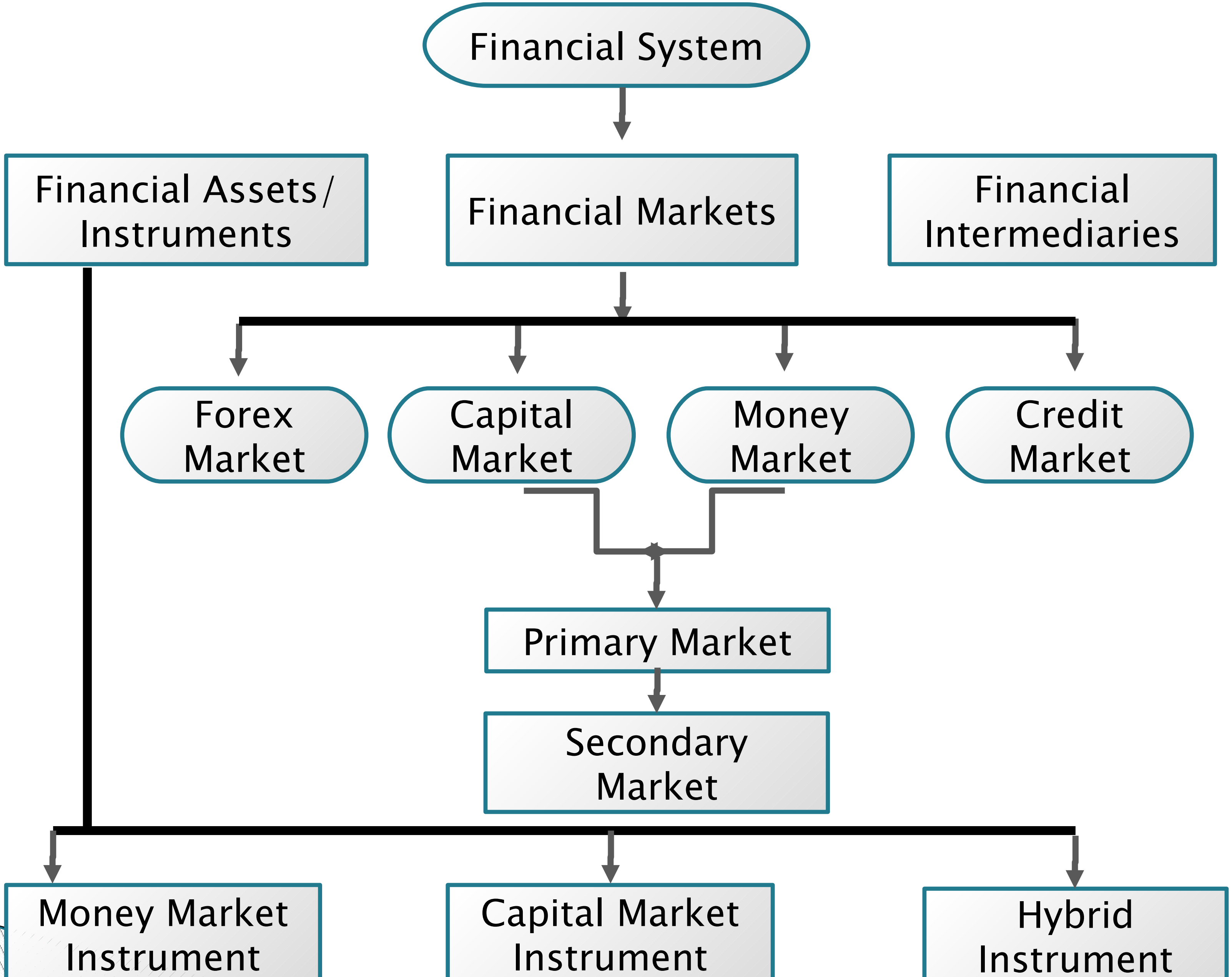
WIRC - ICAI

NBFC
Prudential Norms, Auditor's Directions and Other Regulations

CA Bhavesh Vora 18/06/2016

Coverage

- Existence of NBFC and Regulatory Development
- Bank v/s Non Bank
- Meaning of NBFC
- Classification of NBFCs
- Trend and Progress of NBFCs in past years
- Major Changes
- Applicability
- Important Definitions and Terms
- Other Compliances and related aspects
- Auditor's Report Direction
- Foreign Investment


Financial System
Financial Assets / Instruments
Financial Markets
Financial Intermediaries
Forex Market
Capital Market
Money Market
Credit Market
Primary Market
Secondary Market
Money Market Instrument
Capital Market Instrument
Hybrid Instrument

Companies
(Registered under Section 3 of the Companies Act 1956)

NBFCs Registered with RBI *

Regulation, Supervision, Surveillance & Enforcement under RBI

NBFC Regulated by Other Regulators

Type of Financial Institutions	**Authority for Regulation, Supervision. Surveillance & Enforcement**
Housing Financial Inst.	National Housing Bank
Merchant Banking Co, Venture Cap Fund Co, Stock Broking, CIS	SEBI
Nidhi Companies, Mutual Benefit Co	MCA
Chit Fund Companies	State Govt.
Insurance Companies	IRDA

Non Banking Non Financial Companies

Regulation, Supervision, Surveillance under the Companies Act 1956.

Regulator : ministry of Corporate Affairs (MCA)

Enforcement Agency : State Governments

Existence of NBFC

- Effective Financial Intermediary
- Earlier there were no entry norms and no requirement of compulsory registration
- Amendment related to compulsory registration came in January 1997
- Various Norms prescribed
  - Prudential Norms
  - Auditors' Direction
  - Prohibition on Acceptance of Deposits, etc…

Last Decade of NBFC

- Qualitative changes in functionin
- Effective Financial Intermediation
- Customisation of Service and quicker decisions
- Innovative products
- Increasing Financial Assets and becoming like a small Bank
- Gaining Sectoral Importance

Banks Vs. Non-Banks

- Both are Financial Intermediaries
- Banks Can:
  - Maintain Demand Deposits (savings/current Accounts)
  - Form a Part of Payment and Settlement Mechanism
- Non-banks Can
  - Accept only term Deposits
  - Does not form Part of Payment and Settlement Mechanism

Meaning of NBFC

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, 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

Classification of NBFCs

Mainly there are following class of NBFCs

- Asset Finance Company
  - Equipment Leasing
  - Hire Purchase Finance
- Investment Company
- Loan Company
- Core Investment Companies
- Infrastructure Finance Companies
- Factor
- Micro Finance Institutions
- Infrastructure Debt Funds

Types of NBFCs

- **Based on Liabilities**
  - Deposit Accepting (NBFC-D)
  - Non-Deposit Accepting (NBFC-ND)
- **Based on Assets (Activities)**
  - Loan Companies
  - Investment Companies
  - Asset Finance Companies
  - Infrastructure Finance Companies
  - Micro Finance Companies
  - Core Investment Companies (CIC)

Trend and Progress of NBFCs in past years

- Total about **11,769** NBFCs as on 30th September, 2015

- Number of NBFCs total is 11842 (31st March 2015) :

	NBFC-ND	**NBFC-D**
Number of NBFC	11622	220

- Total about 12,029 as on 31st March, 2014

Source: RBI

Note: No. of NBFCs reduced due to deregistration

Number of NBFCs as on 30-09-2015

Type	Number
NBFC-Deposit Accepting (incl. RNBCs)	209
NBFCs with Asset Size Rs. 500 Crore and Above	206
NBFCs with Assets Less than 500 Crore	11358
Total	**11769**

- Total about **12,225** NBFCs as on 31st March, 2013
- Total about **12,029** NBFCs as on 31st

Major Changes in 2007-08

- Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007
- Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008
- Additional obligation to NBFC-ND
- Introduction of Systemically Important NBFCs (ND-SI)

Recent Developments

- New prudential norms and revamp of old directions related to SI and Non-SI NBFCs based on regulatory framework issued in November 2014 (27th March, 2015)
  - Systemically Important NBFC (Non-Deposit Accepting or Holding) Companies Prudential Norms, 2015
  - Non-Systemically Important NBFC (Non-Deposit Accepting or Holding) Companies Prudential Norms, 2015
- Corporate governance directions 2015 introduced (10th April, 2015)
- Master Circular dated 03rd June 2015 and

Systemically and Non-Systemically ND-NBFCs

Particulars	Non-Systemically Important	Systemically Important
Asset Size	Less than Rs. 500 crore	Rs. 500 crore and Above
Not Accessing Public funds	Exempt from observing Prudential Norms, 2015 (Except Annual Certificate)	Not Relevant

- Relevance of Last Audited Balance sheet?
- NOF for all NBFCs – Rs. 200 Lacs
  - Rs. 100 Lacs by 31-03-2016
  - Rs. 200 Lacs by 31-03-2017

Applicability

- In order to identify a particular company as an NBFC, consider **both, the assets** and the **income pattern** – from the **last audited balance sheet** to decide principal business.

Financial Assets are more than **50%** of its **Total Assets (netted off by Intangible Assets)**

AND

Income from financial assets should be **more than 50% of the gross income**

- Fixed Deposits with Banks are not considered as Financial Assets (RBI Notification no. 259)

Important Definitions and Terms

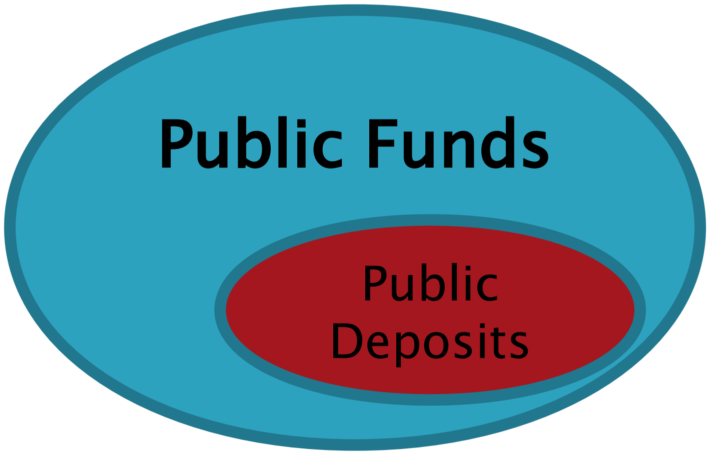
- **Owned Funds:**
  - Paid up equity capital, preference shares which are compulsorily convertible into equity,
  - Free reserves, balance in share premium account and capital reserves (representing surplus arising out of sale proceeds of asset), excluding reserves created by revaluation of asset
  - As reduced by accumulated loss balance, book value of intangible assets and deferred revenue expenditure,

Important Definitions and Terms....

- **CRAR** – (Tier I+Tier II)/Total Risk Weighted Assets
- **Conduct of Business Regulations** – Guidelines on Fair Practice Code and Know Your Customers
- **Customer interface** – interaction between NBFC and its customers while carrying on its NBFC business
- **Leverage Ratio** = Total Outside Liabilities/Owned Funds

Public Funds vs. Public Deposits

- "Public Funds" includes funds raised directly or indirectly through
  - Public Deposits
  - Commercial Papers
  - Debentures
  - ICDs
  - Bank Finance
  - And Excludes
    - Fund raised by issue of compulsory convertible instruments within a period not exceeding five years from the date of issue



Lending Against Shares

- Applicable to All NBFCs having asset size of Rs. 100 Crore and Above
- Against listed shares
- LTV of 50%
- Shortfall to be made good – 7 working days
- Applicability for Margin Trading Funding (MTF)
- Loan of Value more than Rs. 5 Lacs

Lending Against Gold Jewellery/Gold

- LTV ratio not exceeding 75% for loans granted against gold jewellery (raised from 60 to 75%)
- No advances against Bullion/Primary gold/Gold Coin
- Disclosure in the balance sheet
- Verification of Ownership
- Board to make policy
- Valuation of Gold as per prescribed norms

Leverage Ratio and Capital Adequacy Ratio

- **Non-Systemically Important NBFCs –**
  - Leverage ratio of 7 times
- **Systemically Important NBFCs–**
  - CRAR of 15% (of which Tier I capital shall be at least 8.5% by March 2016 and 10% by March 2017)
- **Gold Loan Companies (All Sizes)**
  - Primarily engaged in Gold Financing (above 50% of their financial assets)
  - Maintain 12% Tier I (for NBFC-ND-SI)

Accounting Aspects

- Investment in Unquoted Shares
- Category wise valuation not scrip wise
- Uniform Accounting year (April to March only)
  - Prior Approval of RBI before Approaching ROC
- Statutory Provision of 20% of PAT U/s 45-IC

Other Compliances

- Fair Practice Code
  - To be kept updated periodically
  - Keep Latest Signed Copy
  - Grievance officer
  - Vernacular language usage
  - Transparency while changes in terms and conditions
- Interest rate policy
- KYC Policy
- PMLA Policy
- Investment Policy
- Corporate Governance Policy

Asset Classification - NPAs

- NPAs – Presently 5 months, 3 months in phased manner (for NBFC-ND-SI and NBFC-D)
- Provision for Standard Assets (for NBFC-ND-SI and NBFC-D)
  - Increased from 0.25% to 0.30% by 31-03-2016, 0.35% by 31-03-2017 and 0.40% by 31-03-2018
- Sub-standard assets
- Doubtful Assets
- Loss Assets
- One account NPA, all facilities of the borrower are NPA

Important Audit Points

- Investment Accounting
- NPA Accounting and provisioning
- Capital Adequacy
- Income Recognition
- Asset Size
- Asset Income Pattern
- KYC Compliances
- PMLA Compliances
- Prudential Norms

AUDIT OF NBFCs

Auditor is required to conduct the audit in accordance with the:

- Requirements of the Companies Act, 2013
- Principles and procedures prescribed by Standards on Auditing (SAs) issued by ICAI and
- Requirements of the RBI Directions.

AUDIT OF NBFCs

Important Standards on Auditing (SAs) issued by ICAI

- Objectives and scope of an Audit of Financial Statements.
- Knowledge of the Business
- Documentation
- Audit Procedures
- Audit Evidence

AUDIT PROCEDURES / CHECKLIST – IMP AREAS

Non-Performing Assets (NPAs)

- The income of an NPA is to be recognized only on the basis of receipt
- To verify the NPA Statement and verify classification of NPA (No. of months, credit weakness, security etc.)
- Upgradation of NPA after it has satisfied the criteria laid down under RBI directions and not merely on account of rescheduling
- Provision against Sub-standard assets, doubtful assets and loss assets and disclosure of the NPA provision in financial statement without netting from the income

AUDIT PROCEDURES / CHECKLIST – IMP AREAS

Investments

- Investment policy framed by the Board of NBFC
- It should spell the criteria for long term and current investments
- To verify whether the inter-class transfer of investment is supported by board resolution, is done on beginning of each half year and at lower of cost or market value (scrip wise)
- Classification of investments and related requirements as to disclosures, valuation, provision for diminution have been complied by the company

AUDIT PROCEDURES / CHECKLIST – IMP AREAS

Investments (Contd…)

- Valuation of investments:
  - Current Investments
    - Quoted Equity Shares – lower of cost or market value
    - Unquoted Equity Shares –lower of cost or breakup value
    - Unquoted preference shares – lower of cost or face value
    - Unquoted units of Mutual Fund – NAV of each scheme
    - Commercial Paper – carrying cost
  - Long Term Investments
    - As per AS-13 on Investments issued by ICAI

If the Balance Sheet of investee company is not available for 2 years, such investments shall be valued at Rupee **ONE** only.

AUDIT PROCEDURES / CHECKLIST – IMP AREAS

Investments (Contd…)

- Investment in shares of another company shall not exceed 15 % of its Owned Fund. Further investment in shares of a group should not exceed 25% of its Owned Fund.
- Dividend on shares / units shall be recognised when the right to receive payment is established.
- To verify the investment as per books is shown in Demat / holding statement or physical verification.

Auditor's Report Direction- Introduction

- The auditor's report directions are issued by Reserve Bank as per powers conferred u/s 45MA of Reserve Bank of India Act, 1934
  - In the public interest
  - In the interest of the depositors
  - For the purpose of proper assessment of the books of accounts

Auditor's report (Reserve Bank) Directions, 1998 repealed

Auditor's Report

Applicability

The directions applies to Auditors of all registered and Non-Registered (Deemed NBFCs) whether Deposit Accepting or Non-Accepting.

Auditors to submit additional Report to the Board of Directors

The auditor to make a separate report to the Board of Directors of the NBFC (including deemed NBFCs) on the matters specified in the directions.

Auditor's Report Cont.....

Matters to be included in the auditor's report

The auditor's report shall include a statement on the following matters, namely:

In the case of all Non-Banking FinancialCompanies

I. Whether the company is engaged in the business of NBFI and whether it has obtained a Certificate of Registration (CoR) from the Bank

(Since the clause specifically mentions about obtaining Certificate of Registration, the clause is applicable to all those companies fulfilling criteria of 50% Financial Assets and 50% Income out of Financial Assets.)

Auditor's Report Cont.....

Points to be reported in case of NBFCs holding/accepting

i. Quantum within Prescribed Limit?
ii. Excess deposits has been regularized?
iii. Acceptance of Public Deposit without Minimum Investment Grade Credit Rating?
iv. Credit Rating obtained is in Force? Aggregate Deposits are as per limits specified in the ratings?
v. NOF level Rs. 200 Lacs? if no, whether deposits are frozen/brought down?

Auditor's Report Cont.....

(vi) Default in repayment of principal or interest by the NBFC?

(vii) Prudential Norms Compliances

- Income recognition,
- Accounting standards,
- Asset classification,
- Provisioning for bad and doubtful debts,
- Concentration of credit/investments, etc

Auditor's Report Cont.....

(viii)Capital Adequacy Ratio – correctly determined in returns filed? Whether CRAR is as per minimum prescribed?

(ix) Liquid Assets Requirements – Maintenance and communicating to regional office

(x) Return in NBS-1 filed within stipulated period?

(xi) Half yearly return on prudential norms

(xii) Compliance in relation to opening of new branch/office to collect deposits/ closure/ appointment of agent

Auditor's Report Cont….

Reporting in case of Non-banking financial company NOT accepting public deposits

Apart from the enumerated aspects applicable for all NBFCs - the auditor shall include a statement on the following matters, namely:-

1. Resolution for non-acceptance of Public Deposits
2. Accepted any deposits?
3. Compliance with Prudential Norms
   - Income recognition
   - Accounting standards
   - Asset classification and provisioning for bad and doubtful debts

Auditor's Report Cont….

Clause 4. <u>Reasons to be stated for unfavorable or qualified statements</u>

- Reason for unfavorable or qualified statement
- Unable to express any opinion on any of the items, indicate such fact together with reasons thereof.

Auditor’s Report Cont.....

In respect of Systemically Important Non-deposit taking NBFCs

(a) CRAR as disclosed in NBS- 7 return, has been correctly arrived at and whether such ratio is in compliance with the minimum CRAR prescribed by the Bank;

(b) Furnished to the Bank the (NBS-7) within the stipulated period*

*Quarterly within 15 days of the end of the Quarter

In case of companies that has obtained advice from RBI

Auditor’s statement on whether the company has obtained a specific advice from RBI? Whether those conditions are complied?

Auditor's Report Cont.....

Obligation of auditor to submit an exception report to RBI

- Any statement is unfavorable or qualified, or in the opinion of the auditor the company has not complied with:
- (a) The Chapter IIIB of RBI Act, 1934
  (b) The NBFC Acceptance of Public Deposits (RBI) Directions, 1998; or
  (c) NBF (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2015; or
  (d) NBF (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2015;

Auditor's Report Cont.....

Report to regional office – details of unfavorable or qualified statements and about the non-compliance in respect of the company.

- Matters to be included in letter to RBI
- Board report and the letter to RBI should be in sync
- Discussion with the client
- Letter received by auditors directly from RBI
- Proposed Remedial Measures

Change in Management/Auditors

- Generally Missed out changes
  - Auditor Change
  - Director Change
  - Auditor Address Change
  - Director’s Residential Address Change
  - Names and official designations of its principal officers
  - Principal officer and Designated director as per PMLA Rules
  - Specimen signature of the officers authorized to sign on behalf of the company
  - Office Address of NBFC

Foreign Investment

Foreign investment into Non-Banking Finance Companies is allowed to the extent of 100% under the automatic route in only the following activities:

- Merchant Banking, Under Writing, Portfolio Management Services, Investment Advisory Services, Financial Consultancy, Stock Broking, Asset Management, Venture Capital, Custodian Services, Factoring, Credit Rating Agencies, Leasing & Finance, Housing Finance, Forex Broking, Credit Card Business, Money Changing Business, Micro Credit and Rural Credit.

Foreign Investment Cont…

FDI is subject to following minimum capitalization norms:

- US $0.5 million for foreign capital up to 51% to be brought upfront
- US $ 5 million for foreign capital more than 51% and up to 75% to be brought upfront
- US $ 50 million for foreign capital more than 75% out of which US$ 7.5 million to be brought upfront and the balance in 24 months

Foreign Investment Cont…

- NBFCs having foreign capitalization of more than 75% and with minimum capitalization of US $50 million ca set up step down subsidiaries for specific NBFC activities
- Joint Venture operating NBFCs that have 75% or less than 75% foreign investment can also set up subsidiaries for undertaking other NBFC activities, subject to the subsidiaries also complying with the applicable minimum capitalisation norms

Foreign Investment Cont…

- Non- Fund based activities: US$ 0.5 million to be brought upfront for all permitted non-fund based NBFCs irrespective of the level of foreign investment subject to the condition that it would not be permissible for such a company to set up any subsidiary for any other activity, nor it can participate in any equity of an NBFC holding/operating company.

Change of Control

RBI Notification dated July 9, 2015 requires every NBFC to take prior approval from RBI for change in control if:

- It is in the nature of Acquisition of control of NBFC which may/may not result in change in management
- Any change in the management which results in change of more than 30% of directors, excluding independent directors.

Change of Control Cont...

- Any change in the shareholding, including progressive changes overtime which results in acquisition/transfer of 26% or more of paid up equity capital.
- However if such change in shareholding is due to buyback/reduction of capital approved by competent court, prior approval is not required. The same is to be reported within 1 month to RBI.

Application for Prior Approval

Application for prior approval should be submitted to Regional Office of DNBS on the letter head along with:

- Information of the proposed directors / shareholders
- Sources of Funds for acquisition
- Declarations by proposed directors / shareholders
- Bankers report on the proposed directors / shareholders

Prior Public Notice

- After obtaining prior approval from RBI, the NBFC along with the other party, either jointly or severally have to give a Public Notice of minimum 30 days.
- The notice should state the intention, the particulars of the parties and the reasons for such transfer / sale
- The notice should be published in atleast one leading national and one leading local vernacular newspaper

Core Investment Companies (CICs)

NBFC which is carrying on the business of acquisition of shares and securities and satisfies the criteria

(i) Holds not less than 90% of Net Assets in group companies;

(ii) Investments in equity shares in group companies constitutes not less than 60% of its Net Assets; (Net asset defined in Directions)

(iii) It does not trade in its investments except through **block sale** for the purpose of **dilution** or **disinvestment**;

(iv) It does not carry on any other financial activity except some specified acts

CIC is considered SI only if raising/holding public funds <u>AND</u> Total Assets of Rs. 100 crore or above

Other Aspects - CIC

- Other Important Aspects
  - CIC-Non-SIs not needed to provide statutory auditor certificate
  - 50% assets and income from financial assets criteria need not be met by a CIC
  - Planned CIC-ND-SI in the group can be formed by applying to RBI with business plan
  - Currently registered NBFCs can seek voluntary deregistration if fulfills criteria. Audited balance sheet and auditors certificate are required to be submitted for the purpose

Pyramid Marketing Companies

PONZI SCHEME

What is PONZI Scheme?

A Ponzi scheme is a fraudulent investment operation where the operator, an individual or organization, pays returns to its investors from new capital paid to the operators by new investors, **rather than from profit earned by the operator.**

PONZI SCHEME

How PONZI Schemes are operated?

- Operators of Ponzi schemes usually entice new investors by offering higher returns than other investments, in the form of short-term returns that are either **abnormally high or unusually consistent**.
- Ponzi schemes occasionally begin as legitimate businesses, until the business fails to achieve the returns expected.
- The business becomes a Ponzi scheme if it then continues under fraudulent terms. Whatever the initial situation, the perpetuation of the high returns requires an

Peer to Peer Lending (P2P)

- RBI issued consultation paper on P2P lending in April 2016
- P2P Lending a form of Crowd Funding
- The cumulative lending through P2P platforms globally has grown dramatically to 4.4 billion GBP from in 2015 from 2.2 million GBP in 2012
- Presently there are around 30 start-up P2P lending companies in India

P2P Lending (Contd.)

- P2P Companies act as aggregator for lenders and borrowers
- They follow a reverse auction model
- The documentation of the transaction is generally facilitated by the P2P lending platform
- Since all payments are through banks, the KYC is deemed to be conducted by the banks concerned
- The proposed regulatory framework would encompass activity, prudential regulations, governance, customer interface and reulatory reporting

Account Aggregators

- Account Aggregators fill the gap between different regulatory authorities by collecting and providing the information of customers' financial assets in a consolidated, organised and retrievable manner to the customer or any other person as per the instructions of the customer
- Availing the service of aggregators is purely at the discretion of the investor
- The RBI will regulate the activity of Account Aggregation

Account Aggregators (Contd.)

As per the draft directions:

- Only NBFC – AA will be able to undertake the aggregator activity
- Entities regulated by other financial sectors and only aggregating accounts of that particular sector do not need to register with RBI
- NoF should be minimum Rs. 2 Crore.
- Business has to be entirely IT driven
- An account aggregator cannot support transactions in financial assets

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NBFC Prudential Norms, Auditor's Directions and Other Regulations

CA Bhavesh Vora 18/06/2016