Ref.No.: FIDC/ 136/ 0405 June 17, 2004

To,
Mr. P. Chidambaram,
Finance Minister,
Government of India,
North Block,
New Delhi - 110 001.

Hon'ble Finance Minister Sir,

SUB:PRE-BUDGET MEMORANDUM 2004-05 - ISSUES RELATING TO NON-BANKING FINANCIAL COMPANIES (NBFCs)

REF : OUR LETTER NO. REF.NO.:FIDC/ 135/ 0405 DATED JUNE 7, 2004 (copy enclosed)

The Non-Banking Finance Companies(NBFCs) , spread all over the country, and registered with Reserve Bank of India and authorized to accept public deposits, have joined hands and formed a **Self Regulatory Organization (SRO)** under the name of **Finance Industry Development Council (FIDC).** FIDC is **registered** as a Company U/ s. 25 of Companies Act, 1956. Our main objective is to work towards bringing discipline amongst our members by enforcing a model code of conduct, besides presenting a unified face of this sector.

As you are aware NBFCs play a very useful role in channelising funds towards acquisition of vehicles and consequently aid in the development of Road Transport Industry. Needless to mention, road transport industry handles 60% to 70% of movement of goods across the length and breadth of the country and the role of NBFCs in this sector has been historically acknowledged by several committees set up by the **Government and RBI**, over the years. NBFCs have been accepted as integral part of the Indian financial system in view of their complementary as well as competitive role.

A) **Road Transport Finance should be treated at par with Housing Finance**

Road Transport Sector today is the lifeline of our economy. As stated earlier, a major chunk of freight and passengers are carried by the Road Transport Industry. Recently, Government has accorded a **very high priority** to this sector. It is a well established fact that NBFCs provide 80% to 90 % of funding for the Road Transport Sector.

Some of the facts related to Commercial Vehicles and their financing are as follows:

- Indian economy is becoming more dependent on Road than Rail. Heavy government outlay for mega road projects like the Golden Quadrangle.

- Sale of Commercial Vehicles growing to over 30%.

- 95% of the Commercial Vehicles covered under financing.

- Heavy replacement demand anticipated on account of Modernization of old Commercial Vehicles.

- As per ITCOT Study, total funds requirement in the year 2000 for road transport financing was Rs. 7000 crores, out of which used vehicle funding was around Rs. 1100 crores.

- Surface Transport Ministry expects demand to translate into 30 lacs commercial vehicles by the year 2005 with additional investment of Rs. 5000 crores to meet commercial vehicles demand.

- It is estimated by various study groups that each commercial vehicle manufactured, sold & financed in this country gives direct & indirect employment to minimum 6 persons**,** thereby providing **employment generation to several lakhs of people** all across the country. It is the most geographically well spread network accessing and the remotest village in India.

- The potential of the commercial vehicles financing industry is estimated at Rs. 15000 crores and is growing fast. Another Rs. 6000 crores would be required for phasing of commercial vehicles which are more than 15 years old.

- Borrowers Profile : Mainly Retail with minimum individual/ group exposure and therefore, concentration risk is reduced.

- Priority of Repayment : Being an earning asset, it ranks high in priority.

- Ticket value of each transaction : Rs. 6 to 10 lacs for new vehicles and 1.5 to 5 for used vehicles.

- CRISIL in its study has placed commercial vehicle financing under the "low risk" category, in its Risk Continuum.

Under these circumstances, we request you to treat Road Transport Finance by NBFCs as a priority at par with Housing Finance by HFCs (Housing Finance Companies). For this, following steps need to be taken immediately.

1. A New Finance Corporation for Road Transport Finance should be setup.

NBFCs today are faced with an acute shortage of low cost funds. With banks shying away from funding NBFCs and stringent prevailing RBI guidelines restricting our access to public deposits, there is an urgent need to setup a new Refinance Corporation for funding of NBFCs engaged in Road Transport finance on the lines of National Housing Bank (for funding of HFCs).

The Parliamentary Standing Committee on Finance in its 45th report on "The Financial Companies Regulation Bill, 2000" (under para 105) has very strongly recommended the setting up of this refinance institution for NBFCs.

1. NBFCs to be covered under SRFAESI Act, 2002

It is highly unfortunate that there is no law/ regulation prevailing in the country today which facilitates recovery of our dues from our borrowers. Prudence tells us that timely recovery of our dues will ensure timely payment of all our liabilities including public deposits.

NPAs is a problem common to all the lenders in the financial sector whether they are Banks, Financial Institutions or NBFCs. Moreover, prudential norms for asset classification, income recognition, Provisions etc. are applicable to NBFCs at par with those for Banks and FIs.

Under these circumstances, we request you to extend the benefits of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SRFAESI),2002 to RBI Registered NBFCs also, The Parliamentary Standing Committee on Finance in its 45th report (under para 102) has recommended the same.

B. <u>Issues relating to Income Tax Act, 1961</u>

1. ***Tax Benefits for Income Deferral U/s. 43 D of the Income Tax Act*** :

It may be noted that the Section 43D of the Income Tax Act recognises the principle of taxing income on sticky advances 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 Reserve Bank of India (RBI), NBFCs follow prudential norms and like the above institutions defer income in respect 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 should accept this principle of income deferral in the case of NBFCs also 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 financial institutions.***

2. *Allowability of Provision for Non-performing Assets (NPAs) u/ s.36 (1)(viia) of the Income Tax Act:*

NBFCs are now subject to directions of RBI as regards income recognition and provisioning norms. Accordingly, NBFCs are also compulsorily required to make provisions for NPAs.

Under the existing provisions u/ s 36(1)(viia) of the Income-Tax Act, a provision for bad and doubtful debts made by banks is allowed as a deduction to the extent of 7.5% from the gross total income and 10% of aggregate average rural advances made by them. Alternatively, such banks have been given an option to claim a deduction in respect of any provision made for assets classified by the RBI as doubtful assets or loss assets to the extent of 10%(increased from 5%) of such assets. However, the benefits u/ s.36(1)(viia) are not available to NBFCs**.** ***It is appropriate in all fairness that the provision for NPAs made by NBFCs registered with RBI be allowed as deduction u/ s.36(1)(viia) of the Income Tax Act.***

3. *Extension of Income Tax benefits u/ s 10(23G) & 36(1)(viii) of the Income Tax Act for Leasing or Hire Purchase Finance as well as Loans granted to Infrastructure activities by NBFCs:*

The existing provisions of sec. 10(23G) and 36(1)(viii) of Income Tax Act do not extend the Income tax benefits to a lease or hire purchase transaction. As of now, an Infrastructure Capital Company (ICC) or Infrastructure Capital Fund (ICF) as defined under section 10(23G) is entitled to tax exemption in respect of all its earnings arising out of its investments (equity or debt) made in infrastructure projects listed under section 80-IA. Similarly, under section 36(1)(viii), notified Companies, who are engaged in providing long term finance for construction or for purchase of houses for residential use can claim deduction up to 40% of their profits for creating a special reserve. However, an NBFC is not entitled for the same tax breaks in so far as its investments in the specified infrastructure projects through lease or hire purchase or loan transactions are concerned**.** ***It is imperative to extend these benefits to NBFCs also as long as the objective of channelising investment in certain designated infrastructure projects are met.*** Any investment in infrastructure sector should be welcome to meet the country's requirements since it is key to the development of entire economy. If an appropriate environment for development of infrastructure is desired to be created, Government must provide incentives for all kinds of investments in the listed infrastructure projects irrespective of their types or categories.

4. Exemption to NBFCs registered with RBI from Tax Deducted at Source (TDS) requirements u/ s 194A(3)(iii) of the Income Tax Act :

As per Section 194A of the Income Tax Act, tax has to be deducted out of the interest payment made by any borrower to the lender at the rates in force. The rates vary depending on the constitution of the payee (lender). For category of domestic companies in which NBFC's fall, it is presently 20.5%(inclusive of surcharge of 2.5%)

Banking companies, Cooperative societies engaged in banking business, Public Financial Institutions, LIC, UTI, Insurance companies and some other notified institutions are exempted from the purview of this section implying that if the payment of interest is made to them, the borrower is not required to deduct TDS out of the interest payment.

This stipulation puts NBFCs in a disadvantageous position and creates severe cash flow constraints since NBFCs operate on a very thin spread of interest income. If we analyze a typical loan transaction of a NBFC, we may find lending say at 13% and borrowing say at 11%, giving a gross margin of 2%. The interest income of the NBFC will be subject to TDS of 20.5%, implying 2.67% out of 13% will go as TDS deduction, which is more than the total margin available. Therefore, there is no justification in imposing TDS stipulations on the interest payments made to NBFC's.

Such a stipulation forces NBFCs to avoid granting loans or offer high rates of interest to borrowers, which acts as a deterrent for the borrower and defeats the very purpose of NBFC's in the financial sector. Moreover, RBI has now allowed loans against hypothecation of certain assets to be considered along with the lease/ hire purchase assets to satisfy the 60 per cent norms for classification of an NBFC as equipment leasing or hire purchase finance company. Hence it is expected that there will be increased financing by NBFC's in the form of loans. It is thus essential that the TDS anomaly explained above is rectified immediately in order to reduce the cost of intermediaries and ensure flow of capital to the desired sectors of the economy. What we are requesting is what has already been allowed to the other players in the financial sector,

Therefore, exemption from TDS on interest payment to NBFCs may be extended also to the NBFCs registered with RBI, u/ s 194A(3)(iii) of the Income Tax Act.

5. Exemption to NBFCs registered with RBI from the purview of Sec.269T of the Income Tax Act :

Sec.269T of the Income Tax Act was amended by the Finance Act 2002 to make it obligatory on the part of all persons including individuals to repay any loan or deposit only by an Account Payee Cheque or Account Payee Bank draft drawn in the name of the person who has made the loan or deposit if the aggregate amount of loan or deposit together with interest thereon is Rs.20,000 or more. However, transactions with

Banking company are exempt from the operation of this provision. NBFCs are also extending loans to various categories of persons including individuals in large number like banks. The coverage of assistance spreads across the country through several branches of NBFCs. ***In view of the fact that the loan portfolio of NBFCs are similar as that of banks and considering the same regulatory environment under which NBFCs are operating, NBFCs registered with RBI be exempt from the applicability of Sec.269T of the Income Tax Act by a suitable notification.***

It is pertinent to note that the Report of the **Standing Committee of Parliament on Finance on "Financial Companies Regulation Bill, 2000"** submitted in June 2003 has, after hearing the views of Reserve Bank of India, Ministry of Finance and Industry Associations, strongly recommended for extension of the provisions of the Income Tax Act that are presently available to Banks, FIs to NBFCs also. The relevant para of the report is reproduced as under for quick reference :

> ***"111. The committee expect the Ministry of Finance to examine the matter of multiple taxation expeditiously and the genuine concerns of the NBFCs should be resolved at the earliest so as to provide level playing field to them vis-à-vis banks".***

C. <u>Service Tax on Hire Purchase/ Lease Transactions</u>

The Union Budget for the year 2001-2002 imposed Service Tax on Hire Purchase & Leasing transactions. As per the 46th Amendment to the Constitution of India both these transactions have been defined as "deemed sale" transactions. As such Hire Purchase / Lease transactions are subject to Sales Tax @ 4 to 14% in various states. Under these circumstances, this levy of 8% (previously 5%) of Service Tax in addition to the prevailing Sales Tax is unjustified.

Prudence says that any transaction can either be a "Sale" or a "Service", but cannot be both. Moreover, this additional levy of Service Tax has made Hire Purchase/ Leasing transactions economically unviable in today's reduced interest rate regime, where margins are very low. As a result, Leasing which is otherwise a most preferred and effective tool of funding, is dying an untimely death in our country today.

We therefore request you to kindly to treat this as an SOS Message from the NBFC industry and exempt Hire Purchase / Lease rentals from the levy of Service Tax. The only Service element, if any, in these transactions is the lease management fee / processing charges / document charges which is collected as a lump-sum amount upfront. The Service Tax may be levied only on this element of Lease / Hire Purchase Transaction and not on the rentals/ HP Charges (instalments).

What We Demand:

To sum up, we wish to reiterate the representations as under :

1. A New Refinance Corporation for NBFCs engaged in Road Transport Finance should be setup on the lines of National Housing Bank.

2. NBFCs registered with RBI should be covered under Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SRFAESI),2002.3. Tax benefits for Income deferral in NPA accounts u/s 43D of the Income Tax Act be extended to NBFCs.

3. Allowability of Provision for Non-performing Assets (NPAs) u/s.36 (1) (viia) of the Income Tax Act to be extended to NBFCs.

4. Benefits under Sec.10(23G) & 36(1)(viii) of the Income Tax Act be made available for Leasing / Hire Purchase Finance as well as Loans granted to Infrastructure activities by NBFCs.

5. Exemption of NBFCs registered with RBI from applicability of TDS provisions u/s 194A(3)(iii) of the Income Tax Act.

6. Exemption to NBFCs registered with RBI from the purview of Sec.269T of the Income Tax Act.

7. Service Tax in case of a Lease/ Hire Purchase transaction should only be levied on the Lease Management Fees/ Processing Charges/ Document Charges and not on the Lease/ Hire Purchase rentals or instalments.

We trust that our representation would merit your favourable consideration. We would be glad to supplement any other information in this connection.

We would like to discuss **some of the important issues, resolution of which is very important for the industry to survive and contribute effectively in economic development of the country.**

For this purpose, we would request you to kindly grant us a suitable appointment to meet you at your Chamber at New Delhi to discuss our concerns at one of your Pre-Budget Meetings and consider them appropriately in the coming Union Budget.

Let us keep the lines of communication open.

We look forward to an **immediate positive response** and are confident that we are in the process of a **long and beneficial relationship**.

Thanking you,

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

MAHESH THAKKAR
CO-ORDINATOR