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TACKLING VOLATILITY

Central bank places curbs on NBFC loans against shares

Non-banking financial companies with assets in excess of ₹100 cr will have to maintain a loan-to-value ratio of 50%, says RBI

BY JOEL REBELLO & AMI SHAH

MUMBAI

The Reserve Bank of India (RBI) on Thursday, 21 August, clamped restrictions on the amount that non-banking financial companies (NBFCs) can lend against shares pledged as collateral, in an attempt to curb potential volatility in the stock markets after a surge in equity prices and to forestall lending risks amid a pile-up of bad loans.

Effective immediately, NBFCs with assets in excess of ₹100 crore will be required to maintain a loan-to-value ratio of 50%, the central bank said. That means the financiers will be allowed to lend an amount equivalent to only 50% of the value of shares pledged as security. No cap had hitherto been placed on the loan-to-value ratio.

Also, these lenders will be allowed to accept only so-called Group 1 shares as collateral while giving loans amounting to ₹5 lakh and above.

Group 1 shares are those that were bought and sold on at least 80% of the trading days in the previous 18 months on the stock exchanges, and the average cost incurred due to a price decline is less than 1%. In other words, they are likely to be more liquid and less volatile than other shares trading in the market.

The central bank said the changes were necessary to prevent an increase in volatility in the capital markets because of NBFCs selling shares held by them in case of loan defaults. But it has not asked NBFCs to wind down their positions for past loans that do not meet the new norms.

"Default by borrowers can and has in the past led to offloading of shares in the market by the NBFCs thereby creating avoidable volatility in the market," RBI said in a notification.

"Certain other associated areas of concern relate to absence of adequate prior information to the stock exchanges on the shares held as pledge by NBFCs, probable overheating of the market, over-exposure by NBFCs to certain stocks and overleveraging of borrowers," RBI said.

Analysts said the restrictions were a preventive measure by the central bank to protect both NBFCs and stock market investors. The BSE's 30-share benchmark Sensex has risen 47% to 26,360 points from 17,906 points in the past one year, leading to fears of over-exuberance in the stock market.

Bad loans, meanwhile, have been rising as the economic downturn and project delays crimped the ability of borrowers loans to repay on time.

"By applying these restrictions, RBI is saying that it will track lending against shares more strictly," said Daljeet Singh Kohli, head of research at broker **IndiaNivesh Securities Ltd**.

"Borrowers against shares were already taking a haircut, but in some cases it was lenient. RBI is now saying that no leniency will be tolerated henceforth," Kohli added. "This is aimed at curbing risky lending because, of late, as the stock market has gained, this kind of lending has increased. Most of the large brokers will have this book and will be impacted."

In banking parlance, a haircut is the amount deducted from the value of assets pledged as collateral.

As more wealthy individuals are participating in the capital market, loan books have started expanding, said Amisha Vora, joint managing director of **Prabhudas Lilladher Pvt. Ltd**, another securities house.

"This particular move by RBI will definitely cut down such lending and impact that business area of NBFCs, but will also in the long term bring a lot of safety and sanity in markets," Vora said. "In the short run, however, this may create some selling pressure in the market."

Interestingly, norms for lending against shares for banks are much stricter. Banks are not allowed to lend more than ₹10 lakh if the shares are held in physical form and not more than ₹20 lakh if shares are held in demat form.

Banks are also required to maintain a minimum margin of 50% of the market value of shares in case they are held in a physical form and 25% if they are held in the demat form.

"Even with these regulations NBFCs are free to lend whatever amount they wish, which is not the case for banks. Clearly the central bank is concerned that the equity markets will heat up and that is the reason for this change," said an executive at a private bank who requested anonymity.

Besides complying with these restrictions, all NBFCs with assets worth ₹100 crore or more will be required to report to the stock exchanges any information regarding the shares pledged by borrowers for availing of loans.

"The infrastructure for online reporting to the stock exchanges has been put in place. The exchanges may be approached for creation of user IDs," RBI said.

NBFCs with exposure to lending against shares said their business won't be hit in a big way.

"Our loan book for this category (is) ₹250-300 crore; I don't see much impact on our book. We have a very selective policy on lending against only quality stocks," said Motilal Oswal, chairman and managing director of **Motilal Oswal Financial Services Ltd.**

In recent years, there have been instances of many mid-cap stocks collapsing as some financiers offloaded shares and the investors or promoters—who had pledged their holdings—failed to meet margin commitments.

The move would curb such activity. Also, many borrowers managed to procure funding on relatively illiquid stocks, which also won't happen now.

"RBI doesn't want the industry to get exposed to vulnerability arising from excessive and reckless lending in stock markets. This is a move to discourage such activities," said Dhananjay Sinha, head of research and strategist at **Emkay Global Financial Services Ltd.**

"The 50% limit is creating enough buffer to cushion any volatility that arises. Also, they are now allowing quality scrips, thereby bringing down the probability of such situations," Sinha said.

Religare Finvest Ltd, a subsidiary of **Religare Enterprises Ltd**, has oustanding loans of ₹1,700 crore that it has advanced against shares, out of a total loan book of ₹13,000 crore. Its loan-to-value ratio has been in the range of 65-70%.

"We have been waiting for these kind of guidelines for some time. We wanted them to come down with clarity on the right framework for lending against shares We will align with the guidelines," said Kavi Arora, managing director and CEO of Religare Finvest. "It doesn't impact us in a big way, as it is not a big share of our total loan book."

joel.r@livemint.com

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Precautionary move: *The central bank said the changes were necessary to prevent an increase in volatility in the capital markets because of NBFCs selling shares held by them in case of loan defaults.*