Snapshot: regulation of bank loan facilities in India

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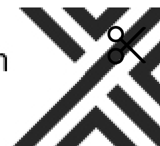

Regulation

Capital and liquidity requirements

Describe how capital and liquidity requirements impact the structure of bank loan facilities, including the availability of related facilities.

The Reserve Bank of India (RBI) requires lending institutions to maintain capital adequacy ratios and leveraged ratios at specific rates and further conform to exposure norms issued by the RBI from time to time. The imposition of these capital requirements affect the bank's ability to effectively lend in the market. During the economic recession of the late 2000s, RBI took a stringent approach in respect of the capital and liquidity requirements that banks had to maintain. However, with time, these norms were relaxed with the intention to harmonise them with the Basel III norms. Even so, the RBI capital adequacy percentage is stricter than the existing Basel III requirement. The RBI is also yet to implement its framework on the total loss absorbing capacity and on the revised Pillar 3 disclosure requirements as required under the Basel III norms. Usually, related working capital facilities, either fund- or non-fund-based, are provided in the form of sub-limits to the main term loan and do not get affected by the above norms.

Disclosure requirements

For public company debtors, are there disclosure requirements applicable to bank loan facilities?

Public listed entities must make certain disclosures to the stock exchanges where their securities are listed in relation to certain secured debt obligations. The regulator has also mandated that debenture trustees and other parties related to the issuance of debt securities must make certain additional disclosures to the public and to each other. Specific disclosures must also be made by listed entities in the event of default in the payment of interest or instalments on any loan or debt securities.

Further, an offer document of a company issuing securities to the public must include an auditor's report, mentioning the principal terms of the loan and assets charged as security as well as the total outstanding unsecured loans and their terms taken by the issuer company, its promoters, group companies and associate companies.

Indian company law requires a public company to obtain approval from its shareholders when the total borrowings of the company (apart from temporary loans) exceeds its paid-up share capital, free reserves and securities premium. The extracts of all shareholder meetings must be disclosed to the Registrar of Companies, after which these become public documents.

The Insolvency and Bankruptcy Code imposes a further obligation on financial creditors to disclose information pertaining to the loans provided to corporates to the relevant information utility.

Use of loan proceeds

How is the use of bank loan proceeds by the debtor regulated? What liability could investors be exposed to if the debtor uses the proceeds contrary to regulations? Can investors mitigate their liability?

Loans issued by banks are regulated under the Banking Regulation Act 1949, and various directions and regulations issued by the RBI from time to time. There are multiple restrictions imposed on banks for the granting of loans (eg, certain restrictions on acquisition financing). Banks must conform with the know your customer guidelines and monitor transactions with borrowers.

Under the know your customer guidelines, banks must have a know your customer policy that is duly approved by its board of directors and that must include a customer acceptance policy, risk management, a customer identification procedure and monitoring of transactions.

Banks must also conduct ongoing due diligence of borrowers and their businesses and source of funds. The types of activities that should be mandatorily monitored are:

- large and complex transactions, including:
  - large fund transfer transactions;
  - those with unusual patterns inconsistent with the normal and expected activity of the customer; and
  - those with no apparent economic rationale or legitimate purpose;
- transactions that exceed the thresholds prescribed for specific categories of accounts;
- high account turnover inconsistent with the size of the balance maintained; and
- deposits of third-party cheques and drafts in existing and newly opened accounts followed by cash withdrawals for large amounts.

Banks must also introduce a system of maintaining proper records of transactions in accordance with the provisions of the Prevention of Money Laundering Act 2002 and the rules thereunder. Furthermore, banks must carry out a 'Money Laundering and Terrorist Financing Risk Assessment' exercise periodically to identify, assess and take effective measures to mitigate its money laundering and terrorist financing risk for clients, countries or geographic areas, products, services, transactions or delivery channels, etc. The risk assessment must be properly documented by banks.

Banks must adhere to the provisions of the Unlawful Activities (Prevention) Act 1967, which require banks to ensure that they do not have any account in the name of individuals or entities appearing in the lists of individuals and entities suspected of having terrorist links, which are approved by and periodically circulated by the United Nations Security Council.

In the event of non-compliance with the above mandatory requirements, a monetary penalty may be imposed by the RBI. In some cases, a bank may be forced to forfeit its licence. Loan documentation usually provides protections to the lenders where the borrowers provide specific sanctions-related representations and warranties, and undertakings that are backed up by indemnities. The declaration from the borrower is usually to the effect that there are no sanctions imposed on the borrower and its affiliates, and the borrower has no dealing with any person on whom sanctions have been imposed. The sanction authority is usually referred to the Office of Foreign Assets Control, the RBI or any other regulatory authority in India, the United Nations or the European Union.

Cross-border lending

Are there regulations that limit an investor's ability to extend credit to debtors organised or operating in particular jurisdictions? What liability are investors exposed to if they lend to such debtors? Can the investors mitigate their liability?

The Overseas Direct Investment Regulations issued by the RBI impose certain limitations on Indian residents, including banks, investing in Pakistan, Nepal and Bhutan. The RBI strictly regulates banks from entering into transactions with countries that do not, or insufficiently, apply the Financial Action Task Force (FATF) recommendations. Specific safeguards are put in place while transacting with entities in these countries.

Indian entities are also restricted to borrow funds from entities that are not from FATF-compliant countries. 'FATF-compliant country' refers to a country that is:

- a member of the FATF or a member of an FATF-style regional body; and
- not a jurisdiction that:
  - is identified in the FATF's public statement as having strategic anti-money laundering or combating the financing of terrorism deficiencies to which countermeasures apply;
  - has not made sufficient progress in addressing deficiencies; or

- has not committed to an action plan developed with FATF to address such deficiencies.

Debtor's leverage profile

Are there limitations on an investor's ability to extend credit to a debtor based on the debtor's leverage profile?

There are no such statutory limitations imposed on banks. However, the RBI has issued an extensive set of guidelines to determine the credit risks involved in loan transaction and risk mitigation methods. The different types of risks are categorised as:

- credit;
- interest rate;
- foreign exchange rate;
- liquidity;
- equity price;
- commodity price;
- legal;
- regulatory;
- reputational; and
- operational.

The guidelines provide for a system of credit risk management in the following manner:

- the establishment of a credit approving authority;
- prudential limits to be imposed on various aspects of credit;
- a standardised risk rating system;
- a risk pricing system;
- portfolio management for gauging asset quality; and
- a loan review mechanism.

Interest rates

Do regulations limit the rate of interest that can be charged on bank loans?

The RBI prescribes the marginal cost of funds-based lending rates (MCLR), which is the minimum rate of interest that a bank may charge for lending. The spread, which is in addition to MCLR, is at the discretion of the lender. However, the RBI has required banks to have a board-approved policy delineating the components of spread charged to a customer. The policy should include principles to:

- determine the quantum of each component of spread;
- determine the range of spread for a given category of borrower or type of loan; and
- delegate powers in respect of loan pricing.

Loans raised by Indian entities from foreign investors have restrictions on the maximum amount of interest that can be charged. Currently, the all-in cost for certain types of external commercial borrowing is capped at the six-month LIBOR (or similar benchmark) plus 4.5 per cent.

Currency restrictions

What limitations are there on investors funding bank loans in a currency other than the local currency?

Bank loans are generally issued to borrowers in the local currency. Indian residents are generally not permitted to hold bank accounts in foreign currencies, other than foreign exchange earners, etc. However, Indian banks leverage their foreign exchange treasury holding and provide loans in the nature of foreign currency non-resident loans to Indian corporates. These are primarily provided for meeting import requirements of the Indian entity and are generally cheaper than raising loans in rupees. However, the Indian entity must hedge its exposure that has additional costs attached to it.

Indian companies may raise loans from foreign markets for funding in the form of external commercial borrowings (ECBs). In those cases, the inward remittance is retained by the bank in the foreign exchange and to that extent is lent to the borrower in the domestic currency. However, if the ECB is designated in a foreign exchange, the repayment must happen in the same currency that the loan was made in. Loans raised under ECB regulations are subject to certain end use restrictions. Certain ECBs cannot be used for investment in the real estate sector, repayment of existing rupee loans or in domestic equity investments. However, there have been certain relaxations for ECB end uses for general corporate and working capital purposes, repayment of existing rupee loans and on-lending by non-banking financial companies (NBFCs).

Other regulations

Describe any other regulatory requirements that have an impact on the structuring or the availability of bank loan facilities.

The RBI comprehensively regulates the lending activities of banks in India. Illustrations of some of the regulatory restrictions include:

- exposure limits on lending to the same group;
- restriction on lending to directors and their relatives of the bank;
- threshold limits on holding shares (including by way of pledge) in other companies;
- restrictions on lending against the bank's own securities; and
- restrictions on lending to entities that harm the environment.

Indian exchange control laws impose certain restrictions on foreign-owned and foreign-controlled companies from raising finance in the domestic market for the purposes of downstream investment.

Law stated date

Correct on

Give the date on which the above content is accurate.

10 June 2020.

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