pay dividend to shareholders.
(iii) If the impact of above provision is also applicable on existing outstanding debentures already issued, the net worth/reserves and surplus of the company will be severely impacted.
(iv) Bonds issued with shorter tenor upto 1-3 yrs will have severe impact as opposed to longer tenor bonds. (and there may be limited issuers for such duration considering the impact on the company, which will in turn affect various investor community – Mutual fund, General insurance, Life insurance who normally subscribe to shorter tenor bonds depending on ALM).
(v) Setting aside 15% of coming year's maturity of Debentures in low return investment avenues will directly contribute towards negative carry on such amount which may range from 100-400 bps
(vi) Also the above regulations will directly impact the company's liquidity since 15% investment will be a cash outflow for the companies.
(vii) The companies will have to rely to Commercial paper borrowing for short term requirements and will lead to reduction in duration of liabilities and consequent ALM impact for the companies.

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The earlier provisions:

However, as per para (ii) of the clarification issued by MCA vide its circular no. 04/2013 dated February 11, 2013, for NBFCs registered with RBI under Section 45-IA of RBI (Amendment) Act,1997, the adequacy of DRR will be **25%** of the value of debenture issued through **public issue** as per SEBI (Issue & Listing of Debt Securities) Regulation, 2008. Further, as per General Circular No: 9/2002 of MCA dt. 18-Apr-2002, no DRR was required to be created in case of issue of Secured Debentures on private placement basis.

The reason and logic behind the earlier available exemptions were that as per the Section 45IC of The Reserve Bank of India Act, 1934 (as amended in 1997), every NBFC has to mandatorily transfer at least 20% of its net profit every year (before any dividend is declared) to a separate "Reserve Fund". No appropriation of any amount from this reserve fund is allowed for any purpose except for the purpose as may be specified by the RBI. However, RBI has till date not specified any such purpose. This means that the balance sheet of every NBFC has a separate "Reserve Fund" which is totally free and to which at least 20% of net profit gets added every year. Moreover this being a statutory provision which is in force since 1997 every NBFC carries substantial amount by way of this reserve fund in its balance sheet. This provision is unique to NBFCs only. As such this Reserve Fund can provide the cushion needed to ensure timely repayment of the amount raised by the debentures issued.

Further, as per the prevailing RBI norms for NBFCs, there are clear "Asset Liability Management (ALM) Guidelines" issued for NBFCs with asset size of Rs. 100 crores & above or having public deposit of Rs. 20 crores and above. This prevents any mismatch in the asset liability maturity profile, thereby ensuring sufficient liquidity for meeting all liability including debentures.

It is therefore requested that the status quo as per circular no. 04/2013 dated February 11, 2013 issued by MCA be maintained i.e

- ***I.*** ***the NCDs issued by NBFCs on the private placement basis should not be counted/considered for computation of DRR.***
- ***II.*** ***in case of public issuances of NCDs by NBFCs, the DRR requirement of 25% be maintained.***

III. ***<u>NBFCs should be exempted from the requirement to deposit/invest (in the specified account/securities) not less than 15% of the NCDs maturing during the year ending on the 31st day of March of the next year.</u>***

3. Prior Approval of Shareholders

Rule 14(2) of Companies (Prospectus and Allotment of Securities) Rules, 2014 provides as under.

A company shall not make a private placement of its securities unless the proposed offer of securities or invitation to subscribe securities has been <u>previously approved by the shareholders</u> of the company, by a Special Resolution, for each of the Offers or Invitations:

In case of offer or invitation for non-convertible debentures, it shall be sufficient if the company passes a previous special resolution only once in a year for all the offers or invitation for such debentures during the year.

Impact of the above provisions

All the Companies have to obtain approval of the shareholders by passing a special resolution before making any private placement. In case of closely held companies, obtaining shareholders approval is an easier task. However, in case of listed companies, this requires calling an EGM or sending a postal ballot Notice.

It would entail a huge expenditure and it would take minimum 45 days for completion of entire process of Postal Ballot before a listed entity can start private placement of Debentures.

<u>It is therefore requested that the listed entities making private placement of Non Convertible Debentures should be allowed to obtain approval of shareholders within one year of coming into force of the provisions of this requirement</u>

<u>It is also to be noted that MCA has allowed all companies one year time for obtaining shareholders approval for borrowing in excess of paid up capital and free reserves. Similar exemption should also be provided for obtaining shareholders approval for private placement of NCDs.</u>

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4. **Authority to Borrow Money under Section 180 of The Companies Act, 2013**

As per clarification issued by the Ministry of Corporate Affairs (MCA) vide its Circular No.04/2014 dated March 25, 2014, the resolution passed by companies under section 293 of the Companies Act,1956 ('the old Act') prior to 12.09.2013 with reference to borrowings (subject to the limits prescribed) and/or creation of security on assets of the company will be regarded as sufficient compliance of requirement of section 180 of the Companies Act, 2013 for a period of one year from the date of notification of section 180 of the Act .

It is requested that the ordinary resolutions passed by the shareholders of NBFCs under section 293(1)(d) in the last Annual General Meeting (AGM) held before 12/9/2013 authorizing the board of directors or committee thereof to borrow money should also be treated as sufficient compliance of Rule 14(2) of the Companies (Prospectus and allotment of securities), Rules,2014 as the resolution under the old Act permitted all kinds of borrowing of money including issue of NCDs on private placement basis.

This is because, after the enactment of Companies Act, 2013, NBFCs are currently finding it difficult to issue NCDs on private placement basis, as they are forced to approach shareholders for fresh Special Resolutions under Rule 14(2) of the Companies (Prospectus and allotment of securities), Rules, 2014.

Sir, the key Managing Committee members of FIDC would like to meet you and discuss with you personally the above referred issues.

Thanking you,

Yours sincerely,

For **FINANCE INDUSTRY DEVELOPMENT COUNCIL**

MAHESH THAKKAR
Director General