

## **"CONNECTED LENDING" - GAP IN NBFC GOVERNANCE?**

The business of "banking" is as defined in Section 5(b) and Section 5(c) of The Banking Regulation Act, 1949 (BR Act). The business of a "Non Banking Finance Company (NBFC)" is as defined under Section 45I(f) of Reserve Bank of India Act, 1934. The business of Banking or NBFC can be undertaken only by an entity incorporated under the erstwhile Companies Act, 1956 or Companies Act, 2013. Though there are various aspects that differentiate these two forms of businesses, a key commonality is that both are involved in the activity of "Lending" through borrowed funds - whether through deposit acceptance or raising of funds through other permitted sources.

The lending activity acts as a fuel to economic growth which in turn generates returns/profits for these companies and enable them to duly and adequately repay their depositors/creditors. Hence in order to protect the interest of these depositors/creditors, channelizing the borrowed funds towards the right end use is an essential part of the activity of these companies as it can otherwise pose credit risks to its operations. Lending in the "ordinary course of business" is permitted. However lending by these companies to their directors or parties in whom they may be interested can lead to transactions that may not be in line with the terms and conditions imposed in the ordinary course of business and may lead to pecuniary interest that may affect the interest of other stakeholders. Such lending in simple terms is called Connected Lending.

Section 297 of Companies Act, 1956 imposed the requirement of obtaining Board approval (for companies with paid up capital below Rs. 1 crore) /Central Government approval (for companies with paid up capital of Rs. 1 crore and above) for a director of the company or his relative, a firm in which such a director or relative is a partner, any other partner in such a firm, or a private company of which the director is a member or director; at the time of entering into a contract of sale, purchase or supply of any goods, materials or services with the Company. This restriction was applicable to any NBFC or Banking Company too. However even this section did not impose any prohibition/pre-conditions on lending contracts between the Company and the directors/their relatives etc.

Section 295 of Companies Act, 1956 prescribed prior approval of Central Government for companies prior to lending directly or indirectly to directors. Section 370 of Companies Act, 1956 prescribed the need for seeking shareholders approval or Central Government approval (for exceeding prescribed limits) in case of lending, providing guarantee or security to companies under the same management. This Section was repealed vide Companies (Amendment) Act, 1999 and Section 372A was enacted thereafter widening the requirement of shareholders approval and Central Government approval based on prescribed limits not only on inter corporate loans and guarantees but also on investments. Section 372A was more stringent than Section 370 because it prohibition extended to any body corporate vs. being restricted to only companies under the same management.

Section 372A was applicable to an NBFC (Excluding Investment Companies) as much as it was to any company that pursued any form of business like manufacturing or provision of services, whether financial or otherwise. Similarly NBFCs were required to adhere to Section 297 of Companies Act, 1956 which prescribed board approval for specific value of contracts in which directors were interested. However similar to the other sections of Companies Act, 1956 stated above, transactions in ordinary course of business for banking companies were exempted from such approvals. The reason for these exemptions was that Section 20 of BR Act had posed **statutory restriction** prohibiting banks from extending any loans or advances to directors and to entities in which they were interested without obtaining prior approval from RBI. Banks were also instructed to recover the dues on loans/advances granted prior to the commencement of this Section within a specified duration of time.

RBI has further governed Banking company's "**Grant of Loans and Advances and Award of Contracts to Directors of Banks and their Relatives**" vide circulars DBOD.No.GC.BC.34/C.408C(59)S-84 dated April 12, 1984 read with DBOD.No.BC.110/21.01.001/94 dated October 10, 1994 & DBOD.No.BP.BC.23/21.01.001/96 dated March 1, 1996 and further vide DBOD.No.BP.BC.79/21.01.001/2011-12 dated February 3, 2012. The fact therefore remained that during the Companies Act, 1956 era, there was adequate RBI regulation to govern connected lending activities of Banking Companies.

RBI, with an objective to strengthen governance of NBFCs in connected lending over and above the restrictions placed through Companies Act, 1956, issued guidelines to govern "Connected lending" activities of NBFCs vide Para 2(vi) of DNBS.PD/CC94/03.10.042/2006-07 dated 8 May 2007 as part of its "Guidelines on Corporate Governance" for all deposit taking NBFCs and Systemically Important NBFCs. These guidelines were drafted on similar lines with regulations for Banking Companies.

As per this guideline, NBFCs were required to evolve appropriate operating procedures and information systems for ascertaining the interest of their own Directors as also the interest of the Directors of other companies for the purpose of implementing these instructions and for monitoring ongoing compliance therewith. The objective stated in the guideline was to obviate conflict of interest, enhance transparency and introduce best practices in NBFC's lending operations, by prohibiting grant of any loan, advance or non-fund based facility or any other financial accommodation / facility to:

- a) its directors or their relatives<sup>1</sup>;
- b) to any firm in which any of its Directors is interested as Partner, Manager, Employee or Guarantor;
- c) any individual in respect of whom any of its Directors is a Guarantor;
- d) any company of which, or the subsidiary or the holding company of which, any of the Directors of the NBFC is a Director, Managing Agent, Manager, Employee or Guarantor or any firm in which he holds substantial interest<sup>2</sup>;

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<sup>1</sup> "relative" shall be as defined in the Companies Act, 1956.

e) any entity, whether incorporated or not which uses as a part of its name or in connection with its business, the name of the NBFC or any such word as would show its association with the NBFC.

However the existing arrangements were allowed to continue up to the date when they fell due and any renewal or extension of such arrangements was prohibited. In cases where is no repayment date was fixed for a particular facility, the same were permitted to be recovered within one year from the date of this circular. NBFCs were required to submit quarterly returns in this regard including a nil statement.

Within a short span of time from the release of the above notification, RBI issued DNBS.PD/ CC 104 / 03.10.042/2007-08 dated July 11, 2007 stating that suggestions were received regarding above instructions on connected lending and that Para 2(vi) of the above notification would be operational only after final evaluation of these suggestions and modifications. As a result of this notification, all the compliance requirements under Connected lending as per the 8 May 2007 notification also became ineffective.

Given this scenario, Companies Act, 2013 was passed and it introduced Section 185 of Companies Act, 2013 which imposes restrictions on lending to directors or any other person in whom directors are interested or providing guarantee or security in connection with any loan taken by him or such other person/entity in whom he is interested. Section 186 of Companies Act, 2013 fixes a limit on the granting of loans to any person or other body corporate, beyond which a special resolution would be required from shareholders. However the Banking Companies and NBFCs were specifically exempted from these provisions considering that lending is an activity in their ordinary course of business. The only provision applicable to these entities is Section 188(d) of Companies Act, 2013 wherein rendering of any services to 'related parties' requires assent of shareholders if the value of the transaction exceeds 10% of the Company's net worth. However lending within the abovementioned limit is possible with just the approval of the Board, if it is proven that the transaction is at arms length and in the ordinary course of business. In addition to this, in case of any listed company Securities Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 require all related party transactions to be placed and approved by the Audit committee. However Securities Exchange Board of India (SEBI) has no regulations to govern lending activities of any unlisted entities. A listed NBFC may therefore only on the strength of the principles of self governance chose to incorporate necessary criterion in its 'Policy on materiality of related party transactions and on dealing with related party transactions' to avoid any connected lending transactions.

Therefore as evidenced above, Banking companies still remain adequately regulated in Connected lending activity. In the absence of regulations prescribed either by Ministry of

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<sup>2</sup>"substantial interest" (i) in relation to a company, means the holding of beneficial interest by an individual or his spouse or minor child, whether singly or taken together, in the shares thereof, the amount paid-up on which exceeds Rs. 5 lakhs or 10% of the paid-up capital whichever is less; (ii) in relation to a firm, means the beneficial interest held therein by an individual or his spouse or minor child, whether singly or taken together, representing more than 10% of total capital subscribed by all the partners of the said firm.

Corporate Affairs or RBI or SEBI, today NBFCs have a free reign on connected lending to NBFCs. There is a risk in terms of breach in their governance practices in this regard. Even the latest notification DNBR.019/CGM (CDS)-2015 dated April 10, 2015 on Non-Banking Financial Companies – Corporate Governance (Reserve Bank) Directions, 2015 do not have any reference to "Connected lending".

The lack of governance in "Connected lending" may result in possible diversion of funds of NBFCs and may run the risk of such loans becoming stressed assets affecting the asset books of NBFCs. While there is renewed drive by RBI to clean the books on bringing out window dressed NPAs there is a free highway for NBFCs continuing to fund through connected lending and risking creation of new possible stressed assets.

We therefore believe that there is a need for a more pragmatic approach by the regulators in plugging this gaping hole in governance matters relating to NBFCs lending activity. Given the fiduciary position held by the regulator resulting in non disclosure of the true prudential health of the NBFCs, there is less caution that a depositor or investor of the NBFC may cast upon the company. This may also lead to a similar situation like Banks, where defaulters list would have to be generated for NBFCs given their scale of lending.

We therefore believe that NBFCs formulate policy document with respect to connected lending and not await for the regulations to take force. This would ensure that Board of directors as a body do not violate policies of the NBFC and avoid any "collective conflict of interest".

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