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What Exactly is an NBFC ?

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Non banking financial companies play a crucial role in a developing economy like India. Hence it is not surprising that, their number had been constantly growing in recent years. ‘What exactly is an NBFC’ is the question that is examined here.

While the Indian financial system is dominated by banks, Non-Banking Financial Institutions play an important role by providing complementarity and competitiveness to banks. Non-Banking Financial Companies (commonly referred to as NBFC), are engaged in varied financial activities and provide a wide range of financial services. NBFCs are incorporated under the Companies Act, 1956 and can be classified into two broad categories, *viz.*,

- (i) NBFCs accepting public deposit (NBFCs-D) and
- (ii) NBFCs not accepting/holding public deposit (NBFCs-ND).

Definition under the RBI Act

Section 45-I of the Reserve Bank of India Act, 1934 defines ‘non-banking financial company’ as –

- (i) a financial institution which is a company;
- (ii) 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;
- (iii) such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;

A company is, therefore, considered to be an NBFC if it carries on any of the financial activities listed under clause (i) to (vi) of section 45 I (c) of the Act. Where the company is principally engaged in the business of non- financial nature like real estate, agriculture etc. it is called a non-banking non-financial company. In the case of companies exclusively engaged in financial activity, the nature of “principal business” is evident. However, where a company carries on multiple businesses, both financial and non-financial, in varied proportion, in the

absence of the definition of “principal business” what probably should be the guiding factor is an important question.

In terms of the extant provisions of Chapter IIIB of the Act, the definition of an NBFC is an exclusive definition in the sense that all non-banking companies carrying on some sort of financial business are NBFCs except when carrying on any non-financial business as principal business.

Section 372A, of the Companies Act, 1956, defines an investment company as a company whose principal business is the acquisition of shares, stock, debentures or other securities. No criteria have been laid down in the Act for determining the meaning of the term “principal business”. There are judicial pronouncements which emphasize on the fact that “principal business” is not something that can be quantified in absolute terms with reference to the figures stated in the financial statement of a company. It is the intention of the party to carry on a business activity as its primary activity. The RBI itself has acceded to the fact that where the business profile have undergone a change over a period of time, the principal business may also change and then the company may not require to hold CoR granted by the RBI. Even if, numerical dimension given to the carrying on of “principal business” are not fulfilled, the primary nature of business does not change. Hence the quantification of principality of business is an indicative intention of the RBI and does not supersede the facts of the case. The said numerical dimension and the intention has been discussed below in length.

Principal Business – Criteria laid down by the RBI

In April 1999, the RBI came out with a Press Release¹ announcing that in order to identify a particular company as a non-banking financial company, both the assets and the income pattern as evidenced from the last audited balance

1. Press Release : 1998-99/1269 dated April 8, 1999.



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sheet of the company will be considered to decide its principal business. As per this Press Release, principality of business has been given a numerical dimension. If the financial assets of a company are more than 50 per cent of its total assets (netted off by intangible assets) and income from financial assets is more than 50 per cent of the gross income, then the company will be an NBFC. The criteria of income/assets are cumulative, that is, both the tests are required to be satisfied simultaneously as the determinant factor for principal business of a company.

Revival of 1999 circular with additional requirement

Recently in a circular² issued in 2006, the Press Release was in a way revived from its ashes by the RBI, and a new credential was given to it in the form of requirement of an annual certificate to be given by the auditor of the NBFC in support of commencement/continuance of business of NBFI and fulfilling the criteria of “principal business”.

The Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 2007 – (both deposit taking and non-deposit taking), also reiterated the requirement of obtaining auditors certificate with the addition that such certificate shall also indicate the asset/income pattern of the NBFC for making it eligible for classification as Asset Finance Company, Investment Company or Loan Company. Such a certificate from the auditors was required to be submitted with reference to the position of the company as at the end of the financial year ended March 31 and to be submitted latest by June 30 every year. However, the criterion of principality of business for determining whether a non-banking company is an NBFC was never notified by the RBI.

Intention of RBI behind Auditor’s certification

The Reserve Bank of India in the circulars issued by it in this regard from time to time has also clarified the intent of obtaining such annual certificate. It is a usual practice that the RBI grants Certificate of Registration (CoR) to new companies on the basis of their intention to engage in the business of NBFI, however, such an intention may not have materialized and the said company may not engage in NBFI activity even though it holds CoR from the RBI. In the case of an existing company which holds CoR to carry on NBFI business, its business profile may have undergone a change over a period of time and the criteria of principal business may not be fulfilled anymore.

Hence, it is possible, that there would be companies holding the CoR to commence/carry on the business of NBFI without actually undertaking NBFI activity. These companies continue

to hold the CoR even though they are not required to hold the CoR granted by RBI. Thus, to ensure that only NBFCs which are actually carrying out financial business as its principal business holds CoR, the requirement of annual certification from the auditors have been brought in.

It is implicit that the term “principal business” was quantified by RBI to provide an exit route to those companies which are not required to hold CoR initially granted by RBI and hence, need not carry out the long-drawn compliances prescribed for NBFC. However, in course of time the 1999 Circular has been given an altogether different colour than what was intended. The asset-income criteria have become a tool in the hands of the RBI to deprive the companies of their NBFC status on extraneous grounds.

The question that arises is how far these circulars issued by any authority can go to support the contents of the statute. A circular is an executive action, and not a part of the statute. It does not carry the force of the law. It is not even a rule/regulation which is delegated legislation, and requires tabulation before the Parliament. A circular is merely an administrative order sent to multiple recipients and does not have the enforceability of law. However, it is quite likely that administrative machinery at the RBI might use the circular for deciding whether a particular non-banking company is a NBFC or not. Hence, it is important to understand the legality/practicality of the circular.

Practical analysis

On a practical basis, the following points arise which needs attention:-

- A company can have control over assets, but not income – the circular requires both income and assets to be more than 50% of the total income and assets. A business entity has control over its assets – it may deploy a major part of its money into financial assets. However, income is the result of such deployment, which is not entirely within the control of the entity. For example, a company is engaged in the business of both investments in shares and securities and real estate, investment in shares being its principal business. However, it may so happen, due to difficult market conditions, the business of investment in shares and securities is badly affected. On the other hand, prices of real estate are on the rise. In such a situation, the company’s balance sheet will show the majority of financial assets being securities; in contrast, the Profit & Loss Account will show majority income from real estate. What shall be the nature of the company in such a scenario?

2. DNBS (PD) C.C. No. 81/03.05.002/2006-07 dated October 18, 2006.



- There can be a case where a company runs several businesses, and the income/asset attributable to none of the business is over 50% - say, a company has business X, 30%, business Y, 30% and business Z 40%. Z is a financial business. As per RBI circular, this company does not have principal financial business. Does that mean the company does not have any principal business at all?
- It is quite natural that the income of a company cannot be stable year after year. Income may fluctuate and, the income in a particular year may fall below 50%. Strictly by the circular, a temporal decline in the income below the required threshold disqualifies an NBFC from carrying on business as such. What implications will such de-registration/disqualification have? Will the company stop what it was doing? Will the company be required to surrender its CoR? If doing what the company was doing required registration as an NBFC, then there is no question of de-registration. If doing what the company was doing did not require registration, and hence, the RBI itself opted to de-register the company, there should be no objection to the company doing what it was doing already.
- Imagine now, the next year the income level of the company rises above 50%. Does that mean the company should apply for registration all over again? This sounds patently unreasonable.

Thus, there is no ambiguity in the fact that it is the primary activity carried on by the company which gives it a character and although the figures reported in the balance sheet reflects the business activity of the company, but the same cannot be the sole criteria to determine the character of a company. Judicially also, the Courts have put weightage on the primary activity carried on by the company rather than its assets and income to determine its true character.

Legal analysis

In *Assistant Registrar of Companies v. H.C. Kothari and Others* (decided on 10.10.1991) the Madras High Court in a case concerning section 372 of the Companies Act, 1956 (since repealed) held that “an investment company is, therefore, a company whose principal business is the acquisition of shares, debentures or other securities. It is clear that the income derived from the business is not the criteria. The test would rather be, as to what the principal business of the company is. A balance-sheet should show what the principal business of the company is.”

In *D.C. Kothari and Another v. Assistant Registrar of Companies* (decided on 24.04.1992), the Madras High Court

observed that the term “Principal business” though not defined under the Act, as commonly understood, it would mean the prime business carried on by the company at the relevant point of time and the major source of income, etc.

The Income Tax Appellate Tribunal – (*Ahmedabad*) in *Barkha Investments And Trading Co. Pvt. Ltd. v. Income-Tax Officer* (decided on 07.10.1997) has considered the expression “wholly or mainly in the dealing in or holding of investment” close to and somewhat akin to “principal business” and cited *CIT v. Distributors (Baroda) P. Ltd* [1972] 83 ITR 377 (SC), wherein the Supreme Court said that, in the expression, “wholly or mainly in the dealing in or holding of investments”, the word “mainly” in that clause must necessarily take its colour from the word “wholly” preceding that word in those provisions. In other words, the company which comes within the scope of those provisions must be one whose primary business must be in the dealing in or holding of investments. If a company engages itself in two or more equally or nearly equal important business activities, then it cannot be said that the company’s business consists wholly or mainly in the dealing in a particular thing. Further, even in a case where a company has more than one business activity and one of its activities is more substantial than the others, unless that activity is the primary activity of the company, it cannot be said that that company is engaged in wholly or mainly in any one of its business activities.

Internationally also, the position is quite clear

California Code of Regulations, Title 18, reg 23183 sub-section (a) defines a “financial corporation” as a corporation which ‘predominately’ deals in money or moneyed capital in substantial competition with the business of national banks.

Regs. 23183 (b)(1) provides that :

“Predominantly means over 50% of a corporation’s total gross income is attributable to dealings in money or moneyed capital in substantial competition with the business of national banks. Generally, the determination of predominance will be made based upon the division of gross income for the year in issue. However, the classification of a corporation as a financial corporation or as a non-financial corporation will not be changed based upon an occasional year in which its gross income does not exceed the 50% level. For the classification of a corporation as a financial (or non-financial) corporation to be changed, there must be a shift in the predominant character of the gross income for two consecutive years and the average of the corporation’s gross income in the current and the immediately preceding two years must fail (or satisfy) the predominance test. Where substantial amounts of gross



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income arise from an incidental or occasional sale of an asset of the taxpayers, such gross income shall be excluded for purposes of this subsection.”

Here also it is seen that the nature of business indicated by the revenue generated by it should change over a period of time so as to change the character of business carried by the company. The nature of business cannot be judged on the basis of one particular year’s financial statements.

It may be said generally that although the source of the income of a corporation is an important element to be considered in determining which is its principal business it is not the only matter to be considered and not necessarily the determinant factor. Cameron J. in *American Metal Company of Canada Ltd. v. Minister of National Revenue* [1952] C.T.C. 302 has observed that “Chief business” is not defined in either of the Acts, and the phrase, so far as I am aware, has not been the subject of judicial interpretation. In my view, it is a question of fact to be determined by an examination and comparison of all the facts concerning each of the various types of business in which the company is engaged.” The above ruling was cited with approval by the Supreme Court of Canada in *Minister of National Revenue v. Consolidated Mogul Mines Limited* [1969] S.C.R. 54.

In *Australian Revenue Ruling No. SD 246*, it was observed that in determining a person’s principal business, consideration will be given to a number of factors including the number of

transactions, the amount of staff time spent, and the turnover in relation to each business activity to determine what proportion each bears to the total business. In general, consideration will not be given to figures contained in a company’s balance sheet or profit and loss account where such activities are reported on a net basis. “Principal” does not necessarily mean “more than 50%”. If a company conducts various businesses, the largest of which is, say, 30% of its total business activities, that 30% activity is its principal business.

Conclusion

It is thus clear that the criteria laid down by the RBI to determine the principal business based on asset-income has been applied in a manner which could not have been the intention. The Circular has specified such classification as guidance to the companies which are not required to hold CoR due to non-continuation of financial business as a principal business. It cannot be used as a weapon to de-register/disqualify companies from holding their CoR based on a particular year’s financial statement. The circular, in any case, is only a guidance issued by the RBI and cannot have the force of law. It must be interpreted in a manner to uphold “substance over form” and not to create hindrances in the business activity of the company on the basis of their yearly results. □