FIDC

Finance Industry Development Council

(A Representative Body of Assets and Loan Financing NBFCs)
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December 24, 2020

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.

We **thank you** very much for the personal meeting granted to us through video-conferencing on December 15, 2020 which was attended by FIDC Co-Chairman Mr. Raman Aggarwal. The details of the issues he raised on behalf of FIDC and NBFC sector are being presented here.

SECTION-I: LIQUIDITY SUPPORT

The important role being played by NBFCs in funding the unfunded, including the MSMEs, has been duly recognized by the Govt. This has led to a number of measures taken by Ministry of Finance and RBI to provide liquidity support to NBFCs, especially, during the last 2 years after the

IL&FS debacle. Post the COVID driven lockdown further steps were taken in this direction under the "Atmanirbhar Bharat" package. The World Bank has recently sanctioned a $ 750 million Development Policy Loan to Govt of India for supporting the MSME sector. In their report on the same, they have identified "Strengthening NBFCs" as one of the 3 Key pillars in this venture.

However, small and medium sized NBFCs continue to face challenges on the liquidity front.

A. Issues Related to Funding at the Policy Level

We take this opportunity to highlight the bottlenecks in funding of small and medium sized NBFCs, and suggest the way forward:

1. Mode of Borrowing

All the small sized NBFCs, and also a very large number of medium sized NBFCs, do not access capital market due to the complexities in compliances to various rules and regulations. As such, they do not issue bonds / debentures (NCDs) / CPs and instead borrow by way of "term loans" secured against their receivables, from banks and FIs like SIDBI and NABARD (including its subsidiaries like NABKISAN & NABSAMRUDDHI).

This single factor has ruled these companies out of contention for availing funding under the TLTRO 1.0 & TLRO 2.0 of RBI and PCG 2.0, SPL (Special Liquidity Scheme) of Ministry of Finance as all these schemes entailed investment by banks and SPV in bonds / CPs issued by NBFCs.

2. Eligibility Criteria

All the schemes announced by RBI and MoF have prescribed a minimum credit rating as an eligibility criteria for NBFCs. The rating model which is followed by all the accredited credit rating agencies entails "size" as an important parameter. All the credit rating agencies use the same scale to rate both large and small NBFCs. In such a scenario, it is practically impossible for a small sized NBFC to get the desired level of credit rating despite a sound Balance Sheet and excellent track record.

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It is therefore important that parameters like Capital Adequacy Ratio (CRAR), asset quality (NPA levels), profitability and experience and understanding of the management should be given due weightage in deciding the eligibility of NBFCs to avail funding.

3. Tenure

A vast majority of NBFCs are engaged in financing MSMEs and individuals for purchase of automobiles, tractors, equipment etc. As such, the average tenure of loans given is 24 to 48 months. Therefore, it is imperative that NBFCs need to borrow for a commensurate period in order to avoid creating an asset liability mismatch. Thus, the funding must be provided for tenure of at least 36 months.

Currently, funding under the PCG 2.0 (including the Govt guarantee), SPL and the Refinancing being done by SIDBI, are all for a short tenure of 6 months to 18 months only.

4. Need to Have a Refinancing Body

Bank funding of small and medium NBFCs has been a challenge due to various reasons, especially, during the last 2 years. The tepid response to the TLTRO 2.0, which mandated banks to invest at least 50% of the stipulated amount in small and medium NBFCs, was a clear example of this. The need therefore, is to reduce the over reliance on banks and have a dedicated refinancing body.

Parliamentary Standing Committee on Finance in their 45th report dt. June, 2003 had recommended setting up of a refinance institution for NBFCs on the lines of National Housing Bank for HFCs.

More recently, The World Bank report dt. June, 2020, on the Development Policy Loan for $750 million, also suggests:

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"The post Global Financial Crisis (GFC) experience with large volumes of liquidity provision to the financial system by central banks is important. It is critical to ensure that liquidity is not hoarded by banks which have the broadest access to the central bank liquidity windows and is spread widely throughout the financial system, including both to financial intermediaries (such as NBFCs) and ultimate users of finance (such as MSMEs). Public DFIs serving as quasi-lenders of last resort to NBFCs (e.g., Landesbanken in Germany) can serve as highly relevant examples for India due to its large NBFC sector without a dedicated lender-of-last-resort (LOLR) window."

Under the circumstances, we feel SIDBI and NABARD may be assigned this role.

Request:

Based on the facts explained above:

- *A fund dedicated to Funding Small & Medium NBFCs may be allocated to FIs like SIDBI, NABARD (along with NABKISAN & NABSAMRUDDHI)*
- *These FIs should fund by way of "Term Loans" for a tenure of 3-5 years*
- *All NBFCs, irrespective of their size and credit rating (even unrated), should be eligible*
- *Key Balance Sheet parameters such as CRAR, NPAs, Track Record along with Promoters experience and understanding of the market, should be the important consideration*
- *Govt. may offer First Loss Guarantee to banks and FIs for Term Loans given to NBFCs*

B.Issues Related to Bank Funding of NBFCs

1. **Need for a Carve Out for Small and Mid Sized NBFCs, Within the Sectoral Cap**

While NBFCs account for 25% of total credit in the economy, most banks have capped the exposure to the sector at 8-9%. There is a report from various research houses which shows bank wise exposure to various sectors and it amplifies the point.

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Due to drying up of other avenues post IL&FS n DHFL crisis, banks are the only source of borrowing for most NBFCS and certainly for small and medium ones and they get crowded out by the large ones.
Most if not all, small n mid sized NBFCs cater to the most under-served/credit starved customers in rural and semi-rural markets and new to credit(NTC) customers and they don't get enough support from banks owing to lack of credit rating.

Request:

A Special carve out within overall sectoral cap, for small n mid-sized NBFCs, should be prescribed, like the way RBI has done for several sub-sectors within overall 40% Priority Sector Lending.

2. **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.

Request:

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.

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SECTION- II: 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 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) i.e., 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. Removal of TDS of 30% under Section 194LBC of the Income Tax Act, 1961

TDS under section 194LBC should be removed or brought in parity with TDS rate as per section 194A of the Act (interest other than interest on securities).

Presently, tax is deducted at source at the rate of 30% by securitisation trust from income payable to an investor who is not individual or HUF. Various expenses incurred to earn the said income are not allowed as deduction to arrive at real net income. TDS is applied at the flat rate of 30% on gross income.

While computing its taxable income for the year, the investor considers the income from securitisation trust after deducting eligible expenses and offers net taxable income at the effective tax rate of 25.17% applicable to a company as per section 115BAA of the Act which is also lower than 30% TDS prescribed under section 194LBC.

Request:

Further, if the proposal under section 194A is accepted and TDS on the said section is removed, in parity with the said section, TDS under section 194LBC should also be removed.

3. **Clarity on Tax Impact due to Ind AS: Need for Harmonization**

NBFCs are the only players in the financial services, which are required to follow Ind AS accounting system. This has resulted in a reverse arbitrage with banks and other financial service providers.

Some of the aspects in relation to the accounting impacted by IND AS include: Interest income on NPAs, Fair value measurements, Valuation of Derivative instruments, Expected Credit loss (ECL), Measurement of provisions, Impact on MAT computation f) Income for DA and PTC pools. The current regulatory landscape requires that while arriving at income for the purpose of taxation, reference be made to ICDS or the Income Tax Act. There is lack of clarity on this subject and this may lead to protracted litigation in future.

Request:

A Specific Guidance note be issued by the Income Tax covering various aspects of taxation of NBFCs with respect to Ind-AS, thereby harmonizing the provisions of income tax act with that of Ind AS accounting system.

4. **Taxing on interest income on NPA which is required to be recognized in books of accounts due to Ind AS**

NBFCs are required to book Interest on doubtful assets on time basis irrespective of the fact of unreasonable certainty of their ultimate collection. Thus, recognizing the said interest income on

non-performing assets would lead to taxability of notional income as the probability of receiving this income is remote.

Further, as per Income Tax Act, interest income is offered to tax in the year in which it is credited to PL Account or actually received whichever is earlier. For the companies which are preparing their accounts under Ind AS these interest income on NPA are required to be booked in PL even if they are not received and thus the companies are required to pay tax on notional income.

Request:

It is requested that interest income on doubtful assets should be made taxable only in the year of receipt and not on time basis as the same is notional in nature.

SECTION – III: MEASURES FOR MSMEs

1. **Small businesses, including Trading Community Impacted by the COVID-19 Pandemic**

   While Government is undertaking steps to ease difficulties faced by MSMEs, the trading community has been excluded from the said benefit by virtue of change in definition of MSMEs. The benefits extended by Government of India for supporting MSMEs should be extended specifically to trading community, both retail and wholesale traders. This would allow them a level playing field and will help them tide over the difficulties being face due to COVID-19.

   Request:

   The one-time restructuring schemes launched specifically for MSMEs be extended to the trading community as well.

2. **The MSME Ministry & RBI Notifying Amendment to MSME Definition Mandatorily require Registration on Udyam Portal - PAN and GSTIN are Compulsory Documents w.e.f. April 1, 2021.**

The MSME Ministry and the RBI may kindly permit corresponding exemption from GST registration to entities so that they can register on Udyam portal as well. Making GST compulsory for registration on Udyam portal for classification as MSME would render the exemption provisions under GST Act infructuous, which we believe may not be the objective of the stipulations.

"Individual borrowers", who are involved in small businesses and have availed loans towards purchase of small commercial vehicles, tourist taxis, construction equipment's etc. do not enjoy any benefits, as they are not registered under GST (because of their turnover being significantly lower than the threshold) nor they are classified as MSME. This segment needs to be appropriately recognised in extending the benefits as in the case of MSME.

Request:

PAN & GSTIN should not be mandatory for registration as MSME on Udyam portal to allow individuals running businesses in their names, also avail the benefits.

3. **Interest Subvention Scheme launched by SIDBI had Provided Substantial Relief to MSMEs – Need to Relaunch and Include Traders**

While the scheme may cover MSMEs, it should also include trading community specifically and be re-launched.

Request:

Considering the current state of MSMEs and other small borrowers, including trading community, the Interest Subvention Scheme should be re-launched and be extended to both MSME and Trading Sectors.

SECTION- IV: ENFORCEMENT OF SEUCRITY INTEREST UNDER THE SARFAESI ACT COMES WITH A RIDER OF MINIMUM LOAN TICKET SIZE OF Rs.50 LAKHS

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 was reduced to Rs. 50 lakhs in the Union Budget 2020-21.

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. 50 lakhs 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

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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 Rs. 50 lakhs dilutes the deterrence factor of an important recovery tool like the SARFAESI Act.

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 remove the rider of Rs. 50 lakhs as the minimum loan ticket size for NBFCs to enforce Security interest under the SARFAESI Act.*

SECTION V – GENERAL – DECRIMINALIZATION OF SECTION 138 OF THE NEGOTIABLE INSTRUMENTS ACT

The proposal to decriminalize offence under Section 138 of NI Act, will lead to the NBFCs losing a vital legal instruments to keep the unscrupulous borrowers under check. The NBFCs as an industry will be hugely impacted by this decision.

The stated objective of this move was that it would lead to declogging of judicial system. However, decriminalization of Section 138 of the NI Act, would lead to surge in contract

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enforcement disputes, which would clog the civil courts thereby shifting the nature of the legal battle from 'criminal' to 'civil' defeating and acting against the prime objective of ease of doing business and unclogging the court system.

Request:

It is therefore suggested that Section 138 of The NI Act should not be decriminalized and instead a more efficient case management system be put in place for dealing with cases under Negotiable Instrument Act.

We request your kind and favourable consideration of these requests.

Thanking you,

Yours Faithfully,

For FINANCE INDUSTRY DEVELOPMENT COUNCIL

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