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Analysing developments impacting business

TACKLING NBFC CRISIS: GOVERNMENT WIDENS THE INSOLVENCY NET

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[Background](#)

Taking into account the deepening liquidity crisis in the financial services sector and the resultant failure of some of the biggest non-banking financial companies (NBFCs) in discharging their immediate debt obligations, the Indian government finally took the bull by the horns. On 15 November 2019 and on 18 November 2019, the Ministry of Corporate Affairs (MCA) issued two separate notifications under Section 227 of the Insolvency and Bankruptcy Code, 2016 (Code), which when read together, set out the rules governing the insolvency and liquidation of financial service providers (FSPs) and cast the applicability of these rules and the Code to systematically important NBFCs (including housing finance companies) as a class of FSPs.

While the introduction of these notifications marks a major milestone for India's evolving insolvency regime, it sets out a careful and differential treatment for these financial entities, keeping in mind the complexities and sensitivities of the financial service sector.

[Notifications](#)

MCA issued a notification on 15 November 2019, setting out the rules governing the corporate insolvency resolution process and liquidation process for FSPs under the Code. The Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019 (FSP Rules) keeps FSPs on a different footing as compared to corporate entities in other sectors and sets out certain unique requirements / limitations in respect of initiation and administration of insolvency and/or liquidation proceedings against FSPs.

As regards the entities to whom the FSP Rules will extend, the FSP Rules in line with Section 227 of the Code prescribe that they shall apply to such financial service providers or categories of financial service providers as the Central Government may prescribe. In this regard, by way of a further notification dated 18 November 2019 (18 November Notification), MCA extended the applicability of the Code and FSP Rules to NBFCs (including housing finance companies) having an asset size of over INR 500 crores (SI-NBFCs) and as was indicated in the press release announcing the FSP Rules, other specific categories of FSPs that do not fall under the systemically important category will continue to be dealt with in the usual manner as currently prescribed for other corporate debtors.

In addition to notifying the category of the FSPs to which the Code and FSP Rules shall apply, the 18 November Notification designates the Reserve Bank of India (RBI) as the appropriate Regulator for the purposes of the FSP Rules and specifies that the treatment of third party assets pertaining to SI-NBFCs shall be notified later.

Key Takeaways from the FSP Rules and the 18 November Notification

- **Filing an application:** In contrast to non-FSP entities, a financial creditor / operational creditor of a FSP cannot initiate insolvency proceedings against a FSP. Such an application may be made only by the 'appropriate regulator', which as regards the notified set of FSPs i.e., SI-NBFCs is the RBI. However, the threshold for default for initiation of proceedings under the Code remains the same - irrespective of whether an application is being considered for a FSP or a non-FSP. An application by the 'appropriate regulator' will be treated at par with an application by a financial creditor and same process shall follow in respect of such application, as in the case of non-FSPs.
- **Moratorium:** In addition to the moratorium which is imposed upon the admission of insolvency of non-FSPs, in case of insolvency of a FSP, an interim moratorium will commence on and from the date of filing of the application until the admission / rejection of the application.
- **Licenses:** The license or registration of a FSP will not be suspended or cancelled during the interim-moratorium and/or the CIRP.
- **"Administrators":** Contrary to the usual concept of insolvency professional or liquidator under the Code for non-FSPs, the FSP Rules introduce the concept of an administrator replacing insolvency professionals. The Rules defines the 'Administrator' as an individual appointed by the Adjudicating Authority (i.e. the National Company Law Tribunal) who will exercise the powers and functions of an insolvency professional, interim resolution professional, resolution professional or liquidator for the insolvency and liquidation proceedings of a FSP, as the case may be. The Administrator will be proposed by the appropriate regulator and shall act on the instructions of an "Advisory Committee".
- **"Advisory Committee":** If the appropriate regulator considers it necessary, an Advisory Committee of 3 or more experts will be formed within 45 days of the insolvency commencement date to advise the Administrator on the operations of the FSP during the corporate insolvency resolution process. The Administrator will act as the chairman of the Advisory Committee. The members of the Advisory Committee shall be persons of ability, integrity and standing, and who possess expertise or experience in specified areas such as finance, economics, accountancy, law, public policy or any other profession in the area of financial services or risk management, administration, supervision or resolution of a financial service provider. The terms and conditions of engagement, manner of conducting meetings, observance of rules of procedure, and compensation, of the Advisory Committee, will be determined by the appropriate regulator. The Advisory Committee's compensation, akin to a resolution professional's fee in a regular insolvency process, shall form part of the insolvency resolution process costs.
- **Mandatory contents of a Resolution Plan:** In addition to the mandatory contents of a resolution plan as required for non-FSPs, the resolution plan for FSPs is required to comply with the following conditions:

- include a statement explaining how the resolution applicant satisfies or intends to satisfy the requirements of engaging in the business of the financial service provider as per applicable law.
- following the approval of the resolution plan by the committee of creditors, the administrator will seek a no objection on the resolution plan from the appropriate regulator (ie the RBI in case of SI-NBFCs) to the effect that it has no objection to the persons, who would be in control or management of the FSP after the approval of the resolution plan by the adjudicating authority i.e. the NCLT. Such no-objection shall be provided on the basis of 'fit and proper' criteria applicable to the business of the financial service provider.

Considering the possible delays in obtaining such no-objection, which may in turn affect viability of the FSP under insolvency, the FSP Rules provide for a deeming fiction, whereby if the appropriate regulator does not convey its refusal for a no-objection within 45 days from the date of application, its approval shall be deemed to have been provided. It should be kept in mind that the no-objection requirement from the appropriate regulator is over and above the requirements Section 29A of the Code, as is required in the case of non-FSP corporate debtors.

- **Liquidation Process:** Even in a liquidation process, the license or registration that authorises the FSP to engage in the business of providing financial services will not be suspended or cancelled, without providing an opportunity of being heard to the liquidator. Additionally, the Adjudicating Authority will provide the appropriate regulator an opportunity of being heard before passing an order of liquidation or dissolution of the FSP. It is relevant to note that the FSP Rules do not provide any guidance on the whether the license would be suspended if the liquidator/ Administrator attempts to liquidate the FSP as a going concern.
- **Voluntary Liquidation Process:** The FSP is required to obtain prior permission of the appropriate regulator for initiating voluntary liquidation proceedings under Section 59 of the Code. Further, the adjudicating authority is required to provide the relevant regulator an opportunity of being heard before passing an order for dissolution of the FSP.
- **Status of third-party assets:** Similar to the principles established for non-FSPs, the provisions with respect to the moratorium period will not apply to any third-party assets or properties in custody or possession of the FSP, including any funds, securities and other assets required to be held in trust for the benefit of third parties. Pursuant to the commencement of the corporate insolvency resolution process, the Administrator will take control and custody of such assets or properties, in trust, for the benefit of third parties and shall deal with them in such manner, as may be notified by the Central Government under Section 227. The 18 November Notification does not provide the manner in which these assets are to be dealt with - and merely indicates that this would be notified subsequently.

Conclusion

The financial sector has long been struggling with a liquidity crisis which could not effectively be resolved as NBFCs were excluded from the corporate insolvency resolution process under the Code. While some prominent players succumbed to financial stress, several creditors and investors of struggling NBFCs attempted to resolve the stress by using alternatives such as the RBI's 7 June 2019 Circular. However,

the absence of a comprehensive and codified mechanism such as the Code and multiplicity of legal proceedings impeded resolution of financial stress. Thus, an extension of the remedies available under the Code to the players in the financial sector was widely expected. The issuance of the FSP Rules and the 18 November Notification, has made viable and unified resolution process accessible for the FSPs and their creditors with some procedural differences. There is no doubt that by widening the ambit of the Code to the financial sector, the Government has closed an important gap in the corporate Insolvency resolution regime.

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