HALF-YEARLY NEWSLETTER

THE NON-BANKING FINANCIAL SERVICES SECTOR

August 2019

Snapshot

- So-called 'Liquidity – Crunch' stirred Indian non-banking financial services sector
- Prompt measures taken by regulators and government to avoid ripple effect
- Sector witnessed substantial deal flow
- Budget proposed expansion of the role of RBI in the interest of financial stability
- Expectation of more regulatory reforms, consolidation of smaller players, gradual revival of the market

Overview of the Sector

The Indian financial services sector (particularly the non-banking financial services sector) has been in the front-page news since October 2018. Last year, as the world marked the 10th anniversary of the global financial crisis triggered by the collapse of Lehman Brothers, ironically, the default on payments by certain large NBFCs (such as IL&FS), sparked panic across the sector. This crisis led to speculations about the possibility of a cascading effect and the so-called 'liquidity crunch' in the sector, which faced low market confidence majorly due to short term borrowings by NBFCs to fund long term loans, overleveraging and asset-liability mismatch. As these practices appeared sector wide, stakeholders such as banks, mutual funds and investors feared that many other NBFCs may default. As a result, banks and other institutions restricted lending to NBFCs and the lending rates rose. At the same time, the regulators and the Government took note of the issues plaguing the sector and promptly intervened to take corrective steps.

Despite a sudden collapse in the market, the situation improved since early this year. The regulators picked up the pace by introducing several measures to mitigate the situation. Some of the key regulatory measures included introduction of guidelines on co-origination of loans by banks and NBFCs by sharing of risks and rewards, revision of the Basel III framework to incentivise banks to increase fund flow to NBFCs, increase in the single borrower exposure limit for NBFCs and relaxation of the minimum holding period requirement for securitization of loans. The Reserve Bank of India (RBI) also pumped in money into NBFCs by investing in Government debt papers. RBI cut down the interest rates thrice this year. However, this did not have much trickle-down effect for NBFCs, which continued facing an increased cost of funding.

Recent indicative credentials

DHFL's majority stake sale in Aadhar Housing Finance

Lakshmi Vilas Bank on amalgamation of subsidiary of Indiabulls Housing Finance

Northern Arc on investment by IIFL, Standard Chartered PE and Affirma Capital

Itz Cash Card Limited on acquisition by Ebix Inc., USA of majority stake in Itz Cash

Ziploan's fund raise from Matrix Partners

Meanwhile, most of the NBFCs invested resources in setting their house in order. The measures which were widely witnessed included reduction in short-term borrowings specifically from commercial papers and turning to alternative borrowing routes like retail bonds via public issuances. Use of securitization also increased to free up cash flows and create immediate liquidity.

Amidst all this, market did not fall flat. Instead, the sector has seen massive deals (both private equity and strategic investments) so far this year, which go on to show the interest that investors continue to have in this sector. Some notable deals include:

- acquisition of majority stake in Aadhar Housing Finance Limited by Blackstone Group;
- acquisition of majority stake in Avanse Financial Services Private Limited by Warburg Pincus LLC;
- acquisition of minority stake in Northern Arc Capital Limited by Standard Chartered Private Equity and IIFL Special Opportunities Fund;
- acquisition of an undisclosed stake in ECL Finance, a subsidiary and NBFC arm of Edelweiss Group by CDPQ Private Equity Asia Pte Ltd;
- merger of Indiabulls Housing Finance Limited into Lakshmi Vilas Bank;
- merger of Gruh Finance Limited into Bandhan Bank Limited;
- acquisition of around 50% stake in DHFL Pramerica Asset Managers Private Limited by Prudential Financial, Inc; and
- acquisition of undisclosed stake in DMI Finance Private Limited by New Investment Solutions (Liechtenstein) AG (NIS).

REGULATORY OVERHAUL

Significant reforms proposed in the Finance Bill

The role of RBI has been significantly expanded to bring within its realm the following: (i) ability to remove a director from the board of directors of an NBFC and supersede the board of directors of any NBFC for a period not exceeding 5 years; (ii) ability to frame schemes for the amalgamation, reconstruction or splitting of NBFCs; (iii) ability to regulate housing finance companies (currently regulated by the National Housing Board).

It has been proposed that, for the purchase of high-rated pooled assets of financially sound NBFCs, the Government will provide a one-time 6 months' partial credit guarantee to public sector banks for their first loss of up to 10%. This is likely to provide more access to liquidity to NBFCs.

Further, taxation benefit has also been extended for deposit taking as well as systemically important non-deposit taking NBFCs by allowing taxation of interest on certain bad or doubtful debts of such NBFCs in the year in which the interest is actually received.

Recent Accolades

Ranked as Tier 1 Indian Law Firm

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Ranked as Outstanding Firm

Best Overall Law Firm

Harmonisation of NBFCs

RBI through its notification dated 22 February 2019 merged three categories of NBFCs which largely dealt with financing activities, namely (i) Asset Finance Companies (NBFC-AFC); (ii) Loan Companies (NBFC-LC); and (iii) Investment Companies (NBFC-IC), into a single category called 'Investment and Credit Companies' (NBFC-ICC). The idea behind this harmonisation is to move towards the principal of regulation by activity, rather than regulation by entity. Now, the same set of regulations will govern three types of businesses making it easier for financial institutions to carry on inter-related businesses and reducing compliance and monitoring costs.

Fintech Regulatory Sandbox

In a bid to promote innovations in the fintech industry, RBI and SEBI have introduced a framework for regulatory sandbox in the fintech sector. A regulatory sandbox is a safe space in which businesses can test innovative fintech technologies and products in a controlled environment with regulatory support, often in the form of exemptions from certain regulatory requirements provided on a case-to-case basis. The framework outlines the objectives, risks, benefits, and operational scheme of the regulatory sandbox, which is aimed at overcoming regulatory barriers to disruptive innovations while at the same time, ensuring consumer protection.

Use of Aadhaar Authentication Services for e-KYC by Entities other than Banking Companies

In March 2019, the Aadhaar and Other Laws (Amendment) Ordinance 2019 was passed, which had allowed only banking companies to use Aadhaar number of clients for the purposes of e-KYC authentication. Thereafter, on 9 May 2019, the Department of Revenue issued a circular setting out a detailed application process through which entities other than banking companies, can use Aadhaar authentication services. The procedure envisages the grant of permission by way of a notification issued by the Central Government if it is satisfied with the recommendations of the appropriate regulator and the Unique Identification Authority of India.

Expansion of the Ombudsman Scheme

In April 2019, RBI extended applicability of the 'Ombudsman Scheme for Non-Banking Finance Companies, 2018 (Scheme)' to non-deposit taking NBFCs having customer interface and an asset-size of INR 100 crore and above. The Scheme aims to promote a conducive credit culture among NBFCs and provide a cost-free and expeditious grievance redressal mechanism to customers. The Scheme, however, continues to be inapplicable to NBFC - Infrastructure Finance Company (NBFC-IFC), Core Investment Company (CIC), Infrastructure Debt Fund NBFC (IDF-NBFC) and NBFCs under liquidation.

Mandatory appointment of chief risk officer

RBI on 16 May 2019 mandated finance companies with asset size of more than INR 5,000 crores to appoint a Chief Risk Officer (CRO) to augment their risk management practices. The CRO has to be a senior official and be appointed for a fixed tenure with the approval of the board of directors of the NBFC. Such officer is required be involved in the process of identification, measurement and mitigation of risks.

Liquidity risk management framework

In May 2019, in an attempt to strengthen and raise the standard of Asset Liability Management (ALM) framework of NBFCs, RBI released a draft circular on Liquidity Risk Management Framework. This framework is required to be adopted by all deposit taking NBFCs, NBFCs with an asset size of INR 100 crore and above, and all CICs registered with RBI. The framework proposes a Liquidity Coverage Ratio (LCR) for all deposit taking NBFCs and NBFCs with an asset size of INR 5,000 crore and above. It also proposes (i) a liquidity risk management framework to be framed by the board of directors of all the applicable NBFCs to ensure that such NBFCs maintain sufficient liquidity; (ii) enhanced public disclosure on liquidity risk; and (iii) shorter time periods for measuring the cash flows and net funding requirement.

Impact of the 7 June circular on NBFCs

Until 7 June 2019, the recourse to a creditor for defaults by an NBFC was largely curtailed due to the exclusion of 'financial service providers' from the definition of 'corporate person' under the Insolvency and Bankruptcy Code, 2016 (Code). Therefore, an entity which provided 'financial services' (including NBFCs) could not be made to undergo corporate insolvency resolution process under the Code. The RBI has, in its 'Prudential Framework for Resolution of Stressed Assets' dated 7 June 2019, expanded the scope of such framework to also include NBFCs - a development which was ignored in the erstwhile framework for resolution of stressed assets. To some extent, this development will encourage investment in stressed assets housed in NBFCs by identifying such stressed assets and stitching together a resolution plan in a time bound manner.

Exemption from debenture reserve requirements

The Companies Act, 2013 earlier required NBFCs to create a debenture redemption reserve of 25% of the value of outstanding debentures issued through public issue. This requirement has now been removed. This change will again, go a long way in creating a level-playing field between NBFCs and commercial banks.

CONCLUDING REMARK

The regulatory framework governing the financial services sector has evolved and there undoubtedly is uncertainty about the market. However, regulators are coming up with elaborate and long-term policies to boost the market sentiment and infuse liquidity in the market. With the new Government coming in, fixing the capital crisis will be key to the success of its economic program. In the latter half of the year, we expect to see:

- More streamlined regulations to strengthen the asset liability management;
- Focus on digital transformation and cyber security;
- Increased infusion of funds by RBI into the market;
- Increased deal-making fuelled by consolidation of smaller NBFCs into larger ones; and
- More activity in the fintech space with increased number of financial technology platforms and customer focussed financial solutions.

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