FIDC

Finance Industry Development Council

(A Representative Body of Asset and Loan Financing NBFCs)

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16th December, 2019

Smt. Nirmala Sitharaman ji
Minister of Finance
North Block
Government of India
New Delhi 110 001

Hon'ble Finance Minister Madam,

SUB: PRE-BUDGET MEMORANDUM – SUGGESTIONS FOR HEALTHY GROWTH OF NON- BANKING FINANCE COMPANIES (NBFCs)

Finance Industry Development Council (FIDC) is a Representative Body of Asset and Loan Financing of the NBFCs registered with the Reserve Bank of India. FIDC was formed 16 years ago and is the recognized face of the NBFC sector. We have been engaged in regular interaction both with Reserve Bank of India and Govt. of India, which include pre-budget meetings and also important policy related meetings with RBI. Almost all the leading NBFCs and a large number of small and medium sized NBFCs are our members.

At the outset, we would like to convey our most sincere thanks and appreciation for all the measures announced during the last one year to address the liquidity crunch being faced by NBFCs.

Role of NBFCs in Making India a $5 Trillion Economy

NBFCs are destined to play a very important role in our nation's drive to become a $5 trillion economy by 2024-25. One of the focused areas in this drive is to double per capita income i.e., to ensure more money at the hands of every individual citizen. The three main drivers to set our economy on this path are :

- Massive Infrastructure Development
- Ease the Credit Availability
- Major Structural Changes in Agriculture

NBFCs over the years have played a vital role in the development of the economy, be it in financial intermediation in rural and semi urban areas or financing activities that are engines of growth, such as transport sector, SMEs and MSMEs, leasing, hire purchase etc.

For more than 70 years now, NBFCs have been in the forefront of catering to the segment of customers who are un-banked and under-banked masses in the rural and semi–urban areas. Through strong linkage at the grassroot level, ability to take quicker decisions and highly personalized customer service, they have created a medium of reach and communication and are very effectively serving the segments

that were forced to approach unorganized money lenders for all their credit needs. NBFCs have transformed a borrower, who is "unbanked" into "bankable".

Developments in the Last One Year – Highlighted the Role of NBFCs and their Dependence on Banks

The last one year has been one of the most challenging periods for NBFCs, due to the severe liquidity crunch, post the IL&FS default. With fund raising being a big challenge, it had a direct impact on the credit delivery by NBFCs. This had a multiplier effect on important sectors like automobiles, MSMEs and consumer goods, which faced a severe down turn.

The real contribution being made by NBFCs towards the growth of these important sectors came to lime light which drew the attention of policy makers, regulator and other stakeholders. NBFCs became the talk of the town. It was indeed very encouraging and heartening to see the finance ministry under your able leadership swing into action and take remedial measures.

The two important facts that emerged from the last year's developments are :

1. NBFCs in India, unlike other countries, are a very important and inherent part of credit delivery system, especially retail credit
2. NBFCs are over dependent on banks for their funding

Heterogeneity in the NBFC Sector – Need to Distinguish Between Long Term and Short Term Financing NBFCs

The Non-Banking Finance Companies (NBFC) sector is a heterogeneous mix of companies engaged in long term financing (minimum 10 years) in the infrastructure and housing sectors, and companies following the typical NBFC model of retail small ticket size short term lending (1-5 years). A vast majority of NBFCs are engaged in the short term retail lending, focused on asset creation (other than real estate) and MSME financing.

The core issue in the recent developments post IL&FS default, relates to the asset liability mismatch. While this may be an inherent problem for the long term financing players, asset liability mismatch is not an issue for the short term retail lending NBFCs.

Two major instances of default by NBFCs in the last one year relate to infrastructure financing NBFC and housing finance company – both of whom are long term financers and therefore, were perhaps faced by an asset liability mismatch. However, the entire NBFC sector was viewed and projected to have an asset liability mismatch which resulted in banks and mutual funds suddenly becoming risk averse.

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Platform for Regular Dialogue

Today, in spite of playing an important role in the economy, the NBFC sector does not have a platform to engage with Ministry of Finance on a regular basis. In a fast changing scenario, a structured dialogue on a regular basis is an important need of the hour. This acts as a two way flow of information and areas of concern. It also enables the policy makers to get first hand market report.

Persons "Connected" with Any NBFC Activity are Disqualified to be Appointed as Non -Official Director on the Board of PSBs/ FIs/ RBI / Public Sector Insurance Companies

We sincerely appreciate the initiative taken by Ministry of Finance to induct professionals/ persons with relevant expertise and experience as Non-Official Independent Directors of PSBs/ FIs/ Insurance Companies and invite such persons to register on Ministry's website. The website contains the Criteria laid down by the Government for this purpose.

However, we would like to draw your kind attention to *Para E(b) - Criteria of Disqualification which says, "Persons connected with hire purchase, financing, investments, leasing and other para banking activities, MPs, MLAs. MLCs and Stock Brokers will not be appointed as non-official directors on the boards of Banks/FIs/RBI/ Insurance Companies"*

Providing need based credit is one of the most important components of banking. Moreover, with the rightful thrust and importance being given by the govt. to serve the unbanked segment of the society, retail financing has become one of the most important activities for any bank/financial institution today.

NBFCs have been in the business of retail financing for more than 70 years now. Further, NBFCs are subject to similar financial regulations as banks and have a regulation history of 22 years. As such, people associated with the NBFC sector have vast experience and understanding of financing through different modes and are also well versed with the regulations associated with these activities. They can contribute a lot to the healthy growth of any bank/financial institution.

It is therefore imprudent to disqualify a person connected with the NBFC sector from being eligible to be appointed as Non-Official Director/Independent Director of banks/financial institutions. Moreover, some of the Public Sector

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

- ***It is of prime importance to clearly differentiate the short term retail financing NBFCs from the long term financing players, to ensure that all are not painted by the same brush and perceived to be high risk.***

- ***Funding sources outside the banking system need to be developed to reduce the reliance on banks (Details in Annexure – 1):***
    - ***Refinance window to be developed exclusively for NBFCs***
    - ***NBFCs should be allowed On Tap issuance of secured debentures/bonds***

- ***Department of Financial Services, Ministry of Finance should organize regular meetings (once every quarter with FIDC as the representative body of NBFCs)***

- ***Tax issues as detailed in Annexure -2 be considered favorably***

- ***Recoveries need to be fast racked 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***

- ***Necessary amendments to the MSME Act (to redefine micro, small and medium enterprises on a turnover basis instead of the current basis) and the Factoring Act (to enable non-factoring NBFCs also to participate in the TReDS platforms) may kindly be fast tracked.***

- ***Delete "persons connected with hire purchase, financing, investments, leasing and other para banking activities…." From Para E(b)- Disqualification Criteria of "Criteria laid down by the Government for Consideration as Non-Official Director in Public Sector Banks/FIs/RBI//Insurance Companies"***

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

FUNDING SUPPORT TO NBFCs

1. **Need for Diversification of Funding Sources**

All the measures to address the liquidity crunch of NBFCs, announced by RBI and Ministry of Finance are aimed at nudging/ incentivizing/ advising banks to lend more to NBFCs. Thus, the channel for funding NBFCs is routed through the banks only.

The regulatory regime for NBFCs has evolved to a stage where the regulation relating to the asset side of the balance sheet has been harmonized with that for banks. However, on the liability side NBFCs continue to depend largely on banks. In September 2018, one single default by one NBFC created such a negative sentiment that banks suddenly became very apprehensive and reluctant to lend to NBFCs. This risk averse approach of banks created a liquidity crunch for the entire NBFC sector which in turn had a multiplier effect on the important sector like automobiles, MSMEs and consumer goods.

Therefore, the need of the hour is to develop funding sources for NBFCs outside the banking system.

Request:

1. *Setup up a Permanent Refinance Window for NBFCs*

A dedicated "Refinance window for NBFCs", has been a long-standing demand of the NBFC sector. The Parliamentary Standing Committee on Finance in their 45th Report dated June 2003 (relating to The Financial Companies Regulation Bill, 2000) had recommended setting up of a new refinance institution for NBFCs:

-*Now that the Regulatory function of National Housing Banks (NHB) has been transferred to RBI, NHB may take the role of being the apex refinancing body for the entire NBFC sector and not only HFCs*

-*MUDRA (which has the mandate) can play an important role in refinancing large number of Small and Medium NBFCs*

2. *"On-Tap" Issuance of Secured Debentures*

NBFCs have access to Non-Convertible Debentures ("NCDs") having flexible tenure and rates, both through the private placement (with restrictions) and public issue. While private placements have severe restrictions on the number of investors, the frequency of issue etc., public issue of bonds tends to be very expensive, laborious and inflexible.

Further, Government of India and Economists have all voiced the need for promoting and strengthening the Corporate Bond Market. It is time to think beyond the traditional modes of bond issuances to make them more flexible, acceptable and cost effective.

It is therefore proposed that NBFCs be allowed an ***on-tap facility for issuance of NCDs*** *to the retail market by making the offering of NCDs through an easy- to-operate and less costly procedure, but with proper governance to provide investor protection and comfort. The features proposed are:*

- *Bonds/NCDs to be rated minimum BBB- (minimum investment grade). Instruments must be secured and should not fall under the definition of "deposit"*
- *Company to file umbrella prospectus (valid for one year) with quarterly financial updates. In no event, can the financials be older than 4 months. This document would lay down the overall limits and the type of NCDs to be issued (deep discount/interest bearing etc.)*
- *Under this, NBFC to be allowed to issue as many NCDs as they wish in whatever frequency they wish to. There should be no need to file an updated prospectus – only updated financials may need to be filed as an addendum.*
- *There should be no need for a specific issue closure date and issue allotment date. The allotment of bonds to be similar to acceptance of deposits – with tenure being determined from the date of the application.*
- *NCDs to be marketed similar to deposits. Intermediaries may be allowed*
- *Tenure may be long term say, 2 or 3 years and upwards*
- *Given that these are secured instruments, there should be no need to maintain SLR.*
- *Governance under SEBI guidelines, with overall borrowing cap being permitted by RBI.*
- *Lead Manager to have responsibility of reporting to SEBI & RBI on quarterly basis*
- *Grievance redressal mechanism similar to deposit acceptance regime; access for investors to SEBI and RBI Ombudsman*
- *Minimum investment amount could be low – say, Rs 10,000/- so that greater retail participation is possible.*
- *Instruments would be listed and tradeable on a recognised stock exchange to provide liquidity to retail investors.*

The idea is to make bond issuance an on-going process, with increased Reporting, more so, since NBFCs are already subject to stringent supervision, both "on site" and "off site".

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2. Bank Funding to NBFCs

i) Banks Continue to be Risk Averse in Lending to NBFCs

In spite of the steps taken by Ministry of Finance and RBI, banks continue to be risk averse in lending to the NBFC sector. While banks are willing to buy out NBFCs' portfolio (pool of assets) they have restricted the credit lines to the NBFCs. Buying out of NBFC pool of assets can at best be a band aid solution which does not lead to the growth of NBFCs. Moreover, banks undertake a 100% audit of the asset pool and cherry pick the best performing pool of assets in case of a buyout.

The actual credit flow from banks to NBFCs has declined since October 2018 and is primarily available for highly rated NBFCs. It is an established fact that the rating model which is followed by all the accredited credit rating agencies, entails "size" as an important parameter. This prevents small and medium sized NBFC from getting the desired level of credit rating in spite of sound financials. Thus, small and medium sized NBFCs continue to grapple for bank funding.

All banks prescribe a minimum "bank loan rating" as one of the eligibility criteria for any NBFC to avail credit (by way of term loans or cash credit limits). World over credit rating is used as a guiding tool to the investor and thus cannot take the shape of Quasi regulatory parameter.

ii) Encourage Bank Lending to NBFCs for On-Lending to Priority Sector to be Treated as Priority Sector Lending for Banks

Since 1999, RBI had allowed all bank lending to NBFCs for on-lending to the priority sector, to be treated as priority sector lending by banks. This gave a huge incentive to banks to lend to NBFCs. While it ensured sufficient bank funding to NBFCs at a reasonable cost, it also facilitated banks to meet their PSL targets. This was abruptly withdrawn in 2011.

However, RBI re-started this arrangement recently, but only up to 31st March, 2020 and on a very limited scale (only up to 5% of PSL by banks). There is also an artificial cap of Rs 20 lakhs per loan put on such on-lending transactions which may kindly be done away with.

iii) Co-origination of Loans- Request to allow Deposit taking NBFCs

The concept of co-origination of loans by banks and NBFCs has been an excellent initiative taken by RBI. It has been heartily welcome and highly appreciated by banks and NBFCs, as it combines the strength of the two financial entities.

However, this is currently restricted to Systemically Important Non Deposit Taking NBFCs (NBFCs-ND-SI) only. Deposit Taking NBFCs (NBFCs-D), especially the larger ones, have built a

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large retail investor base which are also the target segment of borrowers under the co-origination of loan scheme.(since many of them fall under the priority sector category). Moreover, the prevailing regulatory frame work for NBFCs is equally stringent for both NBFCs-ND-SI and NBFCs-D

iv) Reporting of Data on Bank Lending to NBFCs by RBI

RBI publishes data on sectorial deployment of bank credit periodically. Under this, the data on bank credit to NBFCs currently includes bank lending to Government owned NBFCs also. Since Government owned NBFCs are largely engaged in big ticket sized and long term funding, bank lending to these Government owned NBFCs forms a significant portion. In the current scenario, where it is an accepted fact that banks have become risk averse in lending to NBFCs, the RBI data does not reflect the true picture (obviously because of the fact that bank lending to the Government owned NBFCs is not impacted)

Request:

i) *Minimum prescribed credit rating should not be a barrier for NBFCs to avail credit from banks and bank funding to NBFCs should primarily be based on the financials and overall strength of NBFCs, irrespective of their size and credit rating*

ii) *The arrangement of treating bank lending to NBFCs for on-lending to Priority sector to be treated as PSL for banks, should be made permanent and the limit needs to be increased to at least 10% of total priority sector lending (PSL) by banks.*

iii) *It is both prudent and the need of the hour to extend the Co-origination of Loan Scheme to Deposit Taking NBFCs (NBFC -D).*

iv) *The data on bank credit to NBFCs may be split into Government owned and Private NBFCs. This shall not only present the factual position but also facilitate policy formulation.*

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Annexure-2

DIRECT TAX

1. TDS On Interest (Sec 194A) – Request For Exemption

As per section 194A of the Act, any person making payment of interest is required to deduct tax at source ('TDS') @ of 10%. There are certain exemptions given under this section wherein the person making payment to various institutions like Banking Company, Life Insurance Companies and UTI etc., is not required to deduct TDS. Accordingly, any person making payment of interest to Banks is not required to deduct tax

However, no such exemption has been provided to NBFCs from the applicability of section 194A. Accordingly, tax is required to be deducted at the rate of 10 percent from interest paid to NBFCs. This creates severe cash flow constraints since NBFCs operate on a thin spread/ margin on interest which at times is even lesser than the TDS on the gross interest. Further, due to enormous transactions, NBFCs have to face severe administrative hardship in terms of collection of TDS certificates from their thousands of customers.

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.

Co-origination of Loans by Banks and NBFCs – Borrower Cannot Split the Repayment

RBI vide its notification dated 21st September, 2018 has allowed banks and NBFCs on Co-origination of Loans to the priority sector. As per this, a single borrower may be co-funded by bank and a NBFC in a pre-determined ratio. Both bank and NBFC may price the loan independently. However, the borrower shall be offered a single blended rate of interest. All the repayments made by the borrower (including

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the interest) by way of EMIs shall be made to an escrow account from where the amounts shall be credited to the bank and NBFC in respective proportion.

In such a scenario, the borrower shall not be in a position to split the EMI and determine the exact interest component of the NBFC portion and hence TDS deduction shall be practically impossible. It is therefore important to bring both bank and NBFC at par on the TDS provisions.

Exemption May be Granted to Non-Deposit Taking Systemically Important NBFCs (NBFC-ND-SI) and Deposit Taking NBFCs (NBFC-D)

As per the prevailing Regulatory Framework of RBI, the following two categories of NBFCs are subject to the most stringent regulations:

1. All Deposit Taking NBFCs (NBFC – D) irrespective of their size –*there are total 81 NBFCs-D as on 31st October, 2019*

2. Non-Deposit Taking Systemically Important NBFCs (NBFC-ND-SI) ie., NBFCs which do not accept public deposits and have an asset base of Rs 500 crores and above – *there are total 278 NBFCs – ND-SI as on 31st October, 2019.*

All major aspects of working of above said two categories of NBFCs are regulated and monitored by RBI.

NBFCs are Facing Liquidity Crunch

Exemption from TDS provisions shall also be contributing to ease liquidity for NBFCs.

Request:

Based on the above said facts, it is hereby requested to exempt those NBFCs which are registered with RBI and classified by RBI as Deposit Taking NBFC (NBFCs-D) and Non-Deposit Taking Systemically Important NBFC (NBFCs-ND-SI) from the provisions of TDS on Interest Income. The same may be granted by issuance of Notification u/s 194A(3)(iii)(f) of The Income Tax Act, 1961.

2. Request to Allow 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.

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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.

Request:

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 at least at par with commercial vehicles ie; 30%. This will also give an impetus to the infrastructure spend and will incentivize such investments.

INDIRECT TAX : GST

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. Prior to the introduction of GST, Lease / Hire Purchase rentals were 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 was subject to the levy of Service Tax @ 15%.

While GST has done away with the issue of dual taxation, the rate of GST on rentals of lease of any movable asset is equal to the rate of GST levied on normal sales/purchase of that asset, which does not give any incentive to lease.

Request:

- *The interest component of the lease rental may be exempt from the levy of GST on the lines of the exemption given to the interest on loans.*

- *The rate of GST on lease rentals should be reduced to 5% in order to promote and encourage lease as a tool of capital formation.*

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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

Union Budget 2015 had announced coverage of NBFCs (with asset base of 500crs and above) under the SARFAESI Act. This came as a welcome move since the asset classification (NPA) norms for NBFCs were brought at par with banks by RBI. However, in the gazette notification issued on 5th August 2016 to this effect, a clause was inserted 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.

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Request:

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"