FIDC

Finance Industry Development Council

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

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July 23, 2013

To
Shri N. S. Vishwanathan
Principal Chief General Manager
Reserve Bank of India,
Department of Non-Banking Supervision
Central Office, World Trade Centre, Cuffe Parade,
MUMBAI 400 005.

Sir,

Sub: RBI regulation DNBD(PD) CC NO.330 /03.10.001/2012-13 Dt 27th June, 2013 on Raising Money through Private Placement by NBFCs-Debenture etc and the clarification issued vide DNBD(PD) CC NO.349 /03.10.001/2013-14 Dt 2nd July, 2013.

At the outset, we would like to thank Reserve Bank of India for bringing out guidelines to increase transparency in market borrowings of NBFC sector.

The regulation covers NBFCs borrowing through private placement of debentures, security cover on debentures, and disclosures documents. This representation seeks to focus on a few observations in guidelines, which in our view need to be relooked at considering their impact on the NBFC sector. These are enumerated below for your kind consideration.

Why do NBFCs resort to issue of secured debentures and how are they utilized?

Despite instructions of RBI, banks have still reservations in lending to the NBFCs. NBFCs have consequently been issuing secured NCDs to various retail investors on a private placement basis in full compliance with the provisions of the Companies Act and the RBI regulations. NBFCs are dependent purely on the retail market for their funding needs and secured debentures are a very important avenue of resource mobilization for NBFCs as the NBFCs cannot be dependent purely on bank funding for their business. If the banks suddenly refuse to grant loans, the NBFCs would be able to tap the retail market for their funding requirements.

The notable features of the secured NCDs issued by NBFCs are

- The monies raised by these secured NCDs have been deployed in providing credit to the non-corporate MSME sector only and for no other purpose. It is also well recognized that NBFCs are filling a huge credit gap to assist borrowers in several sectors which are underserved by the banking sector

- For the retail investors, this is a safe instrument as it is fully secured.

- The issue of NCDs is as per the provisions of the Companies Act.

- Independent Trustees who fully comply with the eligibility criteria and also perform their duties as prescribed under Section 117B of The Companies Act, 1956 are appointed and a Debenture Trust Deed is executed securing the issue of debentures as prescribed under Section 117A of The Companies Act, 1956.

- The security cover is around 125% of the value of the debentures and is sufficient to cover the principal and interest outstanding. The Trustees do periodic monitoring of this. All the above are to ensure that we are in full compliance with applicable regulations of the Companies Act & RBI.

- Secured debenture issues are also reported to the RBI and are being constantly monitored by the RBI

It is very relevant to recall here that the overall borrowing for NBFCs are controlled by the RBI, through Capital Adequacy Ratio.In such a scenario, NBFCs should be allowed to decide the sources of borrowing.

Specific dispensation for issue of secured NCDs by NBFCs

NBFCs are governed by the provisions of the Companies Act in issuing secured NCDs. Section 67 (3) specifically exempts NBFCs and Public Financial Institutions from the ceiling of 50 persons in case of a private placement. Further, it provides that SEBI would frame guidelines with regard to private placement of debentures by NBFCs.

Section 117A, B & C of the Companies Act which deal with creation of debenture trust deed & security, appointment of trustees, creation of debenture redemption reserve, clearly specify the terms in relation to issue of NCDs by NBFCs.

The RBI Public Deposit Acceptance Directions also exempts NCDs issued by NBFCs which are fully secured, from the purview of “public deposits”.

The Finance Ministry had constituted a Key Advisory Group (KAG) to review the regulatory issues of the NBFC Sector. The KAG in its report has reviewed the concept of private placement as applicable to banks and financial institutions and NBFCs and has recommended that the same be continued. The extract of the report of the KAG is set out below:

> ***3.3 Recommendations***
>
> *Keeping in view all these factors and to harmonise the broader objectives of financial inclusion viz-a-viz to gradually minimise the regulatory arbitrage, we make a few observations on some of the recommendations of the Working Group Report, as under:*

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(iii) At the time the Companies Act was last amended, it provided that an issuance to more than 49 persons would make such issuance a "public issue". However, considering their business requirements and subject to their complying with other requirements of a "private placement" as set out in Section 67 of the Companies Act, the Government of India decided to exempt Banks, Financial Institutions and NBFCs from this limit. ***<u>This exemption to the NBFCs may be allowed to continue.</u>***

When a specialized body such as the KAG which has been set up to review the regulations for NBFCs has recommended continuance of this provision, any restriction on the same, would be contrary to the interests of the NBFC sector.

Suggestion:

If the policy of the RBI is to cover issue of secured NCDs by NBFCs under these Guidelines, we kindly request you to consider the submissions made by us and grant exemption from the ceiling of 49 investors and minimum amount of Rs. 25 lakhs for issue of secured NCDs by such of the NBFCs which are serving the non-corporate MSME sector of the country and supporting Financial Inclusion in its own way. As referred above, such privately placed Secured NCDs to retail investors is well regulated under the Companies Act and the present RBI regulations

2. Minimum Gap of six months between two private placements.

The initial guideline stipulates that there should be minimum 6 months gap between two private placements. However, vide clarification dated July 2, 2013, the same has not been operationalised immediately. Nevertheless, we would like to point out the difficulties in implementing the same.

Likely difficulties:

a. Resource mobilization of NBFCs will be hampered. NBFCs will have to rely on banking system for their primary funding requirements, which also is capped.
b. Prescribing a minimum gap will substantially hamper ALM of NBFCs as NBFCs need to raise funds on a relatively more frequent basis depending on flow of business to ensure management of ALM mismatches appropriately.
c. NBFCs use private placement route to raise funds through different type of instruments such as perpetual debt, Subordinate debt and secured debentures. Keeping a gap between two private placements will significantly affect the NBFC capabilities to raise resources appropriately.

Substantial part of the corporate debt market is invested by Mutual Funds and Insurance companies. They normally support the investors in small tranches depending on their cash flow, based on the maturities of their existing investments and net inflow from the investors. Both the segments of the market viz. Investors as well as the borrowers (all Corporates incl

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NBFCs) would also plan their issuances depending on the interest rate view and liquidity requirement. Any sort of truncation on the number of such issuances would create a serious hardship for both, issuers and investors.

Further, the flexibility on the number of issuances provides an efficient way of managing the funds, as NBFCs would borrow at a point of time, only to the extent they require. Any sort of restriction, like two issuances in a year, would mean bunching of borrowing, by many issuers at the same time, which may not be supported in view of lack of depth in the market resulting in devolvement of issues. This would defeat the very purpose of the funding plan and the consequent impact on ALM exercise.

As you are aware, the Indian corporate debt market is lagging behind the other emerging economies and the government is looking for ways to strengthen the market. In this background, imposing restrictions on the number of issuances in a year would only dampen the corporate debt market rather than strengthening it.

Suggestion:

- Issuances through private placements to retail individual and institutional investors / FIIs and HNIs be kept out of the preview of these guidelines.
- SEBI has permitted 180 days validity for the shelf prospectus (offer document) in respect of debenture issue. Within this period and the limits specified therein, the Companies are permitted to raise funds as and when required, with necessary addendums. On similar lines, the regulations may prescribe the overall validity of multiple issuances for an offer document. This would ensure the desired planning of funds requirement by the NBFCs.

3. Security cover for debentures (by private placement or public issue)

The guidelines stipulate that the debentures issued at all points should be fully secured. In case security cover is insufficient/not created, the issue proceeds shall be placed under escrow until creation of security within one month from date of issue.

Likely Difficulties:

a. No security can be created before the issuance of the said debentures. Hence by default, the guidelines require NBFCs to deposit the issue proceeds in an escrow account. For issuances made to Institutional investors, they derive comfort on the issue based on their understanding of the issuer, in terms of management strength, performance, relationship, past track record, credit rating, pricing etc. The fear that the security may not be created is unwarranted. While all other corporate issuers of debentures have the flexibility to create charge within 90 days, putting a condition that it shall be created within 30 days – only for NBFCs, appears to be unduly harsh. Likewise, the other condition of depositing the issue proceeds in an escrow account, till the security creation, is not applicable to any other corporate issuer of debentures, except NBFCs.

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b. Currently as per extant rules of the Companies act, three month's time is allowed for creation of security which is through a debenture trust deed (as per section 113 and section 117 and para 15 of SEBI (issue and listing of Debt securities) regulations 2008). However, the new guidelines stipulate that the security shall be created within 30 days and till it is created, the issue proceeds shall be placed under escrow account. To keep the money in escrow till that time would significantly increase the cost of funding for NCD issuers and certainly not an efficient deployment of funds.

c. The process of creation of security is generally a two stage process – viz – creation of a mortgage on an immovable property in the sub-registrar office and creation of charge on the receivables with the Registrar of Companies. Further, the documentation as given by the legal counsel is required to be finalised by the issuer and the investor trustees to ensure the interests of all parties involved are protected. This process would normally involve minimum 3 weeks of time. Therefore, to follow this process of security creation every now and then is administratively challenging and time consuming.

Suggestion:

We therefore request that the existing position as permitted under section 113 and section 117 of The Companies Act and para 15 of SEBI (issue and listing of Debt securities) regulations 2008) be retained to NBFCs as well, as applicable to other corporate issuers of debentures.

4. Minimum subscription for a single investor shall be Rs 25 Lacs

Likely Difficulties:

Face value of private placement debentures to institutions, mutual funds, insurance companies, etc. is usually Rs 10 lacs. Market lots to facilitate secondary debt market is in multiple of Rs 10 lacs

Suggestion:

In this regard, minimum subscription of single institutional investor to be in multiple of Rs 10 lacs e.g. Rs 20 lacs. However, the minimum subscription cap should not be applicable to private placement of secured NCDs to retail individual investors.

5. Number of investors restricted to 49: clarification

We understand that the restriction on number of investors applies to unsecured debentures at the time of issue and not to (a) number of debenture holders whether retail individuals or institutional entities, and (b) not to secured debentures; and (c) not to the entities specified in RBI Act the borrowings from whom are exempt from the purview of "deposit" under section 45I(bb) of RBI Act, 1934 and the specific notification issued thereunder excluding inter-corporate deposits in any manner.

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We are also surprised to note that on an important issue like this, concerning the future growth of NBFCs, RBI has not sought public comments on this circular, but made it operational with immediate effect, contrary to the normal RBI's policy of consultation with stakeholders.

We once again thank the RBI for the steps being taken to ensure transparent & investor friendly resource mobilization frame work for Non-Banking Financial system in the country and hope the above suggestions will be taken into consideration.

Thanking you,

Yours sincerely,

FOR FINANCE INDUSTRY DEVELOPMENT COUNCIL

MAHESH THAKKAR
Director General