FIDC

Finance Industry Development Council

(A body incorporated as a Self Regulatory Organisation for Registered NBFCs - AFCs)

5 April 2011

Dr. D Subbarao
Governor
Reserve Bank of India
Central Office Bldg, 18th Floor
Shahid Bhagat Singh Road
Mumbai 400 001.

Respected Sir,

We are writing to place before you a few issues of critical importance to NBFC-AFCs. It has long been our case that our role in funding productive assets, especially to the underserved segments of the economy, needs greater recognition. While HFCs and in recent times, even MFIs seem to enjoy various benefits, Asset financing NBFCs have consistently been denied parity with the other constituents of the financial sector, be it in matters of regulation, legislation or taxation.

CRAR/Risk Weightage for Productive Assets

RBI has vide its notification DNBS.PD/CC.No.211/03.02.002/2010-11 dated Feb 17, 2011 sought to raise the minimum Capital to Risk Assets Ratio (CRAR) for Deposit taking NBFCs to 15 % effective 31.3.2012. These entities have hitherto enjoyed a lower CRAR of 12% based on the fact that almost all of them are NBFC-AFCs and their lending is against productive assets such as trucks, automobiles, infrastructure equipment, tractors and the like which directly support economic growth. The requirement of a higher CRAR of 15% would severely cripple the growth of NBFC-AFCs. In this context, we would like to reiterate the long pending demand of Asset Financing NBFCs for risk based capital allocation.

Under the present dispensation, all the assets financed by NBFCs, regardless of whether they are secured or unsecured and regardless of the risks associated with different assets, carry a uniform risk weightage of 100%. It is a well documented fact, based on the detailed analysis undertaken by credit rating agencies that commercial vehicles, cars and construction equipment have a much lower risk profile as compared to other categories of assets. A copy of CRISIL's risk spectrum is enclosed for your ready reference. By their very nature, they are easily saleable and realise significant residual values. In light of the above, we submit that the risk weightage for assets financed by NBFC-AFCs be revised as under:

- For Commercial Vehicles, Cars & multi utility vehicles- 50%
- For Construction & Material handling equipment &Tractors – 50%
- Three Wheelers -75%
- Two wheelers and industrial equipment -100%

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It is our submission that with the increase in CRAR to 15%, there is a crying need for risk based capital allocation as this would duly reflect the appropriate levels of risk inherent in the respective asset classes and provide NBFC-AFCs a degree of capital relief. This is also in consonance with the Basel III requirement for Banks.

Classification of Asset Financing NBFCs

Some of our members in Tamilnadu and Kerala have brought to our notice a recent objection being raised by inspecting officials from RBI while carrying out inspection of Asset Finance NBFCs (NBFC-AFC).

They appear to have contended that finance for the purchase of Passenger cars, Two-wheelers, etc would not qualify to be treated as Asset finance and such Assets should be excluded while calculating the percentage of income and Assets for the 60% norm prescribed for determining the status as an AFC. They have further contended that the Assets referred above are for the personal use of the borrowers and do not generate any income and therefore should be excluded for the purpose of classification as AFC. (A copy of the letter from RBI, Trivandrum is enclosed). They have further instructed the company not to accept fresh deposits or renew existing deposits, till the matter is finally disposed off.

It may please be recalled that it was pursuant to a detailed representation made by FIDC in October 2006 (Copy enclosed) that RBI was kind enough to recognise Asset financing NBFCs as a distinct class of companies. It is relevant to reproduce this extract from the Mid-term Review of Annual Policy for the Year 2006-07 " A request had been received from the representatives of the NBFC sector to provide a separate classification for NBFCs engaged in financing tangible assets. Companies engaged in financing real/physical assets supporting economic activity such as automobiles, general purpose industrial machinery and the like would generally correspond to the classification as asset financing companies. Accordingly, it is proposed to re-group them as asset financing companies. Detailed operational instructions in this regard would be issued separately."

RBI has all along been recognising such Assets for classification purposes and its present stand that they are personal Assets is therefore very surprising, to say the least. The RBI Directions define an NBFC- AFC as follows:

" AFC would be defined as any company which is a financial institution carrying on as its Principal business, the financing of physical Assets supporting productive/economic activity, such as, Automobiles, Tractors, Lathe machines, generator sets, earth moving and material handling equipments moving on own power and general purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising there from is not less than 60% of its total Assets and total income respectively".

A plain reading of the above would show that in order to be classified as an AFC-

1. The financing should be for real/physical Assets and

2. The Assets should be such that they support productive/economic activity. The interpretation that such Assets should be used for commercial purposes or generate income is without any basis. It is pertinent to note that over 80% of all Automobiles sold in the country are financed and a narrow interpretation of this nature would virtually bring automobile sales in the country to a grinding halt. It is well accepted that financing of tangible assets is safer since, irrespective of their end-use, they are quickly realizable, without much erosion in value.

3. We submit that the laudable objective of creating a distinct class of finance companies who finance tangible assets would be completely defeated if they are classified as loan companies.

NBFCs as Banking Correspondents

We would like to place before you the case for NBFCs to be empanelled as business correspondents (BC) to banks. We believe that NBFCs can contribute significantly in achieving RBI's goal of financial inclusion.

Banking Correspondents are to deliver financial services at an affordable cost to the low-income, disadvantaged groups that normally get excluded by the mainstream banking system. Over their long history, NBFCs have been providing financial services precisely to these segments of people that are not covered by banks. Some of their typical customer profiles include:

- Self employed professionals
- Unorganised sectors such as small traders, shop keepers etc.
- Rural entrepreneurs
- Farmers and farm workers
- Micro and small enterprises

In this context, it is pertinent to elaborate on the inherent strengths of NBFCs which match the requirements of BC model, thus making NBFCs an ideal collaborator for banks as BCs. Some of the relevant NBFC strengths are:

I. Regional Presence

a) Local market knowledge and provision of excellent service levels to the customer, whether in urban, rural or other under banked segments of the country
b) Well trained field staff who understand the customer's financial needs and can educate new customers on banking and credit. This will minimize the need for investments by banks in training BCs

II. Operational Effectiveness

a) Low cost and flexibility in the operations which will be an advantage for the sustainability of the BC model
b) An understanding and proven experience in handling cash transactions in rural areas
c) Proven risk mitigation controls and specifically, the ability to assess credit risk in absence of traditional parameters

III. Technology Leverage

Most NBFCs today, have experimented and adopted various technology enablers to their operations such as internet based information dissemination, hand held devices , smart cards etc. for customer service. The same can be extended to further the needs of the BC model to ensure safety and ease of banking to customers

IV. Financial Strength

The financial strength of the NBFC as compared to an individual or a not-for-profit organization acting as BCs, will help in effective cost sharing with the banks and more importantly result in minimal charges being passed on to the customer

V. Governance and Compliance

NBFCs have been adhering to the governance structure and compliance norms set by RBI and have the necessary processes and systems in place for the reporting requirements expected from BC

It is true that there is a potential conflict of interest between the NBFC and bank's operations while implementing such an arrangement. The solution lies in evolving appropriate monitoring and control mechanisms that will mitigate such risks. Some aspects of such a regulatory mechanism could involve:

A. Development of a operational guidebook for use by the NBFC staff acting as BCs to separate the bank and NBFC interests
B. Set up of minimum/maximum business limits for the NBFCs and banks
C. Varying degree of permissions based on size, track record, geographical presence etc. (e..g a pan India NBFC can operate across India whereas a regional NBFC will be restricted to the region of its prominence)
D. Non compete agreements between NBFCs and banks after termination of a BC
E. Mandatory disclosures for all NBFCs and banks on BC activities. For e.g. customer overlap between normal and BC operations of the NBFC
F. Specific organization structures to be set up in the NBFC and bank for monitoring and internal audit of BC activities
G. Setup of a scheme for peer audit by banks and NBFCs
H. Setup of a banking ombudsman for monitoring all BC activities of NBFC

It has long been our case that the ideal relationship between banks and NBFCs should be that of wholesaler and retailer. It is our submission that the Business Correspondent model provides the ideal framework for both deposit taking and non-deposit taking NBFCs to work with banks under the guidance of RBI to further the financial inclusion goals in a sustainable manner. We trust that this would receive your favourable consideration.

Removal of Sublimit of Rs. 10.00 Crores for Acceptance of Public Deposits by Unrated NBFC-AFCs:

As per para 4 (4)(a) of RBI Notification No. DFC.118/DG(SPT)-98 dt. January 31, 1998 (as amended till date), an asset financing NBFC (NBFC-AFC) which is unrated can accept public deposits up to 1.5 times its NOF or Rs. 10.00 Crores, whichever is lower.

The above Deposit Acceptance Limits were prescribed in the year 1998 as a regulatory measure, to prevent imprudent Deposit Acceptance by NBFCs. The minimum (entry level) NOF prescribed for registration of NBFCs with RBI was Rs. 25.00 lakhs. While the entry level has been raised from Rs. 25.00 lakhs to Rs. 2.00 Crores, the deposit acceptance limits have remained unchanged. It is also worthy of note that the number of Deposit Taking NBFCs has drastically reduced from about 30,000 in 1998 to barely 300 in 2010. It is also relevant to point out that as per RBI norms, all unrated NBFC-AFCs which accept public deposits are required to maintain a Capital Adequacy Rate of at least 15%.

Based on the facts stated above, it is our submission that all eligible unrated deposit taking NBFC-AFCs, which maintain a Capital Adequacy Ratio of 15%, should be allowed to accept public deposits up to 1.5 times their NOF and the cap of Rs.10 crores be removed.

We seek your kind consideration of the abovementioned issues which are vitally important to the survival and growth of this sector and look forward to your early and favourable response.

Thanking you,

Sincerely,

T.T.Srinivasaraghavan
Chairman