EXTERNAL COMMERCIAL BORROWINGS NORMS FOR NBFC FUNDING

By Akash Dubey

External Commercial Borrowings Norms for NBFC Funding

In a recent development, the RBI issued **new guidelines for External Commercial Borrowings (ECB) in NBFC funding**.

The RBI has allowed external commercial borrowings for working capital purposes, general corporate purposes and repayment of bank loans. Borrowing for on-lending (Loan to lend money to the third party) by NBFCs for the above mention maturity and end-uses is also permitted.

The step is taken to grant long term availability of funds to Non-Banking Financial Companies (NBFCs). However, the ECB's should be raised from eligible lenders except for foreign branches/ overseas subsidiaries of Indian banks.

Earlier in its order issued as on 26 March 2019, it debarred ECB proceeding to be used for the working capital purposes, repayment of bank loans. The solution to NBFC problem of mismatch of assets and liabilities is the highlight of this notification.

Change in Provision of ECB for NBFC Funding

The changes in RBI provision in relation ECB funding are as follows:

As Per the Old Provision Dated 26th March 2019

The RBI in its order as released on March 26, 2019, said

"ECB proceeds cannot be utilized for working capital purposes, general corporate purposes and repayment of rupee loans except when the ECB is availed from foreign equity holder for a minimum average maturity period of 5 years. Further, on-lending for these activities out of ECB proceeds was also prohibited."

Who is a Foreign Equity Holder?

The RBI defines Foreign Equity Holder as a person who is a direct equity holder with a minimum of 25 % direct holding in the borrowing entity. If the person is an indirect equity holder then he should possess a minimum of 51 % of equity. Additionally, a group of company with a common overseas parent also fall under this category.

As Per the New Provision Dated 30th July 2019.

The new notification of RBI in concern with the use of ECB allowed the use of such borrowings for working capital purposes, general corporate purposes as well as for repayment of loans. The fact states that the **bank credit for the NBFCs stood at 6.2 lakh crores as on April 2019.**

ECB for Working Capital

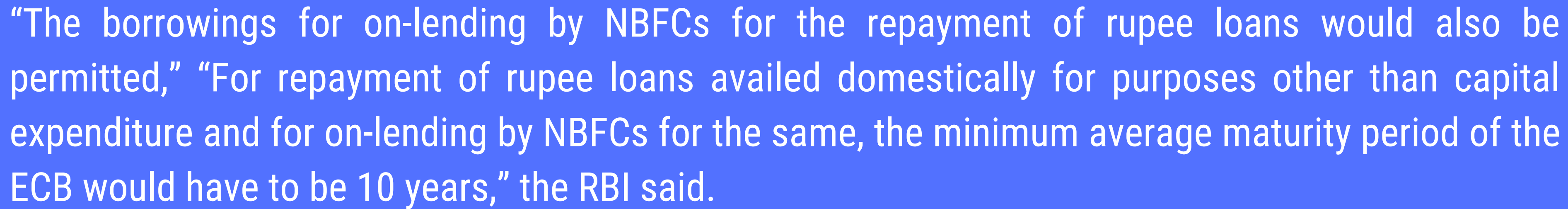
The RBI allowed **ECB's with a maturity period of 10 years for working capital purposes and general corporate purposes.** Borrowing for on-lending by NBFCs for the above-mentioned maturity period and end-uses is also permitted.

"Borrowing for on-lending by non-banking financial companies for the 10-year maturity and end-uses are also permitted," **The RBI said.**

ECB for Repayment of Rupee Loans

The RBI also permitted the **use of ECB's for repayment of rupee loans/bank loans** that were availed domestically for capital expenditure. The average maturity period is of 7 years for such utilization of ECB's.

Additionally, if the existing bank loans are taken for some purposes other than capital expenditure then the period of maturity will remain of 10 years.



> “The borrowings for on-lending by NBFCs for the repayment of rupee loans would also be permitted,” “For repayment of rupee loans availed domestically for purposes other than capital expenditure and for on-lending by NBFCs for the same, the minimum average maturity period of the ECB would have to be 10 years,” the RBI said.

Who are Eligible Lenders and Eligible Borrowers?

The eligibility criteria for borrowers and lenders have been prescribed by the RBI. Only such entities and people are permitted to take and lend funds via ECB route. The eligible borrowers and lenders are divided into two categories.

This distinction is on the basis of the currency that is being used in the transaction of funds. There is different eligibility for funds taken in any freely convertible foreign currency and in Indian Rupee (INR) as per the **Master Direction – External Commercial Borrowings, Trade Credits, and Structured Obligations laid by RBI.**

Eligible Borrowers for Funds Taken in Easily Convertible Foreign Currency

This includes all the entities that are eligible to receive FDI. Further, the following entities are also eligible to raise ECB:

- Port Trusts
- Units in Special Economic Zones
- SIDBI
- EXIM Bank of India.

Eligible Borrowers for Funds Taken in Indian Currency (INR)

- All entities eligible to raise ECB in Convertible Foreign Currency;
- Registered entities engaged in micro-finance activities, viz., registered Not for Profit companies, registered societies/trusts/ cooperatives, and Non-Government Organisations.

Eligible Lenders for Lending Funds via ECB Route

The lender should be resident of FATF or IOSCO compliant country, including on transfer of ECBs. However,

- Multilateral and Regional Financial Institutions where India is a member country are eligible lenders;
- Individuals as lenders can only be permitted if they are foreign equity holders or for subscription to bonds/debentures listed abroad; and
- Foreign branches/subsidiaries of Indian banks are eligible lenders only for FCY ECB (except FCCBs and FCEBs).
- Foreign branches/subsidiaries of Indian banks, subject to applicable prudential norms, can participate as arrangers/underwriters/market makers/traders for Rupee denominated Bonds issued overseas. However, underwriting by foreign branches/subsidiaries of Indian banks for issuances by Indian banks will not be allowed.

Need for New ECB Norms for NBFC Funding

The new norms came in the awakening of the prevailing problem of Liquidity crunch in the sector. The banks stopped lending to NBFCs significantly after the NBFC crisis surfaced. The situation created an environment of panic for the 10000 odd NBFC in the country.

Bank loans, mutual funds borrowings, and funding are three primary sources of NBFC borrowings. In case of crisis, the NBFC sector faced a tough time in raking funds from any of the three within the domestic market.

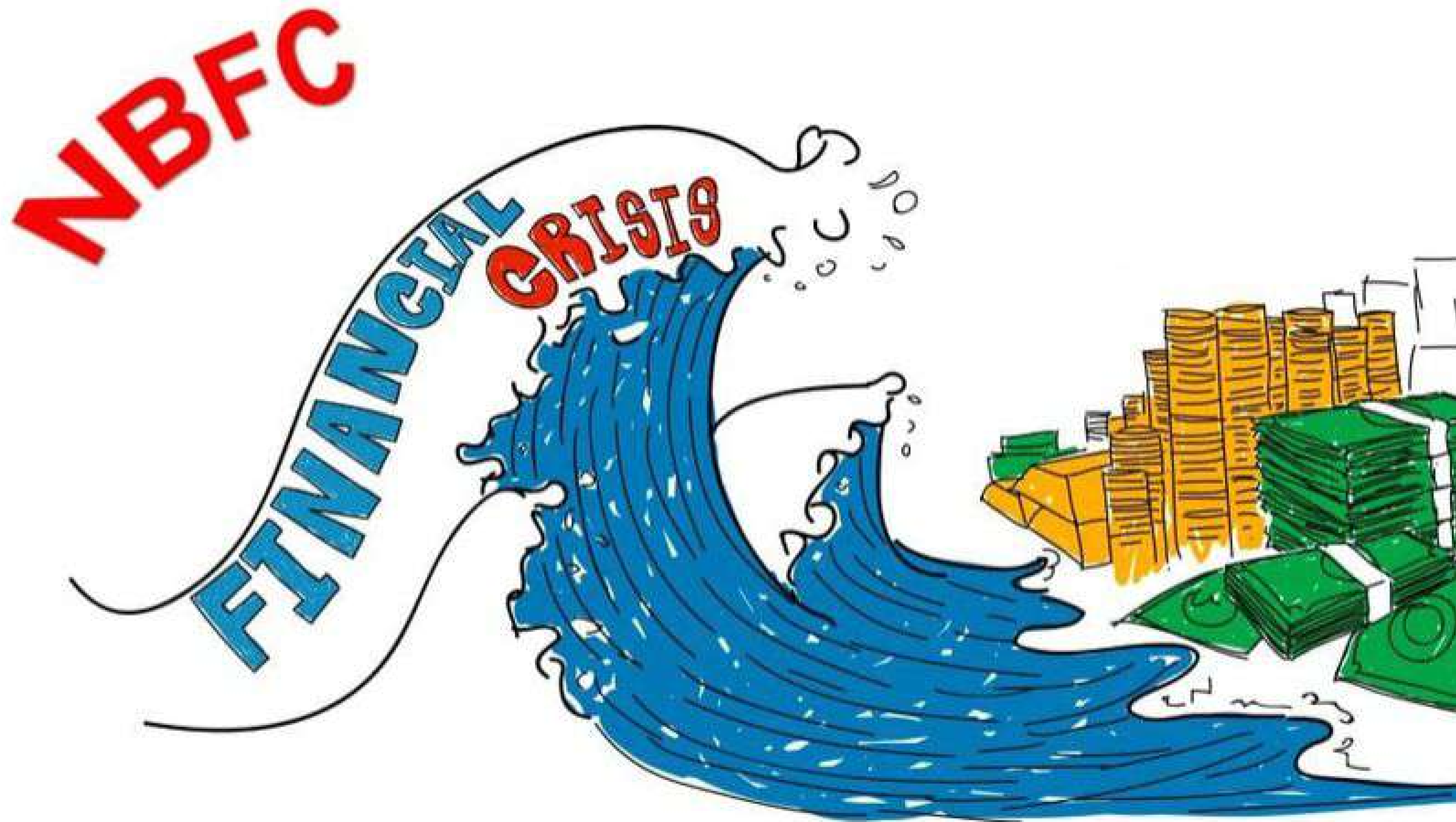
As per the industry experts, the trouble faced by the sector is not mainly because of the lending practices but because of the borrowing patterns of the NBFCs. NBFCs used to take a borrowing in short term debt papers or commercial papers for a period of 6 months to 3 years.

On the other hand, they used to lend loans for a longer period of 8 to 10 years. This is more in practice among NBFCs working in real estate and property loan sector.

Role of NBFC Crisis in Liberalization of ECB Rules

The NBFC crisis took over the sector by storm. The default of Mumbai-based Infrastructure Leasing & Financial Services (IL&FS) in September 2018 wrecked the sector in a doomed state on the investments front. **The 3-decade old NBFC giant reported holding projects worth Rs 1.75 lakh crores (25Billion US dollars).**

The situation became so bad that it was compared to the 2008 Lehman Brother crisis that leads to the recession of 2008. Waking up to the possibilities of sectorial fall, the government took up a step to intervene in the matter to prevent possible damages.



The flawed working **model of lending long terms loans by generating fund by the issue of short term commercial papers is cited as the reason for new norms.** The short term loans or debt papers needed to be either renewed or freshly issued to new buyers.

The model worked fine in times of economic stability. However, this way of raising NBFC funding becomes a difficult task when it not all green in the economy. This mismatch in the asset and liability of NBFC's is the main reason for increasing default rate.

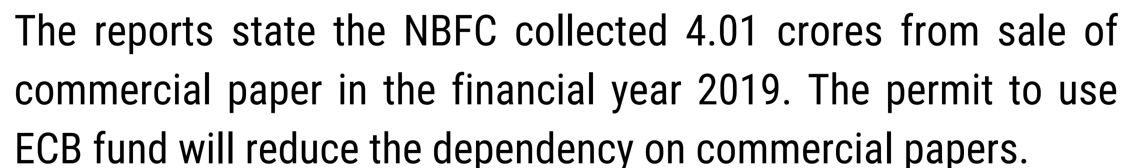
The maturity period of 10 years for working capital purposes and general corporate purposes and 7 year maturity period for loan repayment is aimed to reduce this asset-liability mismatch.

The Impact of ECB Norms For NBFC

The RBI notification came in a time when the NBFC's are struggling to raise funds from the domestic market. The move is expected to provide relief to such entities in raising overseas funds. The minimum ECB maturity period is 10 years for working capital purposes and general corporate purposes as per the new ECB norms by RBI.

The inflow of NBFC funding via ECB route is expected to help NBFC's who are struggling to maintain a positive working capital ratio. The funds will provide flexibility in business operations.

The other benefit came in the permission of utilizing ECB for bank loans repayment. This is expected to balance the default rates among NBFC. The government expects that it will provide financial stability in the NBFC sector and make available for a cheaper source of NBFC funding.



The reports state the NBFC collected 4.01 crores from sale of commercial paper in the financial year 2019. The permit to use ECB fund will reduce the dependency on commercial papers.

Interestingly, **NBFCs are the main source of funds for the MSME sector.** Therefore the stability in the NBFC sector is crucial for the growth of MSME. Experts believe that funding via ECB route in NBFCs will provide flexibility to its lending operations.

Experts Opinion on ECB Funds

The **provisions are not sufficient to curtail the present NBFC crisis.** According to industry experts, the maturity period of 10 years may attract less foreign investors due to the long period of maturity.

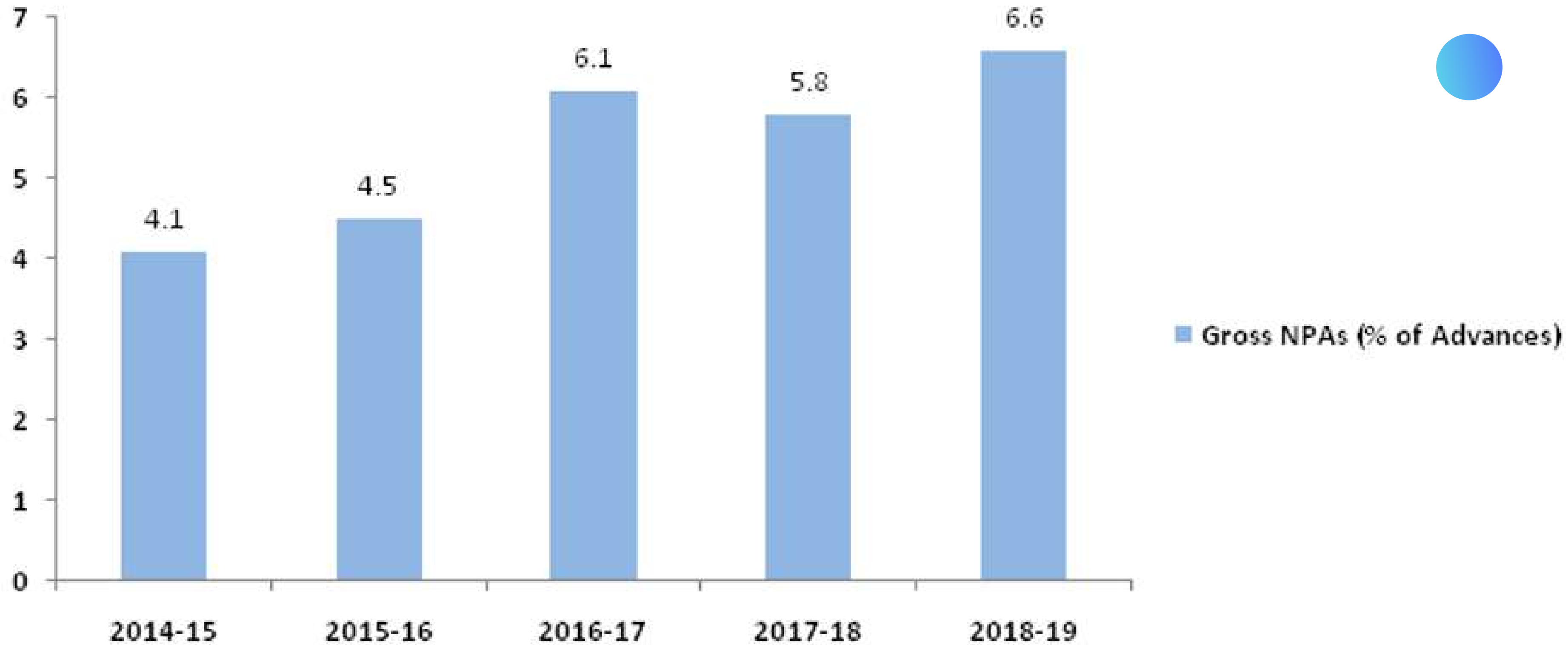
According to them, **the lock-in period of 3 to 5 years is ideal to increase the flow of foreign investments in NBFC** via External Commercial Borrowing.

The Regulatory Outlook

The big question is that why RBI issued a longer period of maturity for ECBs. The RBI is acting guard to prevent a fall out of the NBFC sector. As per the experts, the RBI look no short term provisions to tackle the situation.

The State of NBFC Sector in India	Year on Year % Growth	
Particulars	End of March 2018	End of March 2019
Total Income	11.4	17.8
Total Expenditure	9.6	17.8
Total Profit	27.5	15.3
Total Borrowings	19.6	19.6
Bank Borrowings	34.4	47.9
Commercial Paper	13.3	4
Current Liabilities and Provisions	22.4	48.7

The apex body wants to ensure sustainable and long term solutions to ensure healthy functioning of the NBFC sector. The primary problem of asset-liability mismatch was the pain point of prevailing times. A long maturity period is cited to ensure long term availability of NBFC funding.



At the same time, the dependency of the MSME sector on NBFCs is also a point of concern. Therefore, the stability by way of maturity period was necessary to provide funds availability to the MSME sector.

For a fact, The RBI has bought **debt papers worth rupees 3 lakh crores in the financial year 2019** to help the banking systems in the country.

Main sources of NBFC Funding

Option 1 – Compulsory Convertible Preference Shares ('CCPS')

NBFCs can issue CCPS without obtaining prior approval of RBI if the conversion is capped at less than 26 percent. Hence, we can say that approval is not required in case there is no progressive increase in the shareholding.

However, at the time of conversion of preference shares into equity, prior approval of RBI is necessary. CCPS can be issued for a maximum period of 20 years. Now if we talk about the tax implications then in case CCPS issued at par or face value there shall be no tax implication.

There are some prescribed NBFCs that are allowed to take FDI through 100 automatic route by complying with the other conditions as prescribed by the RBI.

Prior written permission from RBI is required in case of any change in the shareholding of the NBFC, on a progressive basis which would result in acquisition/transfer of shareholding of 26 percent or more of the paid-up equity capital of the NBFC.

Option 2 – Issue of Different Class of Equity Shares

The NBFCs can raise funds by issue of a different class of equity shares. However, the voting rights of this class of equity shares should be less than 26 %.

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Prior written permission from RBI is required in case of any change in the shareholding of the NBFC, on a progressive basis which would result in acquisition/transfer of shareholding of 26 percent or more of the paid-up equity capital of the NBFC.

There are no tax implications for raising funds by this method if the shares are issued at fair market value by merchant banker as per the Rule 11UA of the Income Tax rules.

As per the companies act, the conditions in relation to the issue of differential voting rights shall not be applicable to a private limited company, only if where the Company has provided the same in the memorandum or articles of association

Option 3 – Issue Debt or Redeemable Instruments

NBFC can issue redeemable instruments i.e., Redeemable Preference Shares ('RPS') or Optionally Convertible Preference Shares ('OCPS'). The OCPS / RPS can be redeemed for the maximum period of 20 years. Now if we talk about the tax implications then in case OCPS issued at par or face value there shall be no tax implication.

As per the FDI regulations, the investment made by an FOCC in equity / CCPS / CCD of another Indian company is considered as Downstream Investment. On the other hand, as per the RBI, FOCC can subscribe to other instruments such as RPS, OCPS which shall not be regarded as a Downstream Investment.

Also, Read :-

- **Analysis of NBFC Liquidity Crunch in NBFC Sector**

The Road Ahead for NBFC Funding

The new ECB norms are helpful but not sufficient to curb the prevailing issues in the NBFC sector. The other ways which can be used to facilitate NBFC funding are Public bond Issue, Sale of Assets, etc.

The ECB route to gather NBFC funding will repair the balance sheet of NBFCs for now. However, there is a need for strict norms. The major focus should be on **improving the underwriting quality of the sector.**

There is a need to increase the forensic capabilities to spot the black sheep of the sector. Interestingly, the RBI is also looking for detailed collection of data from NBFCs. Finally, the factor of liquidity will also be taken into consideration.

Ensuring strict norms will help to flow funds via External commercial borrowings route. Moreover, the NBFC sector plays a catalyst role in the growth of the GDP of the country. The **Government projects the GDP growth rate at 8 % whereas the RBI projects it to be 7%.** The state of the NBFC sector will have a considerable impact on GDP growth.

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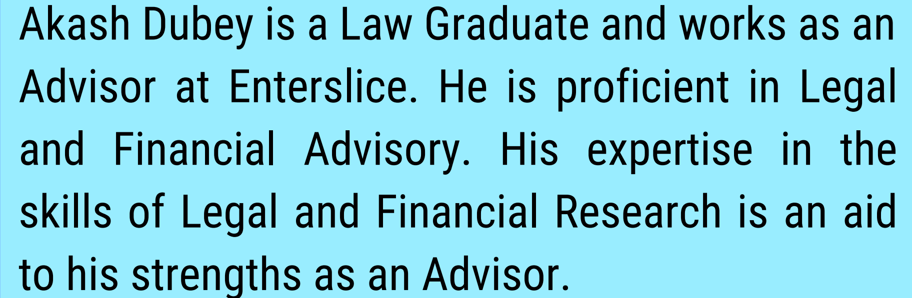

Akash Dubey is a Law Graduate and works as an Advisor at Enterslice. He is proficient in Legal and Financial Advisory. His expertise in the skills of Legal and Financial Research is an aid to his strengths as an Advisor.

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