# ANNEXURE 1

## REDUCTION IN BANK LENDING TO THE NON-CORPORATE MICRO SMALL ENTERPRISES SECTOR IN INDIA

The annual credit requirement of the Micro and Small enterprises (MSE) sector alone is upwards of Rs.15,00,000 crore. The commercial banking sector meets only a small fraction (5%) of this annual requirement.

As of April 2014, the **cumulative** outstanding credit of the banking sector for the MSE sector amounted to only Rs.750,000 crore. Loans to the MSE sector represented only 13% of the total outstanding credit of banks (to all sectors).

The percentage of bank credit to the micro & small enterprises as a percentage to the net bank credit declined from 14.6% in 2000 to around 10.9% in 2010.

In the case of micro enterprises, their share in bank credit declined from 7.8% in 2000 to 4.9% in 2010.

**Credit flow to the micro enterprises and MSE sectors from the public sector banks (PSBs)**

**(Amount in Rs. crore)**

| | As at the end of March | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **2000** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** | ***2008(P)** | ***2009(P)** |
| **Net Bank Credit (NBC)** | 3,16,427 | 3,41,291 | 3,96,954 | 4,77,899 | 5,58,849 | 7,18,722 | 10,17,614 | 13,17,705 | 13,64,268 | 16,93,437 |
| **Credit to MSEs** | 46,045 | 48,400 | 49,743 | 52,988 | 58,278 | 67,634 | 82,492 | 1,04,703 | 1,48,651 | 1,85,208 |
| **MSE Credit as percentage of NBC** | 14.6 | 14.2 | 12.5 | 11.1 | 10.4 | 9.4 | 8.1 | 8.0 | 10.9 | 10.9 |
| **Credit to micro enterprises** | 24,742 | 26,019 | 27,030 | 26,937 | 30,826 | 34,315 | 33,314 | 44,311 | 66,702 | 83,945 |
| **Micro Enterprises Credit as percentage of NBC** | 7.8 | 7.6 | 6.8 | 5.6 | 5.5 | 4.8 | 3.3 | 3.4 | 4.9 | 4.9 |

***Source: RBI Reports***

This declining trend has continued in the current decade also. From April 2010 onwards till April 2014, the share of bank credit to the micro and small enterprises sector has remained static at around 12-13%.

| Credit to Micro and Small Enterprises from Banking Sector | | | | | |
|---|---|---|---|---|---|
| **Rs Crs** | Apr-10 | Apr-11 | Apr-12 | Apr-13 | Apr-14 |
| Total Non Food Credit | 3040000 | 3670000 | 4370000 | 4900000 | 5600000 |
| Credit to Micro & Small | 370000 | 455000 | 493600 | 582300 | 735900 |
| *Of which Manufacturing* | 206000 | 229000 | 239300 | 294300 | 356800 |
| *Of which Services* | 167000 | 225000 | 254300 | 288000 | 379100 |
| Share of Micro and Small in Total Non-Food Credit | 12 | 12.4 | 11 | 11.9 | 13 |

# ANNEXURE 2

## REGULATORY MEASURES WHICH ARE FORCING NBFCs TO MOVE OUT OF THE FINANCE BUSINESS

In 1997, there were around 37,000 NBFCs operating and which were also accepting deposits, however, currently there are only around 250 deposit accepting NBFCs.

The rules and regulations governing the NBFCs have been made so stringent, that even well established NBFCs are contemplating to get out of NBFC business.

The growth of NBFCs have been stifled by a series of stringent regulations which have affected their profitability and therefore their fund raising ability and growth. Some of the key regulatory changes which have had a negative impact on the NBFCs are listed out below. Because of these regulatory changes, the overwhelming majority of finance enterprises had to exit the business during the period 1998 to 2014.

1. **Number of NBFCs -** The number of deposit taking NBFC's has reduced from around 37,000 in 1997 to around 250 in 2013. The percentage of public deposits accepted by NBFCs as a percentage of bank deposits have also come down from 11% to less than 0.1 %.

2. **Reduction in deposit acceptance limits –** NBFCs were permitted to borrow deposits upto their overall borrowing limits. This has been progressively reduced and is currently it is at a maximum of 4 times the Net Owned Funds. Recently the Thorat Committee has even proposed reducing deposit limit from 4 times Net Owned Funds to 2.5 times.

3. **SLR -** SLR on fixed deposits accepted by NBFCs continues to be mandatory – which leads to additional costs for NBFCs. This provision does not service any purpose, including the safety of the depositor's money, which it ostensibly is supposed to do.

4. **Capital Adequacy Ratio -** Capital requirements for NBFC's have been progressively increased and are currently at 15%, out of which Tier I is at 7.5%. It is proposed by RBI to increase the Tier I capital requirements from 7.5% to 10%. This will further reduce the ability of NBFCs to provide credit.

5. **NPA norms -** The current NPA recognition for NBFCs is 180 days past due. This is proposed to be reduced to 90 days. This proposal seems to have been made without considering the peculiarities of the Non Corporate SME sector where earnings are seasonal and they are currently used to a particular repayment pattern, which they may find it difficult to alter. This will result in a sharp reduction of credit to the SME sector.

6. **Priority Sector lending -** Earlier, bank funding to the NBFC sector for on-lending to sectors considered as "priority sector" for banks, was permitted, however, now this facility has been withdrawn since April 2011, even though bank finance to MFIs for on-lending continues to be categorized as priority sector.

7. **Securitisation norms** – the norms regarding securitization by NBFCs are restrictive and do not facilitate ease in securitization transactions.

8. **Issue of retail debentures -** In July 2013 RBI has put further restriction on NBFC's ability to issue secured debentures to retail customers. This reduces options for NBFCs to raise funds.

9. **Debenture Redemption Reserve -** In case of public issuances of debentures, NBFCs are required to maintain DRR of 25%. In addition to this, they are also required to maintain SLR of 15% on the value of debentures maturing during a financial year. All this creates an additional financial burden on the NBFCs.

**ANNEXURE 3**

**MEASURES TO PROVIDE SHORT TERM RELIEF FOR NBFCs AND MICRO SMALL ENTERPRISES**

**1. Capital Adequacy Ratio (CAR)**

Presently, the gearing available for NBFCs is only around 6 times – as opposed to around 12 times in 1997.

A tightening of the CAR norms for NBFCs would only result in reduction of credit available to the Non Corporate SME sector which are dependent on the NBFCs – and they may be forced to turn to the unorganized lenders to borrow monies at huge rates of interest. Hence, the CAR for NBFCs engaged in financing the non-corporate MSME sector could be capped at 10%.

This is also in line with the recommendations of the Key Advisory Group of the Ministry of Finance – vide Para 3.3 (vii), extract of which is set out below:

> ***An increase in the Tier-I CRAR would severely impact the competitiveness of NBFCs. Therefore, KAG is of the view that the Tier-I CRAR requirement for the NBFCs may be retained at 10%.***

**2. Provisioning Norms**

Currently, for all NBFCs,

- the provisioning norms in respect of loans granted by NBFCs is 180 days past due.
- the provisioning norms for hire purchase and lease transactions entered into by NBFCs are fixed at 360 days past due.

The proposal to align the NPA provisioning norms for all NBFCs with that of Banks (i.e.) a 90 days period should not be made applicable for the NBFCs which are engaged in financing the Non Corporate MSME Sector as

- these categories of borrowers do not have predictable cash flows and in most cases, their earnings are seasonal
- their businesses may also be temporarily suspended on account of natural calamities, illness etc

This is also in line with the recommendations of the Key Advisory Group of the Ministry of Finance– vide Para 3.3 (x), extract of which is set out below:

> ***The period for classifying loans as NPAs in case of NBFCs is higher at 180/360 days compared to 90 days for banks. A 90 day reference for recognizing NPAs in NBFCs in line with banks would impose provisioning burden on the NBFCs and could result in NBFCs deciding to opt for early foreclosures, depriving their borrowers of an income generating asset. Given the higher capital requirements, accelerated provisioning would further burden the NBFCs. Any change in the provisioning requirements for NBFCs to match that of Banks***

***may be to the detriment of NBFCs which serve specific unbanked sections of the society, particularly the small truck operators and the SME businessmen. Their repayment to the NBFC is linked to their collection. Invariably, their collection gets delayed due to various reasons beyond their control. Further, the small borrowers of NBFCs have, over the years, tuned their business model to match the collection requirements of the NBFCs. The NBFCs have also been able to exhibit good collection record and the default rate is extremely low. Therefore, KAG is of the view that the current NPA classification norms for NBFCs may continue.***

The provisioning norms for NBFCs in case of hire purchase / lease transactions is still kept at 360 days. The same benefit should be extended for NBFCs granting "loans" also as the borrower profile is the same and the asset for which the funding is given is the same and the shift to a "loan transaction" has happened purely due to tax issues.

NBFCs are currently required to make additional provision for standard assets @ 0.25% on all the standard assets with effect from 17th January 2011. This is additional provision to be made by NBFCs apart from the regular provisions, and is on par with banks. This may be dispensed with.

**3. SLR**

RBI has mandated NBFCs, which accept public deposits, to invest a portion (15%) of said amounts, in liquid securities. A similar concept is present for banks – by way of SLR / CRR. The objective of introduction of SLR/CRR is probably to act as a monetary measure – to control the supply of money into the system.

Initially, there was no SLR in respect of deposits of NBFCs. Even subsequently, the balances held by NBFCs in their current accounts were counted as forming part of SLR. Imposition of a blanket SLR of 15% for NBFCs in respect of their public deposits, deprives them of the funds which they could have otherwise channeled to the non-corporate SME sector. Thus, there is a transfer of credit from the credit-deprived sector to the government.

**4. Debenture Redemption Reserve**

NBFCs are mandated to maintain a 25% Debenture Redemption Reserve for public issuances of debentures in order to meet their redemption requirements.

It may also be noted that the debentures issued by NBFCs funding the Non Corporate SME sector are essentially working capital debentures where the money gets deployed in self liquidating assets, the proceeds of which are sufficient to meet the redemption of debentures.

NBFCs also take sufficient safeguards at the time of issue of debentures by appointing SEBI registered trustees and creation of security over the assets of the company in favour of trustees.

***Hence, the requirement of creating a DRR in respect of such issuances may be dispensed with.***

**5. Private placement of secured debentures**

NBFCs were permitted to issue secured debentures on a private placement basis under the Companies Act, 1956. A similar dispensation prevails even under the Companies Act, 2013.

However, since July 2013, the RBI has restricted NBFCs from issuing debentures on a private placement basis to retail investors.

The NBFCs who are financing the Non Corporate SME sector are heavily dependent on the retail public to mobilise funds for providing credit to the non-corporate MSME sector. This form of mobilization by way of issue of SECURED NCDs is a safe option which has been continuing for a long period now. For the investors also, the instrument is a SECURED NCD and is more preferred. Full security on the principal amount plus interest plus a margin on the same, is created over the assets of the NBFC and independent SEBI registered debenture trustees are appointed to monitor the same. The end use of these funds is also reported to RBI and are also monitored by RBI.

***Hence, considering the above, NBFCs should be permitted to continue with issue of secured NCDs to the retail investors.***

**6. Deposit Acceptance limits**

NBFCs access to bank funding is limited, especially considering that the priority sector lending tag has now been removed. Hence, NBFCs are dependent on the retail segment for their funds. NBFCs access to retail borrowing is only by way of deposits and secured debentures.

***Since, NBFCs are anyway subjected to an overall cap on borrowings, within this overall limit, they should have the flexibility to borrow in any permitted manner.***

**7. Bank loans to NBFCs to be recognized as priority sector lending**

NBFCs have been successful in delivering credit to the priority sectors and have been complementing the services of the banks in relation to the same. The NBFC sector is still focused on this segment.

***Hence, bank loans to NBFCs for on-lending to the priority sector should be considered as "priority lending" for the Banks.***

The **Key Advisory Group constituted by the Ministry of Finance**, has also recommended continuation of bank lending to such NBFC-PS as priority sector lending.

Extract of Para 2.5 of the report of the Key Advisory Group is set out below:

> *The Group has observed that the NBFCs are engaged in financing physical assets and resultant creation of a large number of jobs - which supports and strengthens economic activities across sectors, and play a critical role as an effective instruments of credit delivery particularly in the small and retail sectors of the economy. Therefore, the Group is of the opinion that the policies may be geared towards the development and growth of the sector. The regulator has also been proactive in recognizing the diverse and critical role played NBFCs and has accorded added regulatory focus on the sector by introducing and strengthening prudential frameworks for NBFCs. Considering the role played by NBFCs in creation of assets, financial inclusion, generation of employment opportunities for marginalized sections of the society and their outreach, an additional category of NBFC loan company – priority sector (NBFC-LC-PS) may be looked at for NBFCs engaged in servicing priority sector customers as defined by RBI.*

Extract of Para 4.5 of the report of the Key Advisory Group is set out below

> *4.5 Bank credit for priority sector lending:*
>
> *Banks lending to NBFCs who further supported the priority sector was previously allowed to be classified by banks as priority sector. NBFCs therefore received such funding at a discounted cost of funds. However such on lending by banks has been disallowed for NBFCs in a circular issued by RBI on May 3, 2011.*
>
> *Given the importance of the role that NBFCs play in propagating financial inclusion, i.e serving low income families and small businesses, on lending by banks should be classified as priority sector. This will not only enhance the growth for NBFCs but also give banks a profitable channel to deploy funds earmarked for priority sector instead of investing the funds at a nominal return.*
>
> *The NBFCs could be asked to provide evidence to the effect that the end use of the borrowed funds was by the priority sector participants; Further banks could be assigned the responsibility of monitoring the end use of funds.*

## 8. Securitization norms for NBFCs

The recently introduced securitization norms for NBFCs should be relaxed and made more flexible to facilitate NBFCs to carry out securitization transactions. The cap on interest rate in case of securitizing priority sector advances to banks should be removed.

************