Regulating the disruption wave: RBI issues directions to govern P2P platforms

The Reserve Bank of India (RBI) recently classified peer to peer (P2P) lending platforms as non-banking financial companies (NBFC-P2P). Following this, it issued detailed master directions on 4 October governing the operation of such platforms, which raise some interesting preliminary questions.

Is RBI regulating a tech company as an NBFC?

In April 2016, RBI argued that the sector needs to be regulated, given the growth in online commerce, and to protect participants from succumbing to unethical or coercive practices.

As a registered NBFC-P2P, the firm can only provide a technology platform, through an online marketplace, to connect the lenders and borrowers, and related services such as loan documentation, loan recovery, etc.

They are not entitled to conduct the business of lending and borrowing themselves. In addition, they can provide credit assessment and risk profiling of borrowers, which is disclosed to potential lenders to make an informed decision.

These are important aspects and require some sort of regulation, but was it necessary to regulate essentially a technology platform as an NBFC?

RBI can generally regulate entities operating either as banks or NBFCs. P2P platforms are not banks, since there is no balance sheet lending. Generally, entities with their principal business being financial activity (i.e. more than 50% of the assets are financial assets like shares, loans, etc., and the income from such financial assets is more than 50% of the total income) are considered as NBFCs and required to be registered with RBI.

These conditions too are not satisfied by P2P platforms, since their primary source of income is commission from services. However, the RBI has special powers to classify any entity as an NBFC, after consultation with the government—which it has exercised to classify P2P platforms as NBFC-P2Ps. The RBI has used this in the past to regulate mortgage guarantee companies and account aggregators.

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Are the master directions detrimental to P2P start-ups?

Fintech has been one of the busiest sectors in the Indian VC space. NBFC-P2Ps are expected to be a small subset of the various NBFCs operating in India.

Due to the classification, NBFC-P2Ps are now subject to new conditions such as minimum net owned funds of Rs2 crore, leverage ratio of 2 and limited scope of activities. As a result, the entry barrier for new start-ups has increased considerably, and the ability to move into ancillary business lines has been restricted.

For existing P2P players, while there may be initial hardship, and certain modifications required to their current business model, they already have certain aspects of the regulations covered.

For example, some of the big players are using escrow services for fund transfers, which is now a mandatory requirement under the master directions.

Should investors reconsider their board strategy?

For all NBFCs, approval of RBI is required if more than 30% of the directors (excluding independent directors) are changing. However, for an NBFC-P2P, an additional prior approval is required if any change in shareholding gives the acquirer the right to appoint a director. It is not clear why this condition has been added specifically for NBFC-P2Ps. The right to appoint a director typically does not give control to investors, but this prior approval requirement could delay the investment process. The investor directors are now required to satisfy stringent fit and proper criteria requirements, as well as provide a declaration and undertaking to this effect. As a result, some investors may instead choose to have an observer nominated on the board, with veto rights on critical business items and information rights built into the agreements.

Will the new prudential norms affect business?

RBI has restricted the aggregate exposure (across all P2P platforms) of each lender and borrower to Rs10 lakh, and limited the exposure of a single lender to a single borrower to Rs50,000.

These conditions will severely restrict the business potential of NBFC-P2Ps, unless they are able to bring on many more borrowers and lenders onto the platform.

These numbers may need to be revised in future. Instead of a blanket cap, a cap linked to the category of the participant and their ability to sustain the exposure without any adverse consequences would have been a better alternative.

In the case of existing P2P players, they will need to revise their borrowing and lending limits, with no benefit of grandfathering of the new prudential norms extended to them. This will likely have operational ramifications for these companies.

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