Operational Manual

NBFCs in India

Financing Growth... Powering Progress

About Enterslice

We are an Award Winning Legal and CPA Information Technology Enabled Services (ITES) concern.

We at Enterslice are committed to provide assistance to the entrepreneurs in legal registration procedures and in managing their business globally.

Be it a startup business or a well established concern, our dedicated professionals are resolved to provide bespoke solutions as regards business registration and legal compliance.

Our bevy of competent business advisers help to trace, decode and execute key business growth strategies.

Our wide range of legal & business registration services includes GST Registration, Company Registration, ITR Filing, ESI & PF Registration, NBFC & Microfinance Company Registration, FEMA Advisory and much more.

Our Core Operations:

- **Business solutions**
- **Fin-tech Solutions**
- **ITES Systems**
- **LegalTech Solutions**
- **Management Advisory**
- **HR Services**
- **FEMA Advisory**

From a strategy review of the Business development to the complete hands-on implementation, Enterslice Advisory can be truly your legal companion to grow your venture to a level further.

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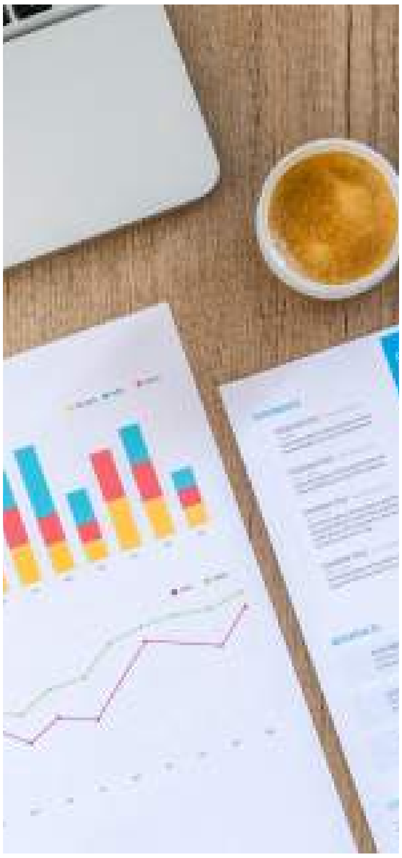

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An Overview of

NBFCs in India

Non-Banking Financial Company (NBFC) is basically an entity registered under the Companies Act, 1956, which offers financial services such as loans and advances. All NBFCs are registerd under the RBI Act 1934, and are governed by the Reserve Bank of India (RBI).

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Financial Instruments of

NBFCs in India

NBFCs in general, deal in the some key varieties of financial instruments that are listed below:

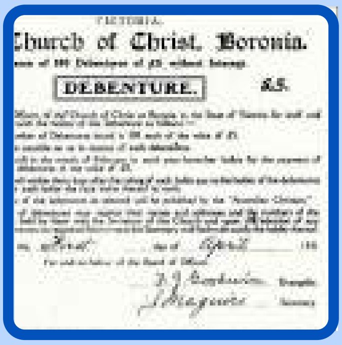
Stock Trading

Equity & preference shares

Bonds

Mutual Funds

Services by NBFCs



Debentures

What NBFCs Don't Do?

NBFCs are not involved into the following types of activities:

Agricultural activity

Industrial activity

Real estate activities

Purchase or sale of tangible goods

Summarized Activities of NBFCs

Here's a tabluar representation to understand what are the key functions of an NBFC:

What NBFCs do?	What NBFCs don't do?
Financial instruments: ▪ Stocks ▪ Bonds ▪ Mutual funds ▪ Debentures ▪ Equity & Preference shares11	▪ Agriculture activity, ▪ Industrial activity, ▪ Purchase or sale of any tangible goods ▪ Real estate activities
Financial services: ▪ leasing, ▪ hire-purchase, ▪ insurance ▪ chit-fund schemes	

On-boarding process of the

NBFCs

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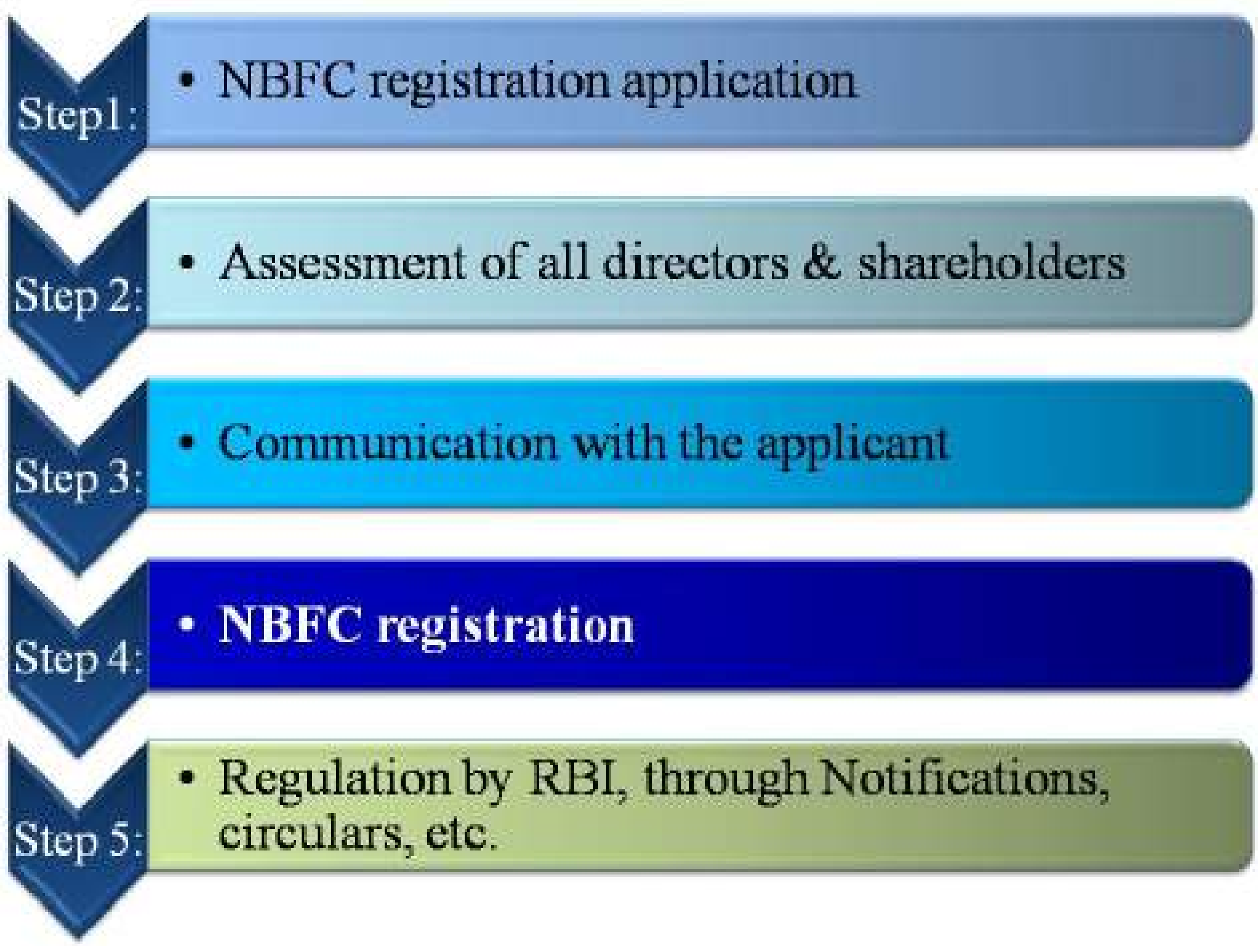
With the help of this flowchart we must briefly go through the process of how NBFCs are on-boarded by RBI:



On-boarding process of NBFCs by RBI

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Which type of NBFCs

to work on???

Before beginning an NBFC, it is very crucial to be sure of what type of NBFC business model to work on. Based on the type of business activity, NBFCs can be classified into the 10 types:-

1. ICC: Investment & Credit Company

This type of NBFC deals with the following lending & investment activities:

- Asset Financing
- Providing Loan
- Providing Investment solutions

2. IFC: Infrastructure Finance Company

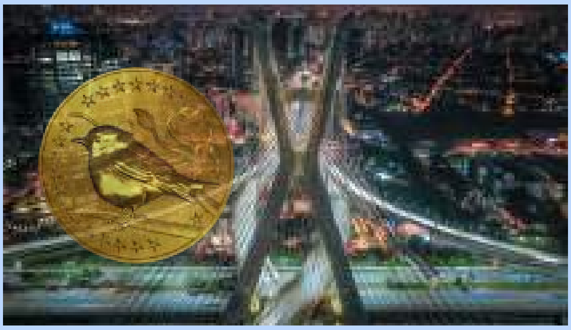
This type of NBFC mainly provides loans to the infrastructure companies, such as real estate or construction companies.

3. NBFC-ND-SI

(Non- Deposit taking Systemically Important Core Investment Company)

This type of NBFC mainly deals in financial instruments such as Equity & Preference shares, Debentures, Stocks. Besides, these NBFCs provide loans to the group of companies. Importantly, only those NBFCs can be classified as Systemically Important whose total assets are above ₹500 Crore as per the last audited balance sheet.

4. IDF: Infrastructure Debt Fund NBFC



Such NBFCs are mainly concerned with facilitating long-term debt to the infrastructural projects.

5. Micro Finance NBFCs

Micro Finance companies are those NBFCs are those which provide credit to marginalized sections of the society.

6. NBFC-Factor

This type of NBFC mainly deals in financial instruments such as Equity & Preference shares, Debentures, Stocks. Besides, these NBFCs The NBFC-Factors are mainly involved in acquiring accounts receivables of an assignor, by accepting assignment of such receivables, thereby providing discounted loans against the security interest over the receivables.

7. NOFHC

Non-Operative Financial Holding Companies (NOFHC) are those NBFCs that facilitate loans for establishing a new bank or a financial institution.

8. Mortgage Guarantee Company

Mortgage Guarantee Company is one that primarily deals in the business of providing mortgage guarantee.

9. Account Aggregators

Account aggregator NBFCs are those which are involved in retrieving or collecting or providing information of its client pertaining to the financial assets under a contract.

10. P2P platforms

Peer to Peer Lending Platform (P2P) is a newly evolved platform that enables the lenders and borrowers to come together for mobilization of funds.

Operational & Credit Policy

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As discussed above, all NFBCs are governed by RBI. Hence, for fair and seamless operations, the NFBCs are required to follow certain norms of the operational and credit policy as prescribed by RBI.

He we shall discuss in detail some key elements of the operational and credit policy stipulated by the Central Bank (RBI):

- Customer KYC Policy
- Anti-money laundering
- Pre-Settlement Policy
- Asset classification & Income Recognition
- Loan Write-off policy
- Restructuring of Loans
- Restricted Loans

We shall now elaborately discuss all the above key elements of NBFC Operational & Credit Policy.

I. CUSTOMER KYC POLICY

RBI directs all the Financial Institution to function as per the prescribed 'Know your Customer' procedure (KYC). KYC is essential to monitor any suspicious transaction nature and to report it to the appropriate authority.

The key motive behind the KYC guidelines is to safeguard the NBFCs & banks from being duped by illicit borrowers that might resort to money laundering activities. Besides, the purpose of KYC is to enable banks to understand their borrowers' needs and their financial dealings in a better way. This in turn helps them tackle their risks more prudently.

Accordingly, all the NBFCs are required to formulate their KYC policy with regard to the following key elements:

- *Customer Acceptance Policy;*
- *Customer identification process;*
- *Monitoring of Transactions;*
- *Financial Risk management.*

II. ANTI-MONEY LAUNDERING

It is quite coherent that fair & transparent transactions are necessary not only for the seamless growth of the industry, but also for the sovereignty & integrity of the nation.

In view of the above, the Department of Banking Operations and Development (DBOD), RBI had given detailed guidelines to all financial institutions, in line with the Recommendations of the Financial Action Task Force (FATF). These guidelines equally apply to the NBFCs. *(source: RBI)*

The recommendations of FATF on Anti Money Laundering (AML) and Combating Financing of Terrorism (**terror-funding**) standards have now become global benchmark for framing AML and anti terror-funding policies by the regulatory authorities.

Compliance with these benchmarks by the banks and NBFCs is therefore necessary for international financial relationships.

Here are the key guidelines by RBI for the NBFCs for drafting operational guidelines in line of KYC and Anti-Money Laundering measures:

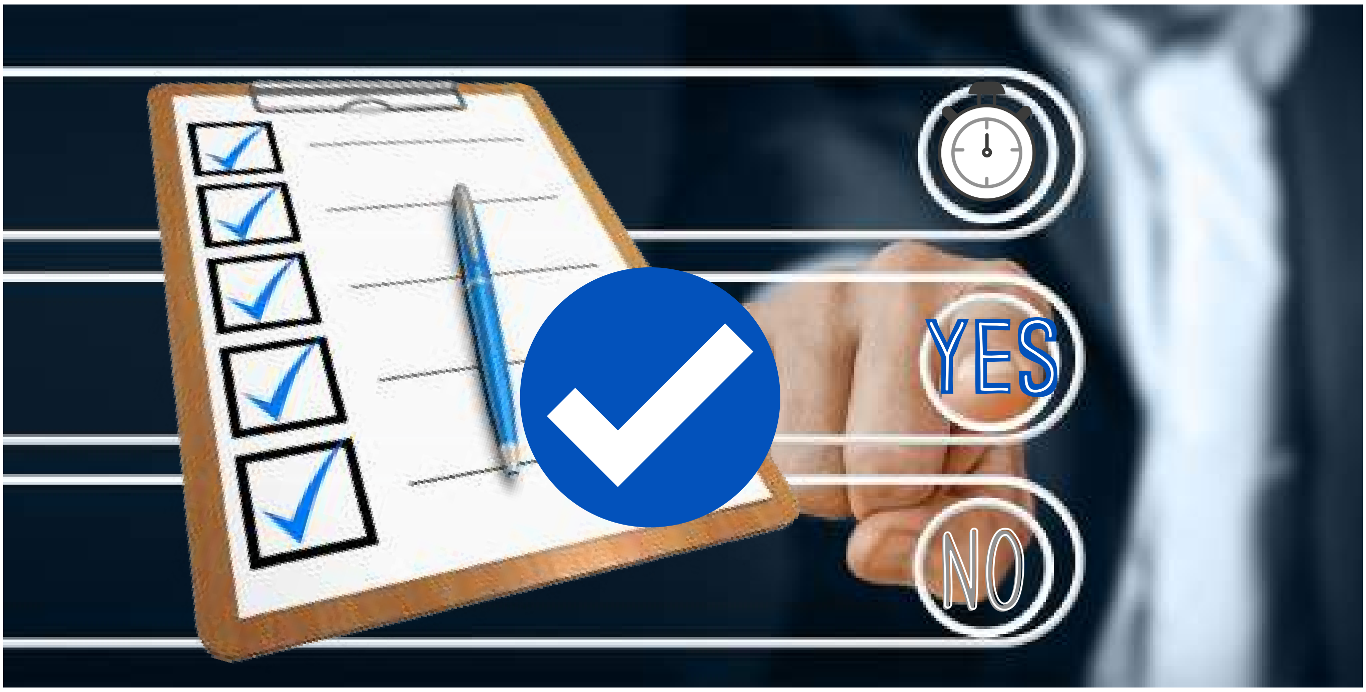
- Information of customer must be kept confidential and must not be revealed for any other purpose.
- Client information must be relevant to the perceived risk, and not intrusive.
- Other information from the customer must be retrieved only with his /her consent and after opening the account.
- The operational guidelines for NBFCs are issued u/s 45K & 45L of the RBI Act 1934. Any non-compliance with these shall be subject to penal action as per the provisions of this Act

I. Customer Acceptance Policy

NBFCs should frame a clear-cut policy vis-a-vis acceptance of customers. The Policy must ensure that precise guidelines are in place on the following aspects:

- No account shall be opened in a bogus/ benami name.
- Categorization of customers into low, medium & high risk, on the basis of their business activity, location of customer, mode of payment, turnover, etc.
- Documentation and other information in line with the Prevention of Money Laundering (PML) Act 2002 and RBI guidelines issued from time to time.
- Not to open an account or close an existing account in case of non cooperation of the customer as regards documentation.
- Necessary checks before opening a new account.
- In case a customer is permitted to act on behalf of another individual/entity, should be clearly spelt out.

II. Customer Identification Procedure



Customer identification implies tracing a customer and ascertaining his/ her credibility on the basis of his documents and information. Hence, NBFCs are required to gather satisfactory information in order to establish satisfactory identity of every new customer. In order to establish legitimacy of a new client-

- Trace the legal status of the individual/ entity through relevant documents
- Trace that any individual asserting to act on behalf of a particular legal person/entity is approved to do so.
- Ascertain the ownership and entitlement structure of a new customer. Accordingly, NBFC must verify the natural individuals who purport to control or act on the behalf of the legal person.

III. Monitoring of Financial Transactions

Monitoring of transactions is indeed an essential part of effective KYC. In fact, the NFBCs can effectively manage and mitigate their risk factor only with thorough understanding of the financial activity of a new customer. Here are the ways to do that:

- NBFCs should establish a system of periodical assessment of risk categorization of accounts (high, medium, low).
- Accordingly, they must take suitable and careful measures to rule out suspicion.
- NFBCs must ensure that all records of transactions in the books of accounts is preserved & maintained as prescribed u/s 12 of the PML Act, 2002.
- Additionally, it's important to ensure that suspicious or dubious are reported immediately to appropriate authority.

IV. Risk Management

For Risk Management, an effectual KYC programme must be there with suitable procedures. Here are the basic elements of the KYC programme:

- It should cover proper management faults, delegation of tasks, training and other related issues.
- NBFCs must create Risk Profiles of their current and new customers and take required Anti Money Laundering measures, to rule out financial risks.
- Effective employee training programme should be there to train the personnel in KYC procedures.
- Training should be different for the front-end staff, and back end staff, i.e. compliance staff.

III. PRE-SETTLEEMNT POLICY

Pre-settlement is a situation when a borrower wants to make an early repayment of his loan, before the tenor is complete. There should be a proper policy for the same. In case of client wishes to prepay/ pre-settle his loan, there must be proper T&C, so that he can pay the balance of his loan amount along with the interest due till date.

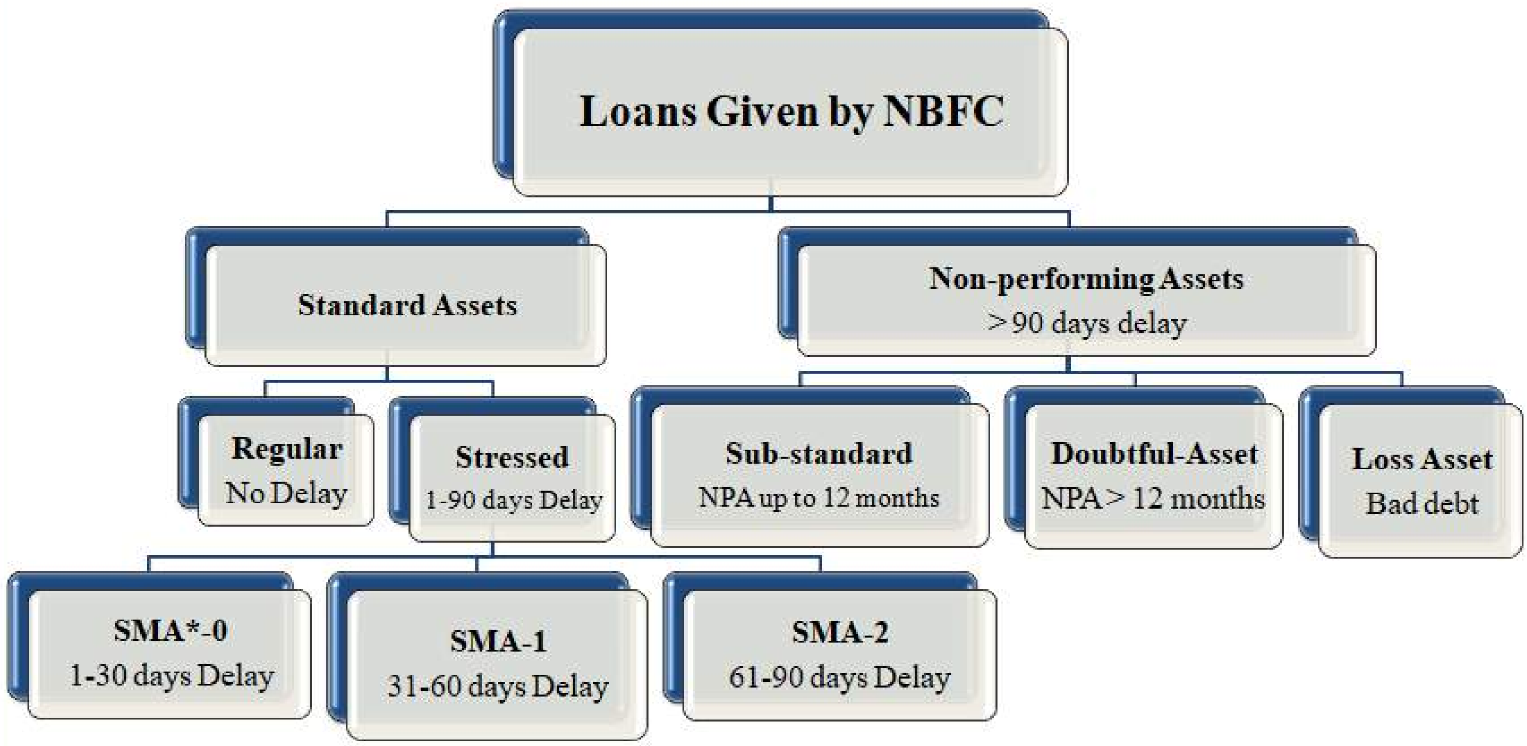
Here are some terms & conditions for Pre-settlement policy:

- Specify whether Part prepayment is allowed or not.
- Mention about prepayment penalty, if any.
- Specify reward/rebate for Pre-settlement, if any.
- Clarify whether Pre-settlement of loan for taking higher loan amount or next loan-cycle is permissible.

IV. ASSET CLASSIFICATION

It is important to note that Loans are an asset for banks, NBFCs or any financial institution. Hence, there's a need to categorize borrowers of loan as standard and non-performing assets.

Given below is the complete asset classification:



***SMA** stands for:- **Special Mention Accounts**, i.e. the loan asset on which principal or interest or both are overdue for a period up to <u>**90 days.**</u>

V. INCOME RECOGNITION

Income recognition by the NBFCs shall be done on the basis of the recognized accounting standards by ICAI. Accordingly,

- Income that includes interest or any other charges with respect to all types of NPAs shall be recognized only when realized.
- Accordingly, income from all NPA shall be recognized on `Cash' basis.
- Any such income to be recognized before the asset became NPA. Remaining unrealised income shall be derecognized and reversed.

VI. LOAN WRITE-OFF POLICY

When a NPA loan attains a certain period in arrears, it can be written off. There are guidelines for NBFC to write-off such loans.

Here are basic RBI guidelines for the same.

RBI guidelines for Loan Write-off Policy

Types of loan assets	RBI Guideline
Standard Assets	1% of the outstanding
Sub-Standard Assets	50% of the outstanding
Loss Asset	100% of the outstanding

In general, the NBFCs must opt for a suitable accounting policy for Loan write-off. A policy that quickly removes NPA loans from the books can however underrate the real value of the portfolio, while simultaneously and unnecessarily overstate quality of the portfolio.

So, while reviewing the portfolio quality, the analyst must trace the level of write-offs as bad debts.

VII. RESTRUCTURING OF LOANS

NBFCs can also restructure or reschedule the terms of existing loan agreement as per policy framework laid down by their Board of Directors. However this may be done in following cases:

- Before commencement of business;
- After commencement of business, but before the asset has been classified as sub-standard.
- After commencement of business and after the asset has been classified as sub-standard.
- In each of the 3 cases, the restructuring of principal and / or interest could be done, with/without sacrifice.

VIII. RESTRICTED LOANS

NBFC & MFIN are required to specifically disapprove the following types of loans:

- Loans to bailout/replace the lenders who wish to withdraw.
- Loans to political candidates, parties or other political organizations.
- Loans to gambling enterprises.
- Loans for drugs and alcohol related activities.
- Loans for weapon/ armament activities.

Thank you!

For more info, please contact:-

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