FIDC

Finance Industry Development Council

(A body incorporated as a Self Regulatory Organisation for Registered NBFCs – AFCs)
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December 20, 2016

Shri Arun Jaitleyji
Minister of Finance
Government of India
North Block
New Delhi - 110 001.

Hon'ble Finance Minister Sir,

SUB: PRE-BUDGET MEMORANDUM - ISSUES RELATED TO NBFCs, SPECIALLY THOSE ENGAGED IN ASSET FINANCING

Finance Industry Development Council (FIDC) is a Self Regulatory Organization (SRO) cum Representative Body of all the Non-Banking Finance Companies (NBFCs) registered with Reserve Bank of India and engaged in Asset Financing. We would like to express our sincere thanks to Ministry of Finance for inviting us to present our views/issues during the Pre-Budget Discussion every year.

We welcome and appreciate the Financial Sector Reforms being undertaken by Ministry of Finance which have put India on the top of the world as the most preferred destination for foreign investment. We also congratulate the Government of India for taking the bold step of Demonetization of Rs.500 and 1000 notes, as a measure towards fighting the menace of accumulation of unaccounted wealth and illegal infusion of fake currency, in the system. We stand fully committed to co-operate and assist in making this endeavor a success.

NBFC Sector – Role and Performance

1. As per the Financial Stability Report (FSR) dated June 2016:
   - The balance sheet size of NBFCs expanded by 15.5.% on y-o-y basis during 2015-16
   - Asset quality of NBFCs improved during the year 2015-16 and is better than the public sector banks
   - The performance of the NBFC sector in terms of RoE and RoA is much better as compared to that of public sector banks
   - NBFCs can support the drive towards promoting inclusive growth by catering to diverse financial needs, specially of MSMEs and individuals.
2. NBFCs have mastered the art of lending to the “unbanked” segment thereby furthering the Government’s agenda on financial inclusion for the last seventy years now.
3. NBFCs have been the pioneers in asset backed retail lending to individuals in rural and semi urban areas, thereby playing an instrumental role in the development of important sectors like transport , infrastructure and SMEs/ MSMEs
4. Majority of the NBFCs’ portfolio comprises of loans with ticket size ranging from Rs.1.0 to 10 lakhs which are a perfect fit for the “Tarun” and “Kishore” categories of MUDRA Loans

5. Inspite of the fact that bank funding is one of the major sources of funds for NBFCs, none of the NBFCs have defaulted in meeting their liabilities towards the banks in the recent past
6. NBFCs have a regulation history of more than 19 years and all the key parameters of our activities are well regulated, almost at par with banks

The healthy performance, despite adverse economic conditions, have projected the sector as a favourable one for Investment including FDI. So, NBFCs need to be given their due recognition and appreciation for their performance.

Further, MUDRA can be the answer to the long standing demand of Small and Medium sized NBFCs for a Refinancing window. This shall also be in line with the objectives with which MUDRA was setup.

Regulation of NBFCs and Compliances

The Revised Regulatory Framework for NBFCs, issued by RBI in 2014, has largely plugged the regulatory arbitrage between banks, FIs and NBFCs. Today, the regulatory norms for NBFCs in all the following key areas are at par with banks:

- Mandatory Registration with RBI along with prescribed entry level
- Minimum Capital Adequacy (CRAR) of 15% which is even higher than the banks
- Know Your Customer (KYC) Norms and all other provisions of Prevention of Money Laundering Act, 2002
- Code of Fair Business Practices
- Asset Liability Management
- Corporate Governance
- Prudential Norms on Asset Classification (NPA Classification), Income Recognition and Provisioning
- Credit Concentration Norms
- Statutory Liquidity Ratio (SLR)
- Onsite Inspection of books and accounts on annual / bi-annual basis
- Offsite surveillance– submission of Returns to RBI on monthly, quarterly & annual basis

The expert committees in the recent past, have all appreciated high levels of compliance being shown by NBFCs, thereby posing lower risk to the system.

Stringent Regulation and high compliance levels, should dispel any doubts regarding the healthy and ethical functioning of NBFCs . As such, let there be no apprehension on how well NBFCs are regulated, while considering our requests

Ease of Doing Business

Innovation in products and flexibility in their operations, without compromising on regulatory compliances, have provided the desired comfort to our customers, specially, MSMEs. However,

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some tax related issues have resulted in complexities which go against the Government's drive to increase the Ease of Doing Business.

Therefore, favorable resolution of these issues shall lead to increasing the Ease of Doing Business

Shift From "Entity "Based Regulation To "Activity "Based Regulation

Based on the recommendations of Financial Sector Legislative Reforms Commission (FSLRC), Ministry of Finance and RBI have now embarked upon focusing on "activity" based regulation rather than the prevailing "entity" based regulation. RBI has stated this clearly in the circular issued on the Revised Regulatory Framework for NBFCs. The objective of this shift is to again bring parity between various entities engaged in similar activity thereby making things simple.

NBFCs are suffering from a distinct negative bias on tax and recovery related issues, inspite of indulging in similar activities like banks and other financial institutions. Parity with banks and other FIs in Regulation MUST lead to parity in matters related to Taxation and Recovery

Request

Based on the facts stated above, we hereby request that :

- ***Eligibility norms for NBFCs to avail refinance from MUDRA need to be made favorable to provide them funding, more so as an alternative to public deposits, which is in tune with the RBI's policy, as detailed in Annexure – 1***

- ***Tax issues as detailed in Annexures- 2 be considered favorably, to bring the much desired parity with banks, FIs including Housing Finance Companies***

- ***Recoveries need to be fast tracked and facilitated by doing away with the rider of minimum loan ticket size of Rs.1.0 cr for Enforcement of Security Interest under the SARFAESI Act , as detailed in Annexure – 3***

We shall be glad to supplement this memorandum with any additional information / clarification that may be required. We thank you in anticipation of a positive response and assure you of our full co-operation always.

Yours Faithfully,
For **FINANCE INDUSTRY DEVELOPMENT COUNCIL**

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Annexure-1

REFINANCING BY MUDRA AS A SUBSTITUTE TO PUBLIC DEPOSITS HELD BY SMALL & MEDIUM NBFCs

In terms of numbers, more than 80% of the NBFCs registered with RBI are small and medium sized. They have been doing an excellent job of furthering the Govt's agenda on financial inclusion by providing need based credit to the "unbanked" segment of the society. It is a well known that NBFCs take the first credit call on an "unbanked" borrower and thus make him part of the mainstream financial system. On the other hand, these small and medium sized NBFCs have been complying to the prescribed RBI norms, thereby posing a low risk to the system (a fact that was recognized by the Usha Thorat Committee).

MUDRA's Exposure to NBFCs is Negligible – Eligibility Norms to be Amended

MUDRA was setup with the prime objective of refinancing banks, NBFCs and MFIs for on-lending to non corporate small businesses. For this purpose three categories of loans have been prescribed – Shishu (upto Rs.1.0 lakh), Tarun (Rs.1.0-5.0 lakhs) and Kishore (Rs. 5.0-10.0 lakhs). While the "Shishu" category is primarily the forte of MFIs, it is the "Tarun" and "Kishore" categories which are a perfect fit for NBFCs.

However, till date MUDRA's exposure to NBFC sector has been negligible. This has been primarily due to the fact that the eligibility norms for NBFCs adopted by MUDRA, are not favorable, specially, for small and medium NBFCs.

RBI Discourages Deposit Acceptance by NBFCs - Credit Rating is Mandatory

It has been a stated policy of RBI that acceptance of deposits shall be the forte of banks in the long run. As such regulations for acceptance of deposits by NBFCs have been made more stringent over the years.

One of the biggest challenges before small and medium NBFCs is to raise funds at competitive costs. These are family run companies who have built a strong niche for themselves in their limited area of operation. There are about 200 small and medium sized NBFCs authorized by RBI to accept deposits. Over the years these companies have also built a strong trust among their close friends and relatives, which enables them to readily raise funds through public deposits at competitive rates.

All the accredited Credit Rating Agencies follow the same rating model and scale, irrespective of the company's size. As a result, these companies are being forced to move out of the deposit acceptance arena. Therefore, obtaining a minimum investment grade credit rating for these companies is a big challenge, simply because of their size.

Refinancing Window – Long Standing Demand of the NBFC Sector also Recommended by the Parliamentary Standing Committee on Finance

In such a scenario, there is a crying need to provide these companies with an alternative source of funding. Creating a refinance mechanism for NBFCs has been a long standing demand of the sector which was also recommended by the Parliamentary Standing Committee on Finance in their 45th report dated June 2003.

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Suggestions

Under these circumstances we feel that the eligibility norms for NBFCs for availing refinance from MUDRA should be made favorable. This shall enable small and medium sized NBFCs to shift from acceptance of public deposits and instead avail refinance from MUDRA.

This shall be a win win situation for all the stakeholders:

- *NBFCs would move out of deposit acceptance, which is in line with RBIs policy.*
- *These companies shall not only survive but also grow and continue the excellent work being done in catering to the unbanked segment, including small non corporate businesses*
- *The objectives for which MUDRA was setup will also be achieved, which shall ensure greater growth and reach for MUDRA in serving the small non corporate businesses.*

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Annexure-2

DIRECT TAX

1. **Tax benefits for Income deferral u/s.43D of the Income Tax Act**

Section 43D of the Income Tax Act recognises the principle of taxing income on sticky advances only in the year in which they are received. This benefit is already available to Banks, Financial Institutions and State Financial Corporations. This benefit has also been extended to Housing Finance Companies by the Finance Act, 1999.

In accordance with the directions issued by the RBI, NBFCs like banks and FIs, follow prudential norms and are required to defer income in respect of their non-performing accounts. Since the directions are mandatory in nature, NBFCs have to adhere to the said directions in preparing their accounts. However, the income tax authorities do not recognise these directions and tax such deferment of income on accrual basis. It is but appropriate that the Income tax authorities accept this principle of income deferral in the case of NBFCs also, who are the only segment of the financial sector denied this tax benefit. *It is, therefore, suggested that Sec.43D of the Income Tax Act be extended to include in its scope NBFCs registered with RBI, as in the case of other institutions.*

2. **TDS on Interest (Sec 194A) – Request for Exemption**

As per Sec 194A of the Act, TDS @10% is required to be deducted on the interest portion of the installment paid to NBFCs under loan/finance agreements whereas banking companies, LIC, UTI, public financial institution etc are exempted from the purview of this Section.

NBFCs carry on the financing business mostly to retail customers who are in unorganized sectors which includes large number of individuals, HUFs and SME sectors. Thus, single point collection of tax by way of advance tax payments from NBFCs would mean greater convenience to the department than collecting tax through large number of such customers from all over the country by way of tax deduction at source.

Apart from this, the distinction in the provision puts NBFCs in a disadvantageous position and creates severe cash flow constraints since NBFCs operate on a very thin spread/ margin on interest which at times is even lesser than the TDS deductible on the gross interest and reduces the effective interest rate of the NBFCs on the loans given. NBFCs are bank- like institutions.

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The additional limitations of the existing system are the following:

a) Follow up with every customer for TDS certificates every quarter (details of which are mandatory for claiming the same in the I. T. return) becomes almost impossible. NBFCs have clients who number in thousands and it is practically very difficult to collect details from everyone.

b) Even if the TDS certificate is issued by the customer, if TDS return has not been filed or not filed properly, the credit for such TDS would not be granted to the NBFC as the details of such TDS would not appear in the NSDL system.

c) Once the TDS credit is disallowed, the NBFCs have a hard time following up with the customers and the exchequer has a hard time clearing outstanding demands against NBFCs which, in reality, do not exist.

Therefore, *NBFCs, like banks, should also be given exemption under section 194A, to bring parity and increase the ease of doing business.*

3. Case for allowing higher Depreciation Rates for Construction Equipment

The I. T. Act allows depreciation at the rate of 100% in case of certain equipment meant for pollution control, solid waste control, mineral oil concerns, mines and quarries, energy saving devices and renewable energy devices. The Act also allows high rate of depreciation (30%) to motorcars, buses, lorries and taxies used in the business of running them on hire. The DTC also prescribes the same rates for these categories.

However, construction equipment which contribute immensely to infrastructure development are not given this benefit of higher depreciation rate when they are financed, instead the depreciation rate for such vehicles is only 15%. For other plant and machinery too, the rate is 15%. This acts as a roadblock to infrastructure development.

In today's age of rapid technological progress, assets like construction equipment and plant and machinery become obsolete faster. Thus, keeping in mind the nature of the asset, its average life-cycle and the pace of technological development, the depreciation rate should be 30%-50%. This will also give an impetus to the infrastructure spend and will incentivize such investments.

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INDIRECT TAX – SUGGESTIONS RELATING TO GST

As we all gear up for the roll out of GST from the coming financial year, we have some suggestions based on the Model GST Law as proposed:

1. GST @5% on Lease / Hire Purchase Rentals – Need to Promote Leasing

World over "Leasing" has been promoted as an important tool for capital formation. Today, the country is making huge investments in the Infrastructure sector and there is a special impetus being given to the MSMEs and the Farm sector. In this scenario, there is a crying need to promote "Leasing" in India, which has suffered a body blow due to imprudent taxation. Lease / Hire Purchase rentals are subject to the levy of VAT @ 4-14% at the state level and in addition, the interest component (to the extent of 10%) of the rental is subject to the levy of Service Tax @ 15%.

The double taxation needs to be done away with and GST @5% should be levied on the Lease / Hire Purchase rentals

2. Input Tax Credit @50% of Capital Goods - Need to Exclude Goods Given on Lease

Under the revised Model GST Law, Section 17 (3) provides that a banking company or a financial institution including a NBFC engaged in supplying services by way of accepting deposits, extending loans or advances shall have the option to avail credit every month @ 50% of inputs, input services and capital goods. This shall lead to a situation where capital goods given on lease by NBFC shall also be entitled to input credit of 50% only. This is not in line with the spirit of the provision and shall have a major dampening effect on leasing activity.

As requested in Para 1, there is a crying need to promote leasing in India.

We therefore request that the restriction of Input Tax Credit @50% on capital goods should exclude goods given on lease.

3. Taxation of Repossessed Assets Where the Owner is Not Registered

As per the current VAT provisions, sale of repossessed assets is not liable to output tax in the hands of Banks/ NBFCs as they do not qualify to be a dealer. However, the model GST law provides that in case where the owner is registered, the liability to pay GST would be in the hands of registered owner. However, it is not clarified whether similar transaction, in case the owner is not registered, shall be liable for GST or not.

In order to have uniformity in taxation and avoid disputes, the transaction of sale of repossessed assets owned by registered/ unregistered persons shall be in the hands of the owner of the goods only.

4. Preparatory Time for transition to GST and transition management:

While the industry wants the GST to be introduced at the earliest in view of its benefits to all stake holders, however *Government should give adequate time for preparation for its smooth transition. Considering significant increase in documentary requirement and digitisation of the entire GST process, industry has to gear up and change their accounting and computer system after the GST Rules are released.*

It is also important that in such a mega tax reform, there will be requirement to issue clarification on various GST provisions hence the Governments at Centre and States should gear up for such facility. Moreover, *the penal provisions for unintended mistake during the transition phase should not be applied as was done in the case of service tax for few years*

5. Centralized Registration and Assessment

Under the current Service Tax regime, service industries such as NBFCs and Banks have a single point registration and assessment. Unlike goods, there is no physical movement of services and many services cut across State or other geographical borders. Depending on the scale of operations, the number of returns to be filed by a lending company could be more than 1300 returns in a year as opposed to just three under the service tax regime. This will lead to significantly higher cost of compliance which in turn would lead to higher rate of interest to consumers culminating into inflationary situation. Modern companies in the financial sector avail many services on centralised basis (IT Systems, software, call centres, BPOs, etc.) while output is from the various branches spread over multiple states and usually pan-India. There is a need to allow simple and practical means of offsetting input credit with output tax.

Appreciating the need to distinguish GST between the Centre and States and to ensure that transactions are not significantly adverse to revenue of the Centre and States, we give below some practical recommendations which will address many of the complex issues.

NBFCs (along with general insurance companies, life insurance companies and banks) may be allowed to register in one state, depending on their principal place of business (Home State). Thus, an NBFC with a principal office in Mumbai, servicing a policyholder in, say Rajasthan, would pay IGST as the NBFC's Home State is Maharashtra

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Annexure-3

RECOVERY - ENFORCEMENT OF SEUCRITY INTEREST UNDER THE SARFAESI ACT COMES WITH A RIDER OF MINIMUM LOAN TICKET SIZE OF Rs.1.0 CRORE

It was after a long wait of 15months that the notification giving effect to the budget announcement was issued on 5th August, 2016. A clause has been added in the notification, whereby sections 13 to 19 of the SARFAESI Act, which cater to the "enforcement of security interest", shall be applicable only in cases where the minimum ticket size of lending is Rs 1crore. This has come as a big surprise to the NBFC sector.

The Underlying Need to Bring Parity with Banks, Housing Finance Companies (HFCs) and Other Financial Institutions (FIs) is not Fully Addressed

The prime objective of giving NBFCs coverage under the SARFAESI Act was to bring parity with banks, HFCs and other FIs, and providing NBFCs with an all important tool of recovery. This has been done in the light of the Revised Regulatory Framework for NBFCs, issued by RBI which is aimed to "address regulatory gaps and arbitrage arising from differential regulations, both within the NBFC sector as well as vis a vis other financial institutions". As a result, the Asset Classification (NPA classification norms) were brought at par with banks.

However, the above said rider of Rs 1crore does not fully justify the objective of bringing parity, since no such clause exists for banks, HFCs and other FIs.

Size of the Loan should not be the Criteria

As per the Prudential Norms for Asset Classification (NPA Classification) for banks, HFCs and NBFCs, it is the duration of the overdue period of a loan,and not the ticket size, which determines whether the loan (Asset) is to be classified as "nonperforming" or not. It is therefore, imprudent and unjustified to make the ticket size of the loan as a determining factor for use of tools of recovery of that particular loan.

The Deterrence Factor Gets Diluted

In addition to enable Financial Institutions make recoveries, such recovery tools play a very important role of being a "deterrent to default". The above said rider of minimum ticket size of Rs1crore, dilutes the deterrence factor of an important recovery tool like the SARFAESI Act.

Suggestion

1. *Based on the facts explained above we hereby request you to kindly do full justice by bringing complete parity with banks, housing finance companies and FIs in matters relating to recovery.*

2. *For this , kindly delete the following words from the Notification dated 5th August 2016:*
   "…….with the exception that the provisions of Sections 13-19 shall apply only to such security interest which is obtained for securing repayment of secured debt with principal amount of Rs 1crore and above"