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Review of extant regulatory framework for Housing Finance companies (HFCs) – Proposed Changes

The Finance (No.2) Act, 2019 (23 of 2019) amended the National Housing Bank Act, 1987, conferring powers for regulation of Housing Finance Companies (HFCs) with Reserve Bank of India. Following the issue of notification by the Government appointing August 09, 2019 as the date on which Part VII of Chapter VI of the Finance (No.2) Act, 2019 (23 of 2019) shall come into effect, a Press Release was issued on August 13, 2019 in which it is mentioned that a review of the extant regulatory framework applicable to the HFCs will be carried out and revised regulations will be issued.

2. A review of the extant directions/guidelines applicable to HFCs has been carried out with a view to regulating HFCs as a category of Non-Banking Financial Company (NBFC). Accordingly, it has been decided that in areas where the extant regulation of HFCs are in tandem with that of NBFCs, the relevant paras in the NBFC Master Directions would be made applicable mutatis mutandis to HFCs. In areas where extant HFC regulation differs from that of NBFCs, either existing provisions would be retained, or changes would be brought out wherever possible while ensuring that the changes are made in a least disruptive manner. Given below are the major changes envisaged in the regulatory framework for HFCs:

2.1. Applicable law for the regulation of HFCs

In order to avoid dual regulation, HFCs were granted exemption from the provisions of Chapter IIIB of the RBI Act, 1934 vide notification dated June 18, 1997 by exercising powers under Section 45NC of RBI Act, 1934. With the transfer of regulation of HFCs to RBI it was decided to withdraw these exemptions and make the provisions of Chapter IIIB except Sec 45-IA of RBI Act applicable to all HFCs. The Gazette Notification No.DOR.047/CGM (MM)-2019 withdrawing the exemptions granted to HFCs was issued on November 19, 2019. Companies intending to function as HFCs shall seek registration with the Reserve Bank under Section 29A of NHB Act, 1987 and existing HFCs holding CoR issued by NHB need not approach RBI for fresh CoR.

2.2. Defining the term 'providing finance for housing' or 'housing finance'

It is observed that the term 'providing finance for housing' or 'housing finance' is not formally defined. However, in general parlance, it can be treated as providing finance for residential housing purposes and should ideally not include finance for non-residential purposes like commercial real estate, etc. For this purpose, the meaning of the term housing finance as indicated for various purposes in circulars issued by RBI, NHB and also under the Income Tax Act 1961 was examined. It is proposed to have an inclusive definition of the terms 'providing finance for housing' or 'housing finance' as per provisions of RBI's master circular on housing finance addressed to banks and NHB's illustrative list of housing loans. Accordingly, 'Housing Finance" or "providing finance for housing" means:

Financing, for purchase/ construction/ reconstruction/ renovation/ repairs of residential dwelling units, which includes:

a. Loans to individuals or group of individuals including co-operative societies for construction/ purchase of new dwelling units.
b. Loans to individuals for purchase of old dwelling units.
c. Loans to individuals for purchasing old/ new dwelling units by mortgaging existing dwelling units.
d. Loans to individuals for purchase of plots for construction of residential dwelling units provided a declaration is obtained from the borrower that he intends to construct a house on the plot within a period of three years from the date of availing of the loan.
e. Loans to individuals for renovation/ reconstruction of existing dwelling units.
f. Lending to public agencies including state housing boards for construction of residential dwelling units.
g. Loans to corporates/ Government agencies (through loans for employee housing).
h. Loans for construction of educational, health, social, cultural or other institutions/centres, which are part of housing project in the same complex and which are necessary for the development of settlements or townships;
i. Loans for construction of houses and related infrastructure within the same area, meant for improving the conditions in slum areas for which credit may be extended directly to the slum-dwellers on the guarantee of the Government, or indirectly to them through the State Governments;

j. Loans given for slum improvement schemes to be implemented by Slum Clearance Boards and other public agencies;
k. Lending to builders for construction of residential dwelling units.

2.2.1. All other loans including those given for furnishing dwelling units, loans given against mortgage of property for any purpose other than buying/ construction of a new dwelling unit/s or renovation of the existing dwelling unit/s, will be treated as non-housing loans.

2.3. Defining 'principal business' and 'qualifying assets' for HFCs

Post enactment of Finance Act, 2019, the amended provisions under Section 29A (1) of NHB Act includes the term 'principal business'. Since the term 'principal business' was not available in NHB Act prior to the amendment, for the purposes of registration of HFCs, NHB was guided by the provisions of Section 2 (d) of NHB Act, 1987 which states *"housing finance institution" includes every institution, whether incorporated or not, which primarily transacts or has as one of its principal objects, the transacting of the business of providing finance for housing, whether directly or indirectly*. For registration purposes, NHB was recognizing companies as HFCs if such company has, as one of its principal objects, transacting of the business of providing finance for housing (directly or indirectly) and registering them under Section 29A of NHB Act, 1987. With the amendment to NHB Act the need for defining the term principal business for HFCs has arisen.

2.3.1. As power for regulation of HFCs is derived from both RBI Act and from the NHB Act, the term principal business as defined for NBFCs vide our Press Release no.1998-99/1269 dated April 08, 1999 is proposed to be extended to HFCs. As per the Press Release, a company will be treated as an NBFC if its financial assets are more than 50% of its total assets (netted off by intangible assets) and income from financial assets is more than 50% of the gross income and both these tests are required to be satisfied as the determinant factor for principal business of an NBFC. However, since HFCs cater to housing sector, it is proposed to introduce the concept of 'qualifying assets' for HFCs as done in case of NBFC-MFIs. The proposed regulations are as under:

Qualifying Assets refer to 'housing finance' or 'providing finance for housing' as enumerated in Para 2.2 above subject to the following:

(a) Not less than 50% of net assets are in the nature of 'qualifying assets' for HFCs as stated at para 2.2 above, of which at least 75% should be towards individual housing loans as stated at clauses (a) to (e) in para 2.2.

(b) "Net assets" shall mean total assets other than cash and bank balances and money market instruments.

2.3.2. Such HFCs which do not fulfil the above criteria will be treated as NBFC – Investment and Credit Companies (NBFC-ICCs) and will be required to approach RBI for conversion of their Certificate of Registration from HFCs to NBFC-ICC. Application for such conversion should be submitted with all supporting documents meant for new registration together with an auditor's certificate on Principal Business Criteria (PBC) and necessary board resolution ratifying the conversion. However, a phased timeline will be given to HFCs which do not currently fulfil the qualifying assets criteria, but wish to continue as HFCs in future. The timeline shall be phased as under:

Timeline	At least 50% of net assets as qualifying assets i.e., towards housing finance	At least 75% of qualifying assets towards housing finance for individuals
March 31, 2022	50%	60%
March 31, 2023	-	70%
March 31, 2024	-	75%

2.4. Classifying HFCs into systemically important and non-systemically important entities for regulatory purposes

Presently HFC regulations are common for all HFCs irrespective of their asset size and ownership. It is proposed to issue HFC regulations by classifying them as systemically important and non-systemically important, so as to introduce a graded approach as applicable to NBFCs in general. In other words, non-deposit taking HFCs (HFC-ND) with asset size of ₹500 crore & above; and all deposit taking HFCs (HFC-D), irrespective of asset size, will be treated as systemically important HFCs. HFCs with asset size below ₹500 crore will be treated as non-systemically important HFCs (HFC-non-SI). While the regulations for HFC-NDSI & HFC-Ds will be as existing under NHB regulations or harmonised with NBFC regulations, the regulations for HFC-non-SI (i.e., HFCs with asset size below ₹500 crore) will be brought on par with relevant regulations for NBFC-ND-non-SI (*Master Direction for non-systemically important NBFCs dated September 01, 2016 and updated up to February 17, 2020*).

2.5. Minimum Net Owned Fund (NOF) of ₹20 crore

In exercise of powers conferred under Section 29A (1) (b) of NHB Act, 1987, the Bank proposes to increase the minimum NOF for HFCs from the current requirement of ₹10 crore to ₹20 crore. For existing HFCs the glide path would be to reach ₹15 crore within 1 year and ₹20 crore within 2 years. This step is aimed at strengthening the capital base, especially of smaller HFCs and companies proposing to seek registration under NHB Act.

2.6. Harmonising definitions of Capital (Tier I & Tier II) with that of NBFCs

The components of Tier I and Tier II capital are similar for NBFCs and HFCs except for the treatment of perpetual debt instruments (PDI). Presently PDIs are not considered as part of capital of HFCs unlike that of NBFCs. It is proposed to align the definitions of capital (both Tier I and Tier II) of HFCs with that of NBFCs as per Para 3 (xxxii) and 3 (xxxiii) of MD – NBFC – Systemically important Non Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 (updated as on February 17, 2020), the changes being:

i. Inclusion of PDIs as a component of Tier I and Tier II capital on the lines of NBFCs.
ii. PDIs can be treated as part of Tier I / Tier II capital only by non-deposit taking systemically important HFCs.
iii. PDIs or any other debt capital instrument in the nature of PDIs, already issued by either deposit taking HFCs or non-systemically important HFCs will be reckoned as Tier I or Tier II capital as the case may be for a period not exceeding three years.
iv. Since HFCs are treated as a category of NBFCs for regulatory purposes, investments in shares of other HFCs and also in other NBFCs (whether forming part of group or not), shall be reduced from the Tier I capital to the extent it exceeds, in aggregate along with other exposures to group companies, ten per cent of the owned fund of HFC.

2.7. Public deposits

The definition of public deposits as given by NHB under Para 2 (1) (y) of Chapter I of Housing Finance Companies (NHB) Direction 2010 dated July 01, 2019 is similar to the definition of public deposits as given by RBI under Para 3 (xiii) of RBI MD on

Acceptance of Public Deposits issued vide Master Direction DNBR.PD. 002/03.10.119 /2016-17 August 25, 2016 (Updated as on February 22, 2019), except that any amount received from NHB or any public housing agency are also exempt from the definition of public deposit as per definition in NHB directions. We propose to align the definition of public deposit as given under RBI master direction with an addition that any amount received by HFCs from NHB or any public housing agency is also exempt from the definition of public deposit.

2.8. Liquidity Risk framework and LCR

Non-deposit taking NBFCs with asset size of ₹100 crore & above, systemically important Core Investment Companies and all deposit taking NBFCs (except Type 1 NBFC-NDs, Non-Operating Financial Holding Companies and Standalone Primary Dealers) were advised to adhere to the guidelines as mentioned in DOR.NBFC (PD) CC. No.102/03.10.001/2019-20 dated November 04, 2019**.** It is proposed to extend these guidelines to all non-deposit taking HFCs with asset size of ₹100 crore & above and all deposit taking HFCs. It will be the responsibility of the Board to ensure that the guidelines are adhered to. The internal controls required to be put in place by HFCs as per these guidelines shall be subject to supervisory review. Further, as a matter of prudence, all other HFCs are encouraged to adopt these guidelines on liquidity risk management on voluntary basis.

2.9. Group entities engaged in real estate business

In order to address concerns on double financing due to lending to construction companies in the group and also to individuals purchasing flats from the latter, the HFC concerned may choose to lend only at one level. That is, the HFC can either undertake an exposure on the group company in real estate business OR lend to retail individual home buyers in the projects of group entities, but not do both. If the HFC decides to take any exposure in its group entities (lending and investment) directly or indirectly, such exposure cannot be more than 15% of owned fund for a single entity in the group and 25% of owned fund for all such group entities. As regards extending loans to individuals, who choose to buy housing units from entities in the group, the HFC would follow arm's length principles in letter and spirit.

2.10. Monitoring of frauds

All instructions to NBFCs with regard to monitoring of frauds is covered in the Master Direction - Monitoring of Frauds in NBFCs (Reserve Bank) Directions, 2016 issued on Sep 29, 2016. These directions cover various aspects pertaining to classification of frauds, monitoring of frauds and reporting to the Board, to the police authorities, RBI, etc. With a view to harmonizing all instructions pertaining to fraud monitoring, it is proposed to make these directions applicable to HFCs in place of present guidelines issued by NHB. All reports in the formats given in these Master Directions of Monitoring of Frauds may however continue to be forwarded to NHB, New Delhi as being done hitherto.

2.11 Information Technology Framework

The Information Technology (IT) Framework for NBFCs issued vide Master Directions DNBS.PPD.No.04/66.15.001/2016-17 dated June 8, 2017 is proposed to be made applicable to HFCs and consequently the guidelines issued vide NHB/ND/DRS/Policy No.90/2017-18 June 15, 2018 is proposed to be withdrawn. The IT framework covers IT Governance, IT Policy, Information & Cyber Security, IT Operations, IS Audit, Business Continuity Planning and IT Services Outsourcing. The directions are categorized into two parts, those which are applicable to all NBFCs with asset size above ₹500 crore (considered Systemically Important) are provided in Section-A of above mentioned master directions. Directions for NBFCs with asset size below ₹500 crore are provided in Section-B of the above mentioned master directions. In view of the decision to classify the HFCs into systemically important and non-systemically important entities these instructions will apply accordingly.

2.12. Securitization

NHB has not prescribed specific guidelines on securitisation. It is proposed to bring all HFCs (systemically important and non-systemically important) under the ambit of guidelines on securitisation transaction as applicable to NBFCs contained in Annex XXII to MD – NBFC – Systemically important Non Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 (updated as on February 17, 2020).

2.13. Lending against shares

Currently, there are no guidelines in place for lending against the security of shares by HFCs. For the sake of uniformity, it is proposed to extend instructions applicable to NBFCs to lend against the collateral of listed shares contained in para 22 of the MD – NBFC – Systemically important Non Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 (updated as on February 17, 2020) to all HFCs.

2.14. Managing Risks and Code of Conduct in Outsourcing of Financial Services

As no guidelines have been prescribed for HFCs with regard to outsourcing of Financial Services, it is proposed to extend the guidelines issued vide Annex XXV to the MD – NBFC – Systemically important Non Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 (updated as on February 17, 2020) to all HFCs.

2.15. Foreclosure charges

As a measure of customer protection and also in order to bring in uniformity with regard to repayment of various loans by borrowers of banks and NBFCs, no foreclosure charges/pre-payment penalties shall be levied on any floating rate term loan sanctioned for purposes other than business to individual borrowers with or without co-obligants. Since similar regulations are currently not prescribed for HFCs, it is proposed to extend these instructions to HFCs.

2.16 Implementation of Indian Accounting Standards

Instructions issued to NBFCs vide circular DOR (NBFC).CC.PD.No.109/22.10.106 /2019-20 on March 13, 2020 on Implementation of Indian Accounting Standards will be extended to HFCs. Prudential floor for Expected Credit Loss (ECL) will be based on the extant instruction on provisioning applicable to HFCs.

3. In addition to the above, there exist certain major differences between extant regulations of the HFCs vis-à-vis that for NBFCs which are as follows:

a. **Capital requirements (CRAR and risk weights)** – The minimum CRAR prescribed for HFCs currently is 12% and which will be progressively increased to 14% by March 31, 2021 and to 15% by March 31, 2022. Further, the risk

weights for assets of HFCs are in the range of 30% to 125% based on asset classification, LTV, type of borrower, etc. However, for NBFCs, the minimum CRAR is 15% and risk weights are broadly under 0%, 20% and 100% categories.

b. **Income Recognition, Asset Classification and Provisioning (IRACP) norms** – There are major differences in provisioning norms applicable to standard, substandard and doubtful assets in HFCs' books.
c. **Norms on concentration of credit / investment** – The credit concentration norms for NBFCs and HFCs are similar. However, NBFCs enjoy certain exceptions in this regard.
d. **Limits on exposure to Commercial Real Estate (CRE) & Capital Market (CME)** – The limits prescribed for HFCs for exposure to CRE by way of investment in land & building shall not be more than 20% of capital fund and for CME shall not be more than 40% of net worth total exposure of which direct exposure should be 20% of net worth. No limits prescribed for NBFCs.
e. **Regulations on acceptance of Public Deposits** viz., period of public deposit (12 months to 120 months for HFCs against 12 months to 60 months for NBFCs), ceiling on quantum of deposit (3 times of NOF for HFCs against 1.5 times for NBFCs with minimum investment grade rating), interest on premature repayment of deposits (ranging from 1% to 4% below prescribed rate for HFCs as against 2% to 3% below prescribed rate for NBFCs depending upon duration and prescription of rate), maintenance of liquid assets (13% for HFCs against 15% for NBFCs), etc.

3.1 Harmonising the regulations mentioned at Para 3 above will be carried out in a phased manner over a period of two to three years, until such time, HFCs will continue to follow the extant norms.

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