India

Chapter 10: Financing

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10.1 Market panorama

The Indian loan market is a milieu of a diverse range of credit providers, ranging from traditional banks, non-banking finance companies (NBFCs), debt funds, portfolio investors, small finance banks (SFBs) and startup lending platforms. These creditors cater to a variety of customers, ranging from deeply leveraged heavy industries, infrastructure projects, medium and small enterprises to the retail segments covering personal and business loans.

Lending in India operates largely in a regulated environment, primarily governed by the Banking Regulation Act, 1949 and supervised by the RBI. Where it involves retail investors or debt capital markets, SEBI in collaboration with the RBI provides additional regulation.

Traditionally, the main source of credit in India has been commercial banks, but over the last decade NBFCs have been increasingly active and have occupied lending spaces where regulated banks cannot operate or find it too risky to operate. This has resulted in the 'shadow' banking infrastructure mushrooming rapidly.

Banks in India operate under a heavily regulated regime. In order to start banking operations, companies are required to obtain a banking licence from the RBI under the provisions of the Banking Regulation Act, 1949. Banks are also subject to heavy regulation in the form of requirements on maintaining capital adequacy ratios, exposure norms, provisioning norms and end-use restrictions on loan proceeds.

NBFCs, while regulated by the RBI and operating under a licence regime prescribed by it, are subject to lighter regulations. In particular, NBFCs are exempt from lending restrictions on pricing and end use, providing greater flexibility to reach some of the underserved sectors and offering more innovative products. Also, depending on the sector and nature of facilities offered by NBFCs, different regulations apply. For instance, NBFCs allowed to accept deposits from the public under their licensing terms are subject to bank-type regulations, while non-deposit taking NBFCs operate under a fairly relaxed regime. Another prominent type of NBFCs are microfinance institutions, which have done tremendously well in boosting access to credit for medium, small and micro enterprises in India.

Other sources of traditional credit include international financial institutions, such as the World Bank Group and other multilateral development finance institutions, but their lending range is limited in light of their specific lending criteria.

Outside traditional credit providers, FPIs, venture debt providers, AIFs, retail lending platforms and SFBs have emerged as alternate sources of credit in the Indian markets. Considering the temporary liquidity stress in the NBFC market and conservative approach of banks, these sources have been progressively increasing their market share in the Indian lending landscape.

Lending by FPIs, venture debt providers and AIFs generally occurs by way of listed and unlisted debt instruments. Given that they operate in debt capital markets, they are regulated by SEBI. These regulations primarily relate to registration with SEBI, minimum eligibility requirements, and restrictions on entry and exit.

SFBs, on the other hand, are more akin to a traditional bank, but set up with the objective of financial inclusion for under-served sections of society. SFBs are also regulated by the RBI and require an SFB licence for providing the basic banking service of the acceptance of deposits and lending.

More recent additions in the retail lending space are platform lending entities and specialised Fintech companies. These entities provide technology-driven platform services for institutional and retail lenders. Platform entities providing services to institutional lenders are vicariously regulated through the regulation of institutional lenders by the RBI and/or SEBI. Platform entities providing services to retail lenders require a NBFC peer-to-peer licence from the RBI and are subject to certain other restrictions, including prohibition on lending on the platform.

10.2 Borrowing by Indian companies

Domestic borrowings from local sources such as banks, NBFCs and SFBs can be in any form depending on the requirement of the borrowers; that is, term loans, non-convertible debentures (NCDs), demand loans, discounting facilities and so on. For availing any of these financings, Indian companies typically need to comply with the requirements of the Companies Act, 2013, primarily comprising various approvals from their shareholders and board of directors, along with general authorisation under their constitutional documents for borrowing.

The RBI regulates loans extended by foreign entities to Indian entities, and such lending is classified as an ECB. Eligible borrowers may raise ECBs for up to $750m in a single financial year from eligible lenders, which must have a maturity period of at least three years. Eligible borrowers include all entities eligible to receive FDI, which excludes individuals. Recognised classes of foreign lenders include international banks and financial institutions, international capital markets, export credit agencies, suppliers of equipment, foreign collaborators and foreign equity holders. Money raised through ECBs cannot be used for on-lending for investment in equity or real estate purposes, acquisition financing or the borrower's general corporate or working capital purposes (unless an ECB for such a general or working capital purpose has a maturity of more than ten years). All eligible ECBs can be availed through an automatic route and, in some cases, require confirmation from the borrower's local AD bank. It is possible to get around some of these restrictions at times by going under the approval route by applying for the upfront permission of the RBI for the transaction after making a full disclosure, but the exercise of this authority by the RBI is entirely discretionary and all such requests are evaluated on a case-by-case basis.

Another route for availing foreign debt by Indian companies is from FPIs by way of the issuance of rupee denominated NCDs. FPIs can invest in NCDs under the following routes: (1) the voluntary retention route with on-tap limits, voluntary maturity thresholds for NCDs and exemption from concentration norms; and (2) the regular FPI route with the minimum short-term maturity of one year for NCDs subject to the monitoring of caps on total annual redemption at a portfolio level. Investment in listed NCDs by FPIs does not have any end-use restrictions. However, proceeds of unlisted NCDs cannot be utilised by the borrower for investment in capital markets, dealing in real estate business or purchase of immovable properties.

Indian companies can also borrow from AIFs and venture debt funds in the form of the issuance of listed or unlisted NCDs. This route is virtually without any material restrictions on maturity and end use, and can be structured as 'short-term' or 'long-term' investment subject to compliance with general requirements for such investments prescribed by the RBI and SEBI from time to time. Venture debt funds usually provide short-term debt funding because their objective is to provide bridge financing for the interim requirement of startups without the founders diluting their ownership and control in their companies. AIFs, on the other hand, have been capturing the void created due to the liquidity crunch faced by NBFCs and are active in infrastructure, real estate and the distressed assets space.

10.3 Security and guarantee

Typically, the most common forms of security are in the form of a mortgage over immovable properties, hypothecation of movable properties (including fixed and current assets) or a pledge over shares. All types of security creation over the assets of any company require the registration of the charge to be made with the ROC within 30 days of the creation of the charge. If this does not occur, the charge will not be taken into consideration if the company goes into liquidation. A mortgage of immovable properties must be registered with the concerned local Sub-Registrar of Assurances for the area where the mortgaged property is situated within four months of security creation. The mortgage is not enforceable until the registration has been made. However, this is not compulsory in some states if the mortgage is in the form of an equitable mortgage effected through the deposit of title deeds.

In respect of a pledge of shares, if the shares are in dematerialised form, a pledge creation form must be filed with the depository before the pledge will be effective. If the shares are in physical form, the pledge is created with the delivery of share certificates along with signed blank transfer forms.

There are no significant costs involved in relation to form filings with the ROC; a very small amount is charged as a nominal fee. However, there is stamp duty payable to the government at the time of the execution of any instrument and as registration fees post-execution in respect of mortgages. The rates of payment differ from state to state. In some states these duties are capped, while in others they are charged as an *ad valorem* percentage on the amount of debt secured without an upper limit, thereby pushing up transaction costs significantly.

It is possible for Indian companies to give downstream, upstream and cross-stream guarantees, provided they relate to the obligations of domestic entities and the passing of some corporate benefit can be demonstrated.

From a foreign debt perspective, the creation of security over the assets of the borrower or pledge over shares of the borrower and guarantees by third parties for securing and guaranteeing ECBs and NCDs subscribed by FPIs is generally permitted. However, obtaining a no-objection certificate from the AD bank of the borrower is a procedural requirement in certain cases.

Security over assets of third parties (promoters, shareholders and group companies of the borrower other than financial securities of the promoter) for securing ECBs may require approval from the RBI, although the RBI occasionally issues directions permitting/restricting such security creations. While structuring a security package for foreign debt, the prevailing foreign exchange directions issued by the RBI should be thoroughly reviewed.

Additionally, pursuant to the Companies Act, 2013, an Indian company cannot issue guarantees or provide any security on behalf of any other company if: (1) the respective boards of the two companies have any directors in common; (2) the directors of the guarantor company can jointly exercise at least 25 per cent of the total voting power available to the shareholders of the borrower company; or (3) the borrower company, its board or managing director is accustomed to acting according to the instructions of the guarantor company or any of its directors (individually or collectively). However, the above three restrictions will not apply if: (1) the borrower company is the wholly owned subsidiary of the guarantor company; or (2) the guarantor company is acting in the ordinary course of its business in giving such a guarantee or providing security; and (3) the shareholders of the guarantor company have approved the provision of such a guarantee or security by 75 per cent majority and the loan for which such a guarantee or security is being provided will be utilised for the principal business of the borrower company.

In India it is only possible contractually to determine the order of priority in conflicting security interests among secured creditors. While there is a statutory order of priority to be followed in the event of liquidation of the company that cannot be contractually overturned, the terms of the contract determine what will ordinarily be the order of priority in which secured creditors are repaid. All creditors of the same rank receive payment on a basis proportionate to their exposure only after the dues of all higher-ranked creditors have been completely discharged.