FIDC NEWS

Finance Industry Development Council

(A Self-Regulatory Organisation for Non-Banking Finance Companies (NBFCs) registered with RBI)

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Allow NBFCs to pursue financial inclusion agenda

It is undisputed fact that NBFCs are playing a very crucial role in Financial Inclusion agenda of the Nation. It caters to the financial need of Lower Income Group (LIG) and Middle Income Group (MIG), many of whom are unbanked, through various innovative products and in turn, support entrepreneurship of millions of small businessmen and create huge employment opportunities.. On the other hand, NBFCs also support manufacturers of vehicles, equipments etc. in creating demand for their products by providing finance to the buyers.

Currently, as per RBI report, around 12300 NBFCs are registered with RBI which were almost thirty to forty thousands in number before the registration was made mandatory by RBI. NBFCs manage around 5% of the total funds managed by the banking industry.

FIDC represents the NBFCs having almost 90% share of the assets financed by the industry as a whole. It emphatically suggests to RBI in respect of Draft Guidelines issued on 12th December the following:

Capital Adequacy Ratio: May be raised after introducing graded risk weight assigned to productive assets like commercial vehicles, equipment etc. which have been categorized as low risk by rating agencies like CRISIL. This is also in line with the graded risk weightage assigned to assets funded by housing finance.

NPA norms: Since NBFCs cater to unbanked customer segment who have no collaterals and irregular cash flows, NPA provisioning should be kept as it is without any change.

Public Deposit Norms: Since NBFCs are maintaining prescribed CAR, prescribing sub-limits for deposits further restrict the fund raising ability and will impact NBFCs adversely, when there is credit squeeze from banks to this sector. Moreover, NBFCs are creating assets as well as maintain SLR against this borrowing providing safety to the depositors.

Entry Norms: The existing norm of minimum NOF of Rs.2 crore to be maintained and not to introduce any new eligibility criteria like minimum assets for registration.

Making funds available to the sector for future growth:

* Almost 50% to 60% of equity in many of the large listed NBFCs of this sector comes from FIIs and if NBFCs are allowed to raise debt overseas through , ECB, will really help in the growth of this sector. ECB window needs to be opened for Asset Financing NBFCs also.
* Removing priority sector status for lending by banks to NBFC has put lot of hardship in raising funds from the banks at competitive rates resulting in higher cost to the end borrowers. The same should be restored as reaching to the end customer is very important agenda. The change in securitization guideline has also affected adversely the flow of funds to this sector through this source.
* There is a strong case for refinance institution for this sector in line with National Housing Bank (NHB) to ensure smooth and continuous flow of resources to NBFCs, playing very vital role in last mile credit delivery in vast county like India where many agencies are required along with bank to fulfil this objective.

R Sridhar, Chairman, FIDC

REGULATORY PERIMETER

RBI NOTIFICATIONS & CIRCULARS :

External Commercial Borrowings Policy – Non-Banking Financial Company – Infrastructure Finance Companies- RBI/2012-13/367-A.P. (DIR Series) Circular No. 69; Jan. 7, 2013

Guidelines on Fair Practices Code for NBFCs – Grievance Redressal Mechanism - Nodal Officer- RBI / 2012-13/416; DNBS.CC.PD.No. 320/03.10.01/2012-13 February 18, 2013

KYC norms /AML Standards / CFT / Obligation of banks under PMLA, 2002 : RBI/2012-13/422 DNBS (PD).CC. No 321 /03.10.42 /2012-13; Feb. 27, 2013

RBI liberalises ECB policy for NBFC-IFCs

RBI on Jan. 7 decided to enhance the ECB limit for NBFC-IFCs under the automatic route from 50 % of their owned funds to 75 % of their owned funds, including the outstanding ECBs. NBFC-IFCs desirous of availing ECBs beyond 75 % of their owned funds would require the approval of the Reserve Bank and will, therefore, be considered under the approval route. RBI also decided to reduce the hedging requirement for currency risk from 100 per

AT A GLANCE

- Allow NBFCs to pursue financial inclusion agenda .... R Sridhar, Chairman, FIDC 1
- Regulatory Perimeter 1
- Issues related to gold loans NBFCs 2
- NBFC sector in India- Evolution of regulation ...Anand Sinha, Deputy Governor, RBI 3
- NBFCs partner India's growth story ...Shinjini Kumar, Director, PWC India 6
- The larger NBFC sector is fighting far too many unequal battles ... T. T. Srinivasaraghavan, Managing Director, SFL 7
- Legal Eagle 8
- SEBI Moves 9
- Beyond Boundaries 9
- Periscope 10
- Dialogue with Authorities 11
- FIDC in Action 12

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cent of their exposure to 75 per cent of their exposure. The permitted end-use should be for on-lending to the infrastructure sector, as defined under the extant ECB policy.

NBFCs to have Grievance Redressal Mechanism - Nodal Officer

RBI revised guidelines on Fair Practices Code (FPC) for all NBFCs vide circular dated 18 Feb.2013 in view of the creation of a new category of NBFCs viz; NBFC-MFIs and also rapid growth in NBFCs' lending against gold jewellery. NBFCs are asked to lay down the appropriate grievance redressal mechanism within the organization to resolve disputes between the company and its customers and the mechanism should ensure that all disputes arising out of the decisions of lending institutions' functionaries are heard and disposed of at least at the next higher level. More over all NBFCs are directed to display prominently, for the benefit of their customers, at their branches / places where business is transacted, the details of the grievance redressal officer belonging to their company as also that of the local office of RBI as detailed at paragraph (A) (vi) of annexe of FPC.

RBI extends deadline for issuance of new cheques

The RBI asked banks to issue new cheque books only under the new format [the new standard CTS-2010] and gave them time till July-end to withdraw the old format cheques. All cheques at present with customers in the old format (non-cheque truncation system) will continue to be valid for another four months (the earlier deadline was March 31), the apex bank said. The central bank also said the system of post dated cheques and payment via equated monthly installment (EMI), in either the old or new format, will be banned from now wherever electronic debit facilities are available. All residual non-CTS-2010 cheques with customers will continue to be valid and accepted in all clearing houses (including the cheque truncation system (CTS) centers) for another four months up to July 31, subject to a review in June 2013, RBI said in a circular to bank heads. [Financial Chronicle/PTI, Mar 18]

Scrap post-dated cheque system: RBI panel

The RBI wants to do away with post-dated cheques (PDC) in all fresh loans. It is also debating putting a charge on cash deposits and withdrawals from banks in current accounts above certain limits. The suggestions have been made in a discussion paper on disincentivising issuance and usage of cheque issued by the Bank. "Existing PDCs should be converted to electronic payment mandates within a prescribed timeline," the RBI paper said. Preference of the lenders for post-dated EMI cheques rather than other electronic modes of collection under the strong belief that the lender gets protection under Negotiable Instruments Act only if the payments are made through cheques. Corporates have to also be discouraged from issuing physical interest warrants and dividend warrants. "Where such physical instruments are issued, a processing charge (for instance Rs 25 per instrument) may be levied by the paying bank when the instrument is presented for payment," the paper said. Similarly, cash deposits in current accounts need to be discouraged actively, the RBI paper said. [Financial Express, Feb. 1]

Present propositions are patently loaded against NBFCs: Mahesh Thakkar

At a seminar organized by Indian Merchants Chambers and FIDC jointly at Mumbai on January 7 Mr. Mahesh Thakkar, director general, FIDC said while outlining the draft guidelines issued by RBI on 12th December 2012 that 'given the ground realities, over two-thirds of registered NBFCs face closure if the recommendation on minimum asset size of Rs. 25 crore of financial assets and mandatory credit rating is brought in'. He further added that 'The present propositions are patently loaded against NBFCs', and appealed that they must be adequately reconsidered.

Panel to plug regulatory gaps in shadow banking

Raising concern on regulatory and data availability gaps on the shadow banking system, the Reserve Bank of India (RBI) on Dec. 28 said plugging these was necessary for a full assessment of the size of the non-banking financial segment, and of the systemic risks posed by the latter. To address these, a working group with representation from all financial sector regulators is attempting to "macro map" the shadow banking sector, it said. RBI also raised concern about regulatory gaps in the case of entities operating collective investment schemes, such as chit funds or multi-level-marketing schemes.

In its Financial Stability Report issued on Dec. 28, RBI cited a few examples from the current financial system which were out of its regulatory purview. "Government-sponsored NBFCs remain outside the regulatory and supervisory framework," it said. It has recently proposed that all government companies qualifying as NBFCs under the revised principal business criteria will be required to comply with the regulatory framework applicable to NBFCs at the earliest. [Business Standard, Dec.29]

Issues related to gold loans NBFCs

Institutional Issues and Domestic Financial Stability Concerns

Indian gold loan market expanded considerably in recent years. The recent developments in the gold loan market have both positive and negative implications. In a country, where illiterate and semi-literate people have to raise a loan for meeting some sudden medical exigency or an educational loan or a business loan by a small and medium enterprise owner, the gold loans extended by the NBFCs are very handy and flexible, though costlier than such loans disbursed by banks. At a time, when financial inclusion is a major policy goal, the services rendered by the gold loans NBFCs, which are a part of the organised loan market are contributing in a reasonable measure to cater to the borrowing requirements of a needy section of the society. Secondly, gold is an idle asset in the hands of individuals and there is a huge unlocked economic value in the Indian economy, which is said to have anywhere between 18000 to 20000 tonnes of gold. Just a small fraction of about three per cent of this idle gold stock is being used for raising gold loans, at present. The process through which gold loans are raised is monetising the gold in the country. If we cannot bring down the demand for gold significantly, at least, we need to ensure that the gold is put to an economic use through gold loans. The Working Group sees huge potential for the gold loans business in India in the medium and long run, as the gold stock increases ceaselessly in the country for varied reasons. Banks and gold loan NBFCs extending gold loans are playing a role in this financialisation process. But, there are developments, which are of concern like very rapid rate of growth of the gold loan business of NBFCs, the speed with which they opened branches, the rate at which they started raising resources both from banks and non-bank sources, their high profitability, complaints made by borrowers against the NBFCs and the steady decline in their capital funds. These developments warranted regulation and careful monitoring of their operations and activities. The regulatory actions initiated by the Reserve Bank in the recent months will have to be viewed against this setting. Customer protection has become an issue in the light of multiple complaints against the gold loans NBFCs.

No immediate systemic implications in terms of domestic financial stability from the gold loans NBFCs.

The financial performance of the gold loans NBFCs and the current level of their borrowings from the banking system are not of a significant concern. There appears to be no immediate systemic implications in terms of domestic financial stability due to the interconnectedness of gold loans NBFCs and banking system. It was empirically tested that increase in gold loans extended by NBFCs and banks does not impact significantly the gold prices in India both in long run and short run. However, if the present rate of growth in their bank borrowings is unchecked, gold loans may become significant portion in the portfolio of banks in the medium term. There were also instances of regulatory violations in the manner in which resources are raised through debentures by the gold loan NBFCs.

The impact of recent regulatory measures on gold loans NBFCs is clearly visible

The recent regulatory measures initiated by the Reserve Bank are in the right direction and is expected to make the gold loans NBFCs robust and reduce the regulatory gaps between banks and gold loans NBFCs. As gold loans NBFCs aspire for a level playing field with banks over medium term, they should be prepared for equal regulatory and supervisory treatment and strengthening of their capital buffers. The Working Group recognises the fact that there is a tradeoff between the goal to monetise as much idle gold in the economy as possible and the need to have a restrictive 'loan to value ratio' imposed on gold loan NBFCs. Therefore, once the business levels of these gold loans NBFCs comes to a level as considered 'appropriate' by the Reserve Bank, there appears to be a case for revisiting the prescribed 'loan to value ratio' of 60 per cent. The Group suggested an alternative uniform method to calculate the LTV ratio and also to have working definition of gold 'value'.

Going forward, customer protection should be the focus of the gold loans NBFCs

Going by the nature of complaints against gold loans NBFCs, like excessive interest rate related disputes, charges of improper documentation and auction related issues, there is a need to monitor the operational practices of the gold loans NBFCs carefully and continuously. There is also a continued need for strengthening the regulations and supervision to make them robust over medium and long haul and also make them highly customer-oriented. The major gold loan companies need to follow appropriate documentation, modify auction procedures and also go for a self-imposed interest rate rationalisation. In sum, the operational practices followed by the NBFCs need an overhaul. The Gold Loan industry can play a proactive role in ensuring the scrupulous implementation of the prescribed fair practices code in all aspects of the functioning of gold loans NBFCs.

[Extract from executive summary of the Final Report of the RBI Working Group to Study the Issues Related to Gold Imports and Gold Loans NBFCs in India]

NBFC sector in India- Evolution of regulation

Mr. Anand Sinha, Deputy Governor, Reserve Bank of India

"The NBFC sector has been the fastest growing segment in the Indian financial sector today with year on year growth higher than that of banking sector."

"we have always been cognizant of the fact that NBFCs play a significant role in the financial system and in the economic growth."

Non-Banking Financial Companies (NBFCs) in India are defined as companies carrying out a range of financial activities such as making loans and advances, investing in shares /bonds/debentures/and other securities, asset financing including leasing, and hire-purchase finance. The recent additions to this sector have been (i) Infrastructure Finance Companies (IFC), (ii) Infrastructure Debt Funds (IDF), (iii) Micro Finance Institutions (NBFC- MFI) and (iv) Factors. In India, NBFCs quintessentially epitomize the shadow banking system as they perform bank like credit intermediation outside the purview of banking regulation. Apart from this, where the entire OFI assets account for approximately 24 percent of bank assets as on March 31, 2012, assets of the NBFC sector alone account for 12 percent, denoting the significance of NBFCs in the Indian shadow banking system.*

As a background to the setting up of the Working Group on NBFCs chaired by Ms. Usha Thorat, let me briefly touch upon the evolution of regulation of NBFC sector in India. Steps for regulation of NBFCs were initiated as early as in the sixties. Regulation of NBFCs was found to be necessary for three reasons viz., ensuring efficacy of credit and monetary policy, safeguarding depositors' interest and ensuring healthy growth of Non-Banking Financial Intermediaries (NBFIs). Thus, the Banking Laws (Miscellaneous Provisions) Act, 1963 was introduced to incorporate a new chapter (i.e., Chapter III B) in the Reserve Bank of India Act, 1934 to regulate the NBFIs. Subsequently, to enable the regulatory authorities to frame suitable policy measures, several committees were appointed from time to time, to conduct in-depth study of these institutions and make suitable recommendations for their healthy growth. These include the Bhabatosh Datta Study Group (1971), the James Raj Study Group (1974), and the Chakravarty Committee, 1985. Thereafter, the Narasimham Committee (1991) outlined a framework for streamlining the functioning of the NBFCs, which would include, in addition to the existing requirements of gearing and liquidity ratios, norms relating to capital adequacy, debt-equity ratio, credit-concentration ratio, adherence to sound accounting practices, uniform disclosure requirements and assets valuation. The Joint Parliamentary Committee (JPC), appointed in connection with the irregularities in the Securities Transactions, had also recommended that legislative framework should be strengthened to vest in RBI more powers to effectively regulate NBFCs. The extant regulatory and supervisory framework as it stands today is based on the recommendations of the Shah and Khanna Committees (1992 and 1995).

The growing significance of NBFCs was also recognized by the second Narasimham Committee (1998) as well as by the RBI in its Discussion Paper on Harmonisation of the Role and Operations of DFIs and Banks. Recognizing the increasing significance of the sector, the Working Group on Money Supply (Chairman: Dr. Y.V. Reddy) in 1998 proposed a new measure of liquidity aggregate incorporating NBFCs with public deposits of Rs. 0.20 billion and above.

There was a significant increase in the nature of NBFC activities in the nineties. NBFCs grew sizably both in terms of their numbers as well as the volume of business transactions. The number of NBFCs grew more than seven-fold from 7,063 in 1981 to 51,929 in 1996. Accordingly, based on the recommendations of the Shah Committee, the RBI Act was amended in January 1997 to provide a comprehensive legislative framework for regulation of NBFCs by effecting changes in the provisions contained in Chapter III-B and Chapter V of the Act and vested more powers with the RBI. The regulatory framework was based on the three pillars viz., onsite supervision, offsite monitoring and exception reporting by auditors. Though the amended Act provided for registration of all NBFCs, the focus continued to be the protection of depositors' interest thus covering the deposit taking NBFCs, while keeping the non-deposit taking NBFCs subject to minimal regulation. These measures resulted in consolidation of the sector, reduction in the number of deposit taking NBFCs, reduction in the quantum of public deposits and increase in the number of non-deposit taking NBFCs. The number of deposit taking NBFCs, including Residuary Non-Banking Finance Companies (RNBCs), decreased from 1,429 in March 1998, to 273 in March 2012. The deposits held by these companies (including RNBCs) decreased from Rs. 238 billion to Rs.101 billion during the same period.

With the consolidation of the sector and stabilising of deposit taking NBFCs, the focus in 2006 widened to include non-deposit taking NBFCs which were growing in number as well as in size. Considering the issue of systemic importance of large NBFCs in view of their size, their enhanced risk taking capabilities, growing complexity of their activities, and the financial market interlinkages, a comprehensive regulatory framework was introduced for these NBFCs. To begin with, non deposit taking companies having asset size of Rs. 1 billion (100 crore) and above were classified as systemically important non deposit taking NBFCs (NBFCs-ND-SI) and subjected to capital adequacy and credit concentration norms. Subsequently, liquidity and disclosure norms were made applicable to them. Presently, as on March 31, 2012, there are 375 NBFCs-ND- SI with a total asset size of Rs. 9213 billion.

The NBFC sector has been the fastest growing segment in the Indian financial sector today with year on year growth higher than that of banking sector as seen from the figures below:

NBFC sector during the 2008 crisis

The NBFC sector came under pressure during the 2008 crisis due to the funding interlinkages among NBFCs, mutual funds and commercial banks. NBFCs-ND-SI relied significantly on short term funding sources such as debentures (largely non convertible short term debentures), and CPs, which constituted around 56.8 percent of the total borrowings of NBFCs-ND-SI as on September 30, 2008. These funds were used to finance assets which were reportedly largely a mix of long term assets, including hire purchase and lease assets, long term investments, investment in real estate by few companies, and loans and advances. These mismatches were created mainly as a business strategy for gaining from the higher spreads. However, there were no fall back alternatives in cases of potential liquidity constraints. The ripple effect of the turmoil in American and European markets led to liquidity issues and heavy redemption pressure on the mutual funds in India, as several investors, especially

*In India, NBFCs constitute a major segment of shadow banking system alongside other entities such as Insurance companies and Mutual Funds, both of which are regulated by other regulators. In the address, NBFCs are referred to be largely representing the shadow banking sector.

Mr. Niranjan Hiranandani, President, Indian Merchants' Chamber (IMC), Mr. Mahesh Thakkar, Co-Chairman, Finance and Banking Committee, IMC, Mr. TT Srinivasaraghavan, Managing Director, Sundaram Finance Ltd., Mr. K V Srinivasan, CEO, Reliance Commercial Finance, Ms. Usha Thorat, currently the Director, CAFRAL and the Chairperson of the Working Group on the issues and concerns in the Non Banking Financial Companies (NBFC) sector, and several other distinguished guests were present at the event.

Growth in Total Assets of Banks vis-à-vis NBFCs

Item	As at end					
	2007	2008	2009	2010	2011	2012
Banks	3459961	4326486	5241330	6025141	7183522	8299400
Growth (Y-o-Y)		25	21.1	15	19.2	15.5
NBFCs	366452	478997	560035	657185	866713.7	1038189
Growth (Y-o-Y)		30.7	16.9	17.3	31.9	19.8

Source: Trend and Progress of Banking in India, various issues

Note: NBFCs include all deposit taking NBFCs and NBFCs-ND-SI

institutional investors, started pulling out their investments in liquid and money market funds. Mutual funds being the major subscribers to CPs and debentures issued by NBFCs, the redemption pressure on MFs translated into funding issues for NBFCs, as they found raising fresh liabilities or rolling over of the maturing liabilities very difficult. Drying up of these sources of funds along with the fact that banks were increasingly becoming risk averse, heightened their funding problems, exacerbating the liquidity tightness.

Measures taken by RBI to enhance availability of liquidity to NBFCs

RBI undertook many measures, both conventional as well as un conventional, to enhance availability of liquidity to NBFCs such as allowing augmentation of capital funds of NBFCs-ND-SI through issue of Perpetual Debt Instruments (PDIs), enabling, as a temporary measure, access to short term foreign currency borrowings under the approval route, providing liquidity support under Liquidity Adjustment Facility (LAF) to commercial banks to meet the funding requirements of NBFCs, Housing Finance Companies(HFCs) and Mutual Funds, and relaxing of restrictions on lending and buy-back in respect of the certificates of deposit (CDs) held by mutual funds.

In addition to these measures, a Stressed Asset Stabilisation Fund viz., IDBI SASF, was set up to provide liquidity to NBFCs through purchase of securities of NBFCs which would in turn be refinanced by RBI through purchase of Govt. guaranteed securities issued by the SASF.

Notwithstanding the market reports, the actual condition of NBFCs was not so alarming inasmuch as only one NBFC availed refinance from the SASF and no NBFCs went under. However, this dichotomy between perception and reality serves to show how susceptible the sector could be to reputational risk. Thus, the significance of the above measures lies also in their ability to create confidence in the sector.

The crisis did, however, highlight some regulatory issues concerning the non-banking financial sector, particularly risks arising from regulatory gaps, arbitrage and systemic inter-connectedness. A need was, therefore, felt to reflect on the broad principles that underpin the regulatory architecture for NBFCs keeping in view the economic role and heterogeneity of this sector and the recent international experience. It was felt necessary to examine in depth, the risks in the NBFC sector in the changed scenario and recommend appropriate regulatory and supervisory measures to address these risks with the aim of creating a strong and resilient financial sector which is vital for all round economic growth of the country. Accordingly a Working Group (Chair: Ms. Usha Thorat) was constituted to suggest reforms in various important areas relating to NBFC sector. The Working Group comprised representatives from the industry and co- regulators like SEBI.

Recommendations of the Working Group

The Working Group in its report submitted in August 2011 made various recommendations both to ensure the resilience of the NBFC sector and also to contain risks emanating from the sector in the context of overall financial stability. The recommendations of the Working Group can broadly be divided into four categories, comprising issues relating to (i) Entry Point norms, Principal Business Criteria, Multiple and Captive NBFCs; (ii) Corporate Governance including Disclosures, (iii) Liquidity management and (iv) Prudential regulation including capital adequacy, asset provisioning, risk weights for certain sensitive exposures, and restrictions on deposit acceptance.

Based on the recommendations of the Working Group and the subsequent extensive deliberations with all the stakeholders, viz, industry participants as well as the Government of India, draft guidelines have been formulated and put in the public domain for comments in December 2012.

As I have stated before, going by Press Reports as well as the responses observed today, some apprehension has been expressed regarding the proposed guidelines. However, let me emphasize that our intention is not to restrict the activities or constrain the innovativeness of the sector but rather ensure that possible risks to financial stability are addressed, thereby creating, or should I say, ensuring continuation of a resilient system of non-bank credit intermediation. To go back to my earlier remarks on shadow banking and global regulatory initiatives, I would stress that the setting up of the Working Group and implementation of its recommendations was undertaken in line with the international agenda for shadow banks.

Some apprehensions have been expressed that the regulation of shadow banking is becoming as rigorous as banking regulation, which is not warranted given the differences in the profiles of these two segments. I agree with the concerns. While one can argue that identical functions should be regulated in an identical manner irrespective of the nature of the legal entity in which these functions are housed, we have gone for differential regulations between banks and NBFCs due to differences in business models, their significance in the financial system and varying risk profiles. Regulations for banks are much more stringent than that for NBFCs and the proposed new regulatory framework for banks under Basel III proposes even more stringent requirements to address the risks of banks.

However, the distinction between banks and non-banks is more fuzzy now and as the global crisis has adequately evidenced, non-banks are increasingly taking up bank-like activities. In such a scenario, where both banks and non-banks undertake similar activities, if only bank regulation is tightened, there is a very distinct possibility of risks migrating from the more tightly regulated sector to a more lightly regulated sector, the way water flows from high pressure points to low pressure points. Therefore, to contain risks in the overall financial system, there is a case for reviewing the regulations of the non-banking sector along with that for banks, holistically. In India, we have been alive to these issues as I have already mentioned earlier. Setting up of the Working Group on the Issues and Concerns of the NBFC Sector in September 2010 is another instance of taking a pro-active stance in dealing with regulatory issues and concerns.

The overarching principles to the new regulatory framework revolve around some guiding principles:

- Appreciating the contribution of the NBFC sector to the financial system and the economy and rationalising regulations to preserve the innovativeness of the sector
- Recognising the need to address systemic risk arising out of concentration and exposure of NBFCs to sensitive sectors
- Recognising that the NBFCs have the ability to leverage on the RBI registration and therefore, rationalising the scope of regulation to address risks appropriately
- Conserving regulatory resources and directing them where required
- Dealing with regulatory arbitrage while not recommending completely bank-like policies and regulation for NBFCs and
- Giving adequate transition period to the industry so as to cause minimum dislocation to the sector.

Let me briefly touch upon some of the significant features of the draft guidelines.

Principal Business Criteria

Under the present dispensation, a company is treated as an NBFC if its financial assets are more than 50 percent of its total assets (netted off by intangible assets) and income from these financial assets is more than 50 percent of its gross income. Both these tests are required to be satisfied. There is a problem with this definition. As a financial regulator, Reserve Bank primarily regulates the financial activities of NBFCs, while they can also engage in non financial activities of comparable magnitude. It is, therefore, important to insulate the sector from the spillover of possible risks from non-financial activities. The most preferred solution, therefore, from a regulatory perspective, would be the one in which the NBFCs do not undertake any activity other than financial activities on the same lines as banks are permitted to undertake only those activities which are enumerated in Section 6(1) of the Banking Regulation Act, 1949. However, that is not possible for the NBFC sector given the structure of the sector. As ensuring 100 percent financial activity is not feasible, the next best alternative would be to raise the threshold for principal business. Accordingly, the threshold has been raised from 50 percent to 75 percent of total assets/income, to ensure that the regulation focuses on predominantly financial entities. However,

raising the threshold could result in keeping out of purview of regulations, certain non banking financial entities having financial activities of significant scale which could adversely impact financial stability. This could happen in the following two situations:

- The financial activities of these entities are a significant proportion of the total activities and of significant magnitude; and
- The financial activities of these entities are not a significant proportion of total activities but are of large magnitude.

To cover (a) above, the definition of principal business has been expanded to cover those non-bank financial entities whose financial assets or income from financial assets are 50 percent or more of total assets or gross income respectively and total assets are Rs. 10 billion or more. However, entities covered by (b) cannot be possibly subjected to entity specific regulation as the scale of non financial activities would be much larger than that of financial activities. Regulatory approach in such a situation will have to evolve over time. One approach could be to subject their financial activities to prudential regulations for those activities. The other alternative would be, as envisaged in FSB's approach, to build up a data base, identify vulnerabilities, and take suitable regulatory action where vulnerabilities could acquire systemic proportions.

Exemption from requirement of registration:

In formulating the threshold for registration of NBFCs, we were guided by considerations of conserving limited regulatory resources and issues of materiality of the risk profile of NBFCs. Accordingly, we have proposed to exempt two categories of NBFCs from registration one, all non-deposit taking NBFCs with asset size below Rs. 0.25 billion and two, NBFCs with asset size below Rs. 5 billion and not accessing public funds. These NBFCs would also be exempt from regulation. Small NBFCs having asset size of less than Rs. 0.25 billion or NBFCs with asset size below Rs. 0.5 billion and not accessing public funds are not likely to create systemic risk in view of their small size and absence of leverage respectively. This is consistent with the recommendations of the Geneva Report which suggested that such small companies, which it termed "Tinies", should have minimal conduct of business regulations especially if they are unlevered. It is possible that some of these companies may pose insignificant risks as individual entities but their correlated behaviour may create risks when they move together as part of a larger group or "herd" and these may not be adequately captured. To address this risk, we have propounded the group concept, in which all NBFCs in a group will be individually treated as Systemically Important (NBFCs-ND-SI) if their aggregate assets total Rs. 1 billion and above. This is not to deny that there may be valid reasons for creation of multiple NBFCs, but the possible risks from their activities need to be addressed.

A lot of apprehension has been expressed in some quarters that NBFCs (i.e., non banking financial entities meeting the Principal Business criteria) having assets below the threshold will be forced out of business. I would like to clarify that this is not the intention of the proposed regulations. All we are saying is that from a materiality perspective such entities need not be the focus of RBI's regulatory oversight and, therefore, should be exempted from registration and regulation. We also do not feel that this will have an adverse impact on their activities because after all, there must be many entities doing business even under the current regime, which have significant financial activities but below the 50/50 threshold and, therefore are not NBFCs and not registered with RBI.

Captive NBFCs

There are some regulatory concerns regarding the business model of captive finance companies. As captives provide finance for purchase of products of the parent, their business is inextricably linked to the parent's fortunes. It is likely that credit underwriting standards in such companies may be weaker. Hence, while setting up of captive NBFCs is a commercial decision, the risks arising out of the business model of such captives need to be adequately addressed and hence the review of guidelines, requiring a higher Tier I Capital.

Prudential Norms

Apprehensions have also been expressed that tightening of prudential norms as proposed in the draft regulations may affect the profits of the NBFCs and increase their lending cost. You would observe that changes have been proposed only in areas where there is a heightened risk perception. While the intention is not to mimic bank regulation completely, I am sure, you all would agree that we should take some of the relevant best practices of the bank regulation which are well developed and tested and adapt them to other sectors where the benefits of such approach outweigh the costs. The proposed increase in the capital requirements for NBFCs is to ensure that the risks in the financial system which surfaced during the crisis are addressed and the regulatory gap between banks and NBFCs does not widen, especially when the capital requirements for banks have increased significantly under Basel III. The proposed measures address regulatory arbitrage between banks and NBFCs in areas such as capital market or real-estate exposure through the calibrated use of prudential measures such as higher capital requirements, and risk weights for sensitive sectors, wherever greater risks are perceived. Accordingly, we have proposed to raise the minimum Tier I capital requirement, for captive NBFCs, NBFCs with major exposure to sensitive sectors such as capital market, commodities and real estate, and NBFCs predominantly engaged in lending against gold jewellery. For NBFCs that are part of a banking group, risk weights for capital market exposure (CME) and Commercial Real Estate (CRE) would be the same as that for banks; for others these would be revised upwards.

Convergence in regulation between banks and NBFCs is thought to be required in the areas of asset classification and provisioning norms. This is because both banks and NBFCs are financing similar assets and there is no logical reason for prudential norms to be different. In fact, initially when the 180 day norm was introduced for NBFCs, for assets other than lease and hire purchase transactions, for whom the norms were even more relaxed, the norms were similar to those of banks at that time. However, while banks migrated to 90 day norm, NBFCs continue to be on 180 days norm., As regards the proposed 90 day norm for classification of assets, it has been argued that the clientele of NBFCs is very different from that of banks and hence a longer collection period is needed. I would like to emphasise that once an amount becomes due there is no reason why it should not be paid within 90 days irrespective of the nature of business and clientele. As regards fixing the payment schedules, there are no regulatory prescriptions or constraints. As lenders, NBFCs have the option of fixing the repayment schedule suiting the credit cycle of the borrowers. However, to ensure minimal dislocation, this convergence of time norms will be brought about in a phased manner, and a one-time adjustment of the repayment schedule which shall not amount to restructuring, is proposed to be permitted. Similarly, in the case of provisioning for standard assets, convergence with the banking sector is envisaged and sufficient transition time will be given for compliance.

Deposit acceptance

Since 2004-2005, we have maintained that, as a policy, only banks should be allowed to accept public deposits. Deposit acceptance in the NBFC sector is a legacy of the past but no new NBFC has been given a license for acceptance of deposits. Initially, the concept of rating had been introduced for NBFCs accepting public deposits, but, as an exception, unrated AFCs were allowed to accept deposits up to `Rs. 0.10 billion. You would all agree that depositor protection is not a function of the amount of deposit. It is, therefore, proposed to make it compulsory for all existing deposit accepting NBFCs to obtain credit ratings from credit rating agencies. In future, unrated NBFCs will not be permitted to accept deposits and existing unrated deposit taking NBFCs will be given a period of one year to get themselves rated if they wish to continue to accept deposits. Further, to bring parity in the sector, the limit for acceptance of deposits for rated AFCs is proposed to be reduced in line with other deposit taking NBFCs.

Liquidity Management

I have spoken in detail about the liquidity risk due to maturity transformation during the credit intermediation process and how this affected NBFCs in 2008. As seen during the crisis, liquidity risks can rapidly translate into solvency risks. Taking lessons from the global crisis, the Basel Committee on Banking Supervision has stipulated that a banking institution should maintain adequate levels of high quality liquid assets which can be converted into cash at very short notice and at small discount to enable it to survive a stress situation over a 30 day time horizon. The Committee has also looked at a longer time horizon by expecting institutions to fund their activities with more stable sources of financing on an on-going basis. These are prudential practices and need to be adopted by all financial entities. Consequently, it is proposed that all registered NBFCs would be required to maintain high quality liquid assets in cash, bank deposits available within 30 days, money market instruments maturing within 30 days, actively traded debt securities (valued at 90 per cent of the quoted price and carrying a rating not lower than AA or equivalent), equal to the gap between total cash inflows and outflows over the 1 to 30 day time bucket as a liquidity coverage

requirement. For deposit taking NBFCs, the extant requirement of maintenance of liquid assets will continue. I would like to clarify that the proposed requirement is much less onerous than that for banks inasmuch as the holding of liquid assets is not calibrated to a stress scenario and holding of financial sector liabilities as liquid assets is permitted which is not the case for banks.

Corporate Governance

The global financial crisis exposed major weaknesses in corporate governance systems, particularly in risk management policies and procedures. Internationally, the emphasis on good governance is increasing and it is firmly believed that improving corporate and risk governance could prevent, or at least mitigate, systemic crises. In 2007, the OECD lauded Asian countries for substantially revamping their corporate governance frameworks, but warned that enforcement remained the most significant challenge and an "unfinished agenda". CLSA and the Asian Corporate Governance Association echo the same conclusion in their 2010 Corporate Governance Watch Report for Asia. A key observation is that "regulators make it too easy for companies to get away with box-ticking," which keeps even the best Asian markets far from international best practices. As per BCBS principles (October 2010) for enhancing corporate governance, effective corporate governance practices are essential to achieve and maintain public trust and confidence in the banking system, which are critical to the proper functioning of the banking sector and economy as a whole.

The above arguments apply to the NBFC sector also, especially, in view of their growing size, multiplicity of stakeholders and the increasing complexity of operations. For the purposes of corporate governance, we have felt it necessary to increase the focus on companies with asset size of more than Rs. 10 billion, i.e., the really large companies. Again, the proposed prescriptions in this regard centre around materiality, whether in ensuring fit and proper shareholders and management or the quality of disclosures. The proposed prescriptions are aimed at enhancing governance standards in NBFCs by, inter alia, stipulating that all registered NBFCs will require prior approval whenever these is a change in control, or a significant increase in share holding; requiring RBI's approval for appointing CEOs of large NBFCs. Other measures are: restricting the number of directorships a director can accept; putting in place a system of due diligence to ensure fit and proper criteria; and requiring enhanced disclosure requirements, including those mandated under Clause 49 of the SEBI listing agreement, etc.

Conclusion

In conclusion, let me reiterate a few points. The NBFC sector is a very important segment of the financial system warranting encouragement for further development, but at the same time, would also require to be watched and regulated more closely given its growth, increasing complexity and impact on the financial system due to increased interconnectedness. Said differently, the very factors which would require the NBFC sector to be actively promoted would also require the sector to be actively regulated. In India, we have always been cognizant of the fact that NBFCs play a significant role in the financial system and in the economic growth. The regulatory framework has been designed and is reviewed from time to time keeping in mind the requirement of the sector as well as the changing dynamics in the financial system due to increased interconnectedness. It may be said that while the shadow banking sector in India did come under stress during the global financial crisis, the stress levels were comparatively modest which did not threaten their solvency. The sector has been largely sound, mainly due to the kind of regulation that has been put in place. Nevertheless, continuing fine tuning of regulation is required to monitor the growth of this sector as it can take unexpected and unforeseen turns and mutations. That is ultimately the objective of the proposed Guidelines. In my remarks today, I have elaborated on the rationale behind the proposed guidelines so that there is a better understanding of the revised regulations. I am sanguine that the new regulatory framework would address risks and help build a more resilient and robust NBFC sector.

[Extract from the address by Mr. Anand Sinha, Deputy Governor, Reserve Bank of India at the event organized by the Indian Merchants' Chamber, Mumbai and FIDC jointly on January 07, 2013 published under the title "Regulation of Shadow Banking – Issues and Challenges." on RBI website on Feb.1. 2013.]

NBFCs partner India's growth story

Shinjini Kumar
Director,
PwC India

One of the lasting contributions of the 2007-08 financial crisis will be the poetic phrase 'shadow banking'. Aptly, shadows are determined by the size of the obstruction, which, in this case, may have been the long-held article of faith called depositor protection, on which the elaborate edifice of regulation was built.

Fortunately, for India, "the whole alphabet soup of levered up non-bank investment conduits, vehicles, and structures" (Paul McCulley, 2007) had barely begun to bubble before the lessons from the global crisis were staring regulators and policymakers in the face. The aftermath created the opportunity to set in place ground rules for a future financial system that would avoid mistakes of the past; a necessity in the face of a high growth economy and increased attention of global investors. The draft guidelines, based on the Thorat Committee Report on NBFCs, is part of that architecture.

In all fairness, the NBFC sector was not in regulatory shadows as RBI has, over the years, tweaked and implemented a differentiated regulatory regime for deposit-accepting, systemically important, and other non-bank institutions. A few famous failures of deposit-accepting institutions in the 1990s led to legal and regulatory measures to curb and regulate the activities of loosely regulated institutions that garnered substantial deposits from areas where banking could not, and indeed would not, reach.

New generation private sector banks and newly-energised and technology-powered public sector banks helped by filling in the gap and the situation was quickly contained. Regulatory focus then shifted to the non-deposit accepting NBFCs and attendant issues relating to classification, public funds and core investment companies. Once the framework for such lenders was put in place with a bank-like prudential and capital regime, it gave the market the confidence required for growth.

Indeed, the past two decades have witnessed the evolution of multiple types of NBFCs and NBFCs can be said to have partnered the India growth story as sanguinely as banks. From financing long-term infrastructure and running the financial ecosystem around construction, leasing, equipment, real estate, second-hand machinery, vehicles and creation of small asset backed loans, NBFCs came to be synonymous with local growth stories, often maintaining good capital adequacy, asset quality and growth. So, why the need to look at something that seemed to be doing just fine? For one thing, the problem of plenty had to be addressed.

In the nineties, with the new regulatory framework, the net was cast wide, leading to registration of NBFCs with extremely basic capital and infrastructure (sometimes no more than a paper folder and a rented registered address), probably motivated by the typical Indian proclivity for cornering licences. The recommendations address this issue boldly; balancing delicately the existing legal framework based on net worth and the proposed asset criteria. Definitions are modified, exemptions are created, but with the end goal to deregister non-serious players.

Trading in licences is set to become outdated as rules on change in control become strict, providing opportunity for due diligence to regulators. There are many interesting recommendations around governance, including approval for CEO remuneration for large NBFCs, adherence to listing conditions, improved disclosures and greater responsibility of directors.

Overall, the guidelines seem to converge further towards banking regulation on the important parameters of capital and liquidity, thereby mitigating potential concerns around stability and systemic risk. The NPA classification is also set to converge to banking after a transition time.

Alternative mechanism of raising debt locally is not so swift to develop, making it difficult for even the best-managed NBFCs to fund growth. On the equity front, although leasing and finance have been put under automatic route for FDI, multiple issues persist in establishing presence and developing viable business models.

Largely, Indian NBFCs are engaged in consumer financing and asset creation, both being relevant activities in the current phase of growth. Two scenarios are possible: better regulation will create better opportunities and better NBFCs will adapt as they have done in the past and deliver. On the other hand, many of them may not find the business viable in the absence of the opportunity space between banks and borrowers and shut shops.

But regardless of these outcomes, what needs to be thought through is the continuing interplay between banks and NBFCs. Do NBFCs have a roadmap to grow healthy, well-run businesses and/or eventually become banks? Or, do they continue to live under the shadows of the banking system? [Economic Times, Dec 26]

Excerpts from an interview of Mr. T. T. Srinivasaraghavan by K. T. Jagannathan and Anuj Srivas of Hindu published on 28 Jan.

The larger NBFC sector is fighting far too many unequal battles

T. T. Srinivasaraghavan, Managing Director, Sundaram Finance Ltd. and past chairman of FIDC

> "Interest rate is important but it is certainly not the most important. Nor is it the only factor that is influencing the overall economic growth and development."

> "Plans for growth have to be balanced & there has to be a longer term perspective. You have to be conscious of 3 things: growth, quality & profitability."

> "There is enough room for banks & non-banks to play."

How do you see the economy going, and what has to be done to revive the larger India growth story?

Everyone believes that India continues to be a great growth story. There is no disagreement on that. India is still a very attractive investment destination. We have sort of lost our way a little bit in the wake of global events and also because of our own issues domestically. But the India story is not over. There will be far more credibility to the whole process than when it is just a talk. We are hearing very positive noises. The talk is very encouraging. How much of it translates into action is the key.

What is the scenario in the auto industry, and how is that panning out for the commercial vehicle sector?

India is a top manufacturer of cars, and has been a huge market for a while now. I believe we have now reached a size where it is unrealistic to say that our industry should be growing at 30 per cent. You can't be perpetually growing at 30 per cent. Similar is the case with the commercial vehicle (CV) sector. Add to that is the change in profile of tonnage in the CV sector. Twenty-five tonne is slowly phasing out. As against two 16 tonners a few years ago, you have got a 31 tonner now. We should not look at sales in terms of number of units. If you look at sales in terms of tonnage, you will find that over a period the industry has actually grown. There has to be a greater realism and maturity in terms of how we evaluate and benchmark.

What is your view on the impact of the much talked about interest rates in this whole consumer spending story?

We have beaten interest rates over the head for so long. Assuming that the Reserve Bank of India Governor drops rates by 50 basis points, will we go back to 7 per cent GDP growth rate in 2013? We are over-simplifying the issue by saying that interest rate is the only thing that stands between us and phenomenal growth. I don't buy that. Interest rate is important but it is certainly not the most important. Nor is it the only factor that is influencing the overall economic growth and development. There is a whole bunch of factors that contribute to the growth

What is the scene on the vehicle finance front?

The vehicle finance situation faithfully mirrors what is happening in the auto sector. Commercial vehicle sales are down steeply, and passenger car sales are flat. The only areas where there is some growth is in the small CV segment (the sub-one tonne) and the utility vehicle segment. The haulage segment has taken a real beating, which, again, logically fits in with the industrial production and the overall economy being down.

What strategy can NBFCs have in this kind of a scenario?

Over the nearly 60 years of our existence, we have seen some real highs and lows. If you recognise that over the decades you are going to see these highs and lows, then you build a business model and a strategy that allows you to come through these with a certain amount of equilibrium, which is the policy we follow. We have been within a much narrower band of growth with far less volatility.

Top line growth has to be tempered with asset quality and profitability. In lending, the day you give money is when the game starts. You have to balance growth with perception of what the future holds, and one has to plan based on the trends that you see and based on your past experience. Plans for growth have to be balanced, and there has to be a longer term perspective. You have to be conscious of 3 things: growth, quality and profitability.

But isn't there a big role for NBFCs to play in the economic growth?

Yes, definitely there is. And that probably explains why we continue to be successful and why we continue to grow. There is enough room for banks and non-banks to play. If banks act as wholesalers and we as retailers, if people are really committed to financial inclusion beyond talk, then you will realise that financial inclusion will only happen by fully leveraging the NBFCs.

Financial inclusion is a new buzz word. The hire purchase companies that started several decades ago were the original pioneers of financial inclusion. They took credit to the un-banked and to the rural areas. There needs to be discipline, and to that extent, regulation is fair and we are fine with it. Where we do have a problem is with us having to be fighting in an uneven playing field, whether it relates to taxation or in terms of the legal remedies available. The larger NBFC sector is fighting far too many unequal battles. If everyone is committed to financial inclusion, there has to be the recognition that we too are an important cog in the wheel. There have to be a number of supporting actors. The NBFCs are one of those key supporting actors.

Depreciation of leased vehicles

The Supreme Court ruled in a recent case that a leasing company is entitled to the benefit of depreciation under Section 32 of the Income Tax Act for vehicles it had let out to its customers. In this batch of cases involving non-banking finance companies, the assessees bought vehicles from manufacturers and leased them out to its customers as part of business. The lessees were registered as owners under the Motor Vehicles Act. When the companies claimed depreciation, the revenue authorities denied it on the ground that they were neither owners of the vehicles nor users. The dispute travelled to various appellate forums. In the lead case, ICDS Ltd vs Commissioner of IT, the Karnataka high court agreed with the revenue department. Reversing this view, the Supreme Court stated that the leasing firm was the owner as well as the user. The registration in the name of the lessee was only to fulfil the requirement of the Motor Vehicles Act. Otherwise, the leasing firms fulfilled the requirements of the IT Act. The lessor is therefore entitled to claim depreciation at higher rate since the legal title to the assest vests with him, the court said. [Business Standard, 17 Jan.].

Supreme Court Order allows the Lessor to claim Depreciation, that too at a higher rate, on the trucks given on Lease, even though the trucks were registered in the name of the lessee. It is a very logical and categorical order favourable to Leasing. Please note that this seems to be a case of Financial Lease and so all the more important, notes Mr.Raman Aggarwal, past co-chairman, FIDC.

Goodwill arising on merger is eligible for depreciation: Apex Court

Goodwill may not be figuring expressly in the inclusive list of intangible assets mentioned in section 32 of the Income-tax Act qualifying for depreciation but being an asset belonging to the same genre, it is indeed a depreciable asset if it has been paid for. The Supreme Court gave this seminal ruling in Commissioner of Income-tax Kolkata vs. Smifs Securities Ltd by invoking the principle of ejusdem generis which means terms falling within the sweep of the general definition must be included in it though not expressly named.

The income-tax law grants depreciation to know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature. The Supreme Court had no hesitation in granting depreciation to goodwill as well because it fell within the sweep of the elastic phrase "any other business or commercial rights of similar nature". It brushed aside the contention of the Revenue that goodwill was not paid for so as to be eligible for depreciation. It pointed out that when the acquirer (the amalgamated company) debits goodwill for the difference between the net assets acquired and the purchase consideration, he is virtually paying for goodwill. The court in the same case also reiterated its position that membership card of a stock exchange too belonged to the genre of intangible assets and hence was eligible for depreciation. [Business Line, Dec. 27]

Tax payment no proof of title

The Supreme Court ruled that payment of municipal or agricultural tax on a property or even a revenue record would not confer ownership of the property on the claimant. There is no presumption of ownership even if a bank had granted a loan hypothecating the property. The court stated so while setting aside the judgment of the Andhra Pradesh high court in the appeal case, State of AP vs Star Bone Mill & Fertiliser Co. The City Improvement Board, Hyderabad, had given the disputed land to the Forest Department. It gave the land on lease to one firm with certain conditions. However, the lessee raised some structures and then sold it to another firm. The government invoked the Land Encroachment Act to evict the new occupant. It was challenged in the civil court and the high court, both maintaining that the occupant had a better title to the land than the government. In the appeal of the government, the Supreme Court rejected the argument of the buyer-firm that the previous owner was paying taxes and the entries in the revenue records showed it was the owner. No one can claim a title better than he himself possesses, the judgment said and emphasised that the government owned the land since 1920.[Business Standard, 3 March]

Debt recovery only by tribunal

High courts should not exercise its writ powers to interfere in debt recovery matters, the Supreme Court has stated in the case, T P Vishnu Kumar vs Canara Bank. The bank moved the tribunal for recovering open cash credit, packing credit and foreign bills of exchange. The firm countered the move by demanding several documents from the bank. The latter opposed the demand stating that they were not germane to the case and it was made only to protract proceedings. This was accepted by the tribunal. The firm moved the Madras high court against it and succeeded before the single bench. The division bench, however, ruled that the firm should have moved the appellate tribunal and not the high court. The Supreme Court upheld this view. Chastising the single judge bench, the Supreme Court stated that "if the correctness or otherwise of each and every interim order passed by the tribunal is going to be tested in a high court, it will only defeat the object and purpose of establishing such tribunal."[Business Standard, 24 Feb.]

Cheque issued towards security case quashed

A cheque issued towards security in business transactions is not covered under Section 138 of the Negotiable Instruments Act dealing with bounced cheques, the Supreme Court stated in the case, Vijay vs Laxman. Laxman was a village milkman who supplied milk to a dairy owner. The latter used to demand security in cheque in advance. When they fell out, the dairy owner immediately deposited the cheque which bounced due to insufficiency of funds. The payee then filed a criminal case. The magistrate sentenced the milkman to one year's prison and imposed a fine of Rs 1.20 lakh. The district court upheld the sentence. However, the Madhya Pradesh High Court set aside the order. The Supreme Court also quashed the conviction and acquitted the villager as the cheque was not given in discharge of a legal debt and the factual evidence was against the complaining party. [Business Standard, 17 Feb.]

SC notice to Centre, states on pendency of cheque bounce cases

Expressing concern over huge backlog of cheque bounce cases in various courts, the Supreme Court on Jan.21 sought response from the Centre and all the state governments to a plea for framing guidelines for their speedy disposal. While seeking responses of various governments, a bench of Justices K S Radhakrishnan and Deepak Misra said it is "very serious issue."

The court gave the order while hearing a PIL filed by Indian Bank Association, which sought directions for speedy trial of cheque bounce cases alleging that there are around fifty lakh such cases pending in various courts. Senior advocate Shyam Divan, appearing for the association submitted that the Delhi High Court had recently framed some guidelines for such cases and it should be implemented across the country. The bench while issuing notice to the Centre and the states asked the association to conduct proper research on the issue. [Financial express/PTI Jan.21]

Pledging fake gold in bank

The Supreme Court has acquitted a number of persons who were convicted for pledging fake gold ornaments to get loans from a bank. In this case, Kumar vs Karnataka Industrial Coop Bank, they were charged with breach of trust and cheating. The trial court acquitted them. On appeal, the Karnataka High Court ordered their conviction. The Supreme Court set aside the high court order stating that it had no power to convict persons who had been acquitted by the trial court. It can only order retrial. Moreover, the appeal was filed after a delay of more than a year and no reason was given for the delay. [Business Standard, 24 Dec.]

AP MFI Act: Court asks State to take a call on enforcement

The Andhra Pradesh High Court on Feb. 11 said it was for the State Government to take a call on enforcement of the AP MFI (Regulation of Moneylending) Act, 2010. The court 'closed' a writ petition filed by SKS Microfinance Ltd and some other industry players challenging the Act without passing any order against the Act as sought by the petitioners. As a Central Bill on microfinance regulation is currently under way along with Reserve Bank of India's guidelines to microfinance institutions (MFIs), the AP Govt might take a comprehensive view on the issue, the court said. When contacted, Reddy Subrahmanyam, Principle Secretary, Department of Rural Development, Government of AP, told Business Line that the Act would stay on. [Business Line, Feb.11]

Cash down in auction not vital

When an auction is for large amounts, running in crores of rupees, nobody can expect the auction purchaser to pay the amount in cash on the fall of the hammer, the Supreme Court has stated while upholding the sale of a prime property in Delhi. Giving a liberal interpretation to procedures in the judgment, Ram Karan vs J S Exim Ltd, the court rejected the argument of one of the prospective bidders that the auction purchaser had not complied with the mandatory provisions of Order 21 Rules 84 and 85 the Civil Procedure Code, inasmuch as he did not deposit 25 per cent of the bid amount immediately on the fall of the hammer. Rejecting the contention, the Supreme Court said that the term "immediately" is required to be construed as meaning "with all reasonable speed", considering the circumstances of the case. The payment was made within reasonable time by producing 27 demand drafts and therefore the auction sale was confirmed, the court said while dismissing the appeal against the Delhi high court order. [Business Standard, 31 Dec.]

SEBI asks banks, NBFCs to isolate their investment advisory services

The capital markets regulator SEBI on Jan. 22 notified rules for investment advisors in India, directing that "Investment advisers which are banks, NBFCs and body corporate providing distribution or execution services to their clients shall keep their investment advisory services segregated from such activities." [Financial Chronicle, Jan 22]

SEBI allows debenture trustees to seek credit rating details

SEBI asked the credit rating agencies (CRAs) to share with the debenture trustees all relevant information about the ratings assigned by them for debt securities and about the issuers of such instruments. With the latest move, SEBI has enabled a two-way information sharing arrangement between the CRAs and Debenture Trustees (DTs) to help them effectively discharge their respective functions. As per the new guidelines, DTs can ask CRAs about rating assigned and/or revised for debt securities along with the rationale for the same. On the other hand, CRAs can ask DTs whether the assets for which securities have been created are "free from any encumbrance and adequate to ensure asset cover for the debentures or if there is any breach of the terms of creation of the security". The DTs would need to provide such information on a half-yearly basis. Besides, CRAs can also seek information related to funds transferred to Debenture Redemption Reserve (DRR), depletion of the DRR or invocation of guarantee, which could affect the payment of debenture obligations. Such details would need to be shared on a yearly basis. CRAs can also gather from DTs details of redemption, defaults, or any change or restructuring of the terms of the issue. SEBI said that CRAs can also seek details of grievances filed by debenture-holders and action taken to resolve them in addition to non-cooperation by the issuer with respect to furnishing required reports / certificates / information, SEBI said. [Business Standard, March 15]

SEBI moots corp governance norms overhaul for listed companies

Market regulator SEBI has proposed wide-ranging overhaul of corporate governance norms for listed companies, through measures like checks against unjustifiable CEO pay, greater powers to minority shareholders, an orderly succession planning and hefty penalties for non-compliance in a discussion paper. Besides, the regulator has also proposed a new concept of 'Corporate Governance Rating' by independent agencies to monitor the level of compliance by the listed companies and regular inspection by SEBI and stock exchanges. SEBI has also proposed measures for a greater oversight by and on independent directors, as well as greater alignment of CEO salaries with the performance and goals of the company. [PTI, Jan 04]

SEBI issues guidelines for separate debt segment on bourses

As part of its efforts to boost the country's corporate debt market, SEBI has come out with guidelines for setting up a separate debt segment on bourses where entities like banks and pension funds can also execute trades.The capital market regulator said the debt segment would provide separate trading, reporting, membership, clearing and settlement rules. [PTI, Jan 25]

SEBI forms panel to review insider trading norm

The SEBI has formed a high-level committee to review insider trading regulations. "To ensure the regulatory framework dealing with insider trading in India is further strengthened, SEBI seeks a review of the extant Insider Trading Regulatory regime in India," SEBI said in a release. The 15-member committee will be chaired by N K Sodhi, former presiding officer of the Securities Appellate Tribunal (SAT). [Business Standard, March 5]

Raters can't offer fee-based services beyond ratings, research

SEBI has said that a credit rating agency cannot offer any fee-based services other than credit ratings and research to its rated clients, while its regulations would apply to ratings of all kinds of securities, bank facilities and services. Capital markets regulator SEBI, which also regulates credit rating agencies in the country, has expressed its views in this regard in an 'interpretative letter' sought by SME Rating Agency of India Ltd (SMERA) under the regulator's informal guidance scheme.[Business Standard, Feb.6]

Institutional investors tend to exhibit "herd-like" behavior

The Federal Reserve posted a research paper online that delves into how investor dynamics affect the corporate-bond market. Researchers say institutional investors tend to exhibit "herd-like" behavior more in the corporate-bond market than in stocks. "We find substantial institutional herding in U.S. corporate bonds, much higher than that previously documented in the equity markets," staff economists Fang Cai, Song Han and Dan Li. [Reuters/ELFA News, 31 Jan]

China to tighten shadow banking rules

China is to rein in its fast-growing shadow banking system by requiring banks to provide extensive disclosures about the off-balance sheet investment products that they sell to customers, according to people briefed on the new rules. The Chinese shadow banking system – credit flows beyond traditional bank loans – has increased fourfold in size since 2008 to about Rmb20tn ($3.2tn), or 40 per cent of gross domestic product. These flows were crucial in reviving the country's growth last year, but banking analysts and rating agencies have warned that they pose an increasingly serious risk to Chinese economic stability.

In addition to the disclosures, there is also discussion about whether to establish a hard cap on the number of investment products that banks can issue as a percentage of their assets.Taken together, the new regulations could lead to a slowdown in the explosive growth of China's shadow banking by making it tougher for banks to funnel deposits into off-balance sheet vehicles. But the moves will not spell the end of shadow banking. Instead, they reflect a consensus among policymakers that credit flows outside the banking system are a healthy development for China, so long as they are monitored and kept in check. [Financial Times-London, Feb. 26]

Four-plus years after crisis, SEC mulls credit-rater reforms

In the balance is the future of the big three credit rating firms, Standard & Poor's, Moody's Corp. and Fitch. The SEC is implementing a series of new restrictions on raters, including a measure that would hike disclosures about when a rater employee involved in a rating later leaves to take a job at the firm that issued the security. However, the SEC is still scratching its collective head over what to do about credit rating agencies providing inflated opinions in exchange for business. The goal is to eliminate a practice known as "ratings shopping," in which an investment bank hired by a corporation privately solicits preliminary ratings from multiple agencies for a securitized product and then only pays for and discloses the most favorable rating received.

Expect raters and outside experts at the SEC proposed roundtable discussion on May 14 to evaluate what to do about credit rating agencies and to evaluate a measure sought, which seeks to dismantle that so-called "issuer-pay model." It would require the SEC to create a government-mandated clearinghouse through which credit raters would be randomly assigned to handle structured finance product ratings. Many consider the approach a radical one that comes with its own difficulties. However, the SEC is considering it and several other measures to limit rater conflicts that it first considered in a study the agency put out in December. (The study suggested that the SEC hold a roundtable on the subject). Another model would have sophisticated investors create and operate an investor-owned credit rating agency. Firms seeking a rating would need to obtain two ratings — one from the investor-owned rating agency and one from another rater. [Wall Street journal, March 3]

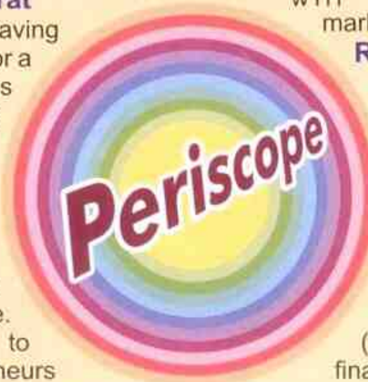
Global lending conditions improve for emerging economies

Easy monetary policies in mature economies are cited for a positive turn in bank lending conditions for emerging markets, the first plus reading since the second quarter of 2011, according to the Institute of International Finance. The improvement was documented globally but was particularly strong in Asia. [Xinhuanet.com (China),31 Jan.]

Basel panel eases up on liquidity-coverage ratio

The Basel Committee on Banking Supervision has granted a four-year reprieve and phase-in period for its liquidity-coverage ratio, a step that banks had argued was necessary to sustain lending. Originally, banks were required to have in 2015 sufficient liquid assets to cover expected outflow over 30 days. [Financial Times-Londion Jan.6]

Banks cater to India, NBFCs cater to Bharat



On Parliament passing the new banking bill, paving the way for granting new bank licenses a case for a bank license to some of the qualifying NBFCs is made out in backdrop of RBI guidelines. "While banks cater mostly to the population of 'India', large segments of population living in 'Bharat' and in the remotest of places actually rely on NBFCs for all their credit needs. Thus, NBFCs are actually filling in where banks fail to deliver," said Hemant Kanoria, CMD, Srei Infrastructure Finance in an interview to Financial Chronicle. Elucidating further he said, "NBFCs cater to numerous micro, small and medium entrepreneurs (MSMEs) who form the backbone of the 'India Growth Story' and yet continue to remain outside the ambit of normal banking channels. I do not foresee any radical change in the coverage of banks in the immediate future. Thus, NBFCs will continue to play a crucial role in the Indian financial architecture".

Interest cost of India Inc doubles in 2 years

The slump in industrial and consumer demand appears to be hurting Indian corporates where it matters the most. The proportion of interest cost in both revenue and operating profits at the aggregate level has nearly doubled in two years, dragging down the efforts of companies to maintain profit by cutting cost. An ETIG analysis shows that interest cost related to net sales shot up to 4.2% during the December 2012 quarter for a sample of 2,242 companies, excluding banks, financial institutions and petroleum companies. Two years ago, interest outgo for a similar sample was just 2.3% of revenue. What could stoke more worries is the fact that one out of every three rupees of profit before interest and taxes (PBIT) (a little over 34%) was spent on servicing debt during the December quarter. Two years ago, the sample companies spent around one out of six rupees of PBIT (over 16%) to cover interest costs. The slack in demand has reduced revenue generated by capacities which were added over the last three years, largely funded by debt. This has led to sharp rise in interest expenses and has also dampened corporate India's efforts to support net profitability by curbing operating costs since interest and finance costs have a direct impact on a company's net profit. Analysts feel the scenario may worsen in FY14 unless demand picks up. "The cost of funds continued to remain high on the ground though benchmark interest rates have not risen. This is because companies who expanded capacities since 2008-09 have not been able to generate revenue from additional production facilities," said Sonam Udasi, research head, IDBI Capital. [Economic Times, Feb. 18]

Union Budget tax clarity to boost Indian securitisation market: India Ratings

In the Union Budget 2013-14, the Finance Minister provided much clarity on taxation for Securitization Trusts, a move expected to bring back mutual funds as investors in the Indian securitization market, India Ratings, said in a report. The budget announcement provides that no additional income tax shall be payable if the income distributed by the securitization trust is received by a person who is exempt from tax under the Act. "This announcement will benefit Indian securitization market as mutual funds who had largely withdrawn on account of tax demand raised on their investments in securitization instruments in early 2012, may stage a comeback. Investors such as mutual funds are crucial as they participate primarily for 'investment' purposes, unlike banks whose participation is predominantly driven by 'balance-sheet' considerations." The provisions of announcement are effective June 1, 2013.

Securitisation, the bundling of financial assets of banks, NBFCs and financial institutions into transferable securities, is likely to rise multifold in coming financial year 2013-14 from the existing levels of Rs 20,000 crore per year. Consultant Vinod Kothari claims that FM's proposal to introduce tax on income distributed by special purpose vehicles, formed to acquire receivables of banks and financial institutions for the purpose of securitisation, will boost the country's debt capital market. [myiris.com/Eco.Times, March 1]

Retail bond issue down 78% in FY13 as loan demand declines

Lower loan demand in a slowing economy, coupled with softening of interest rates, has resulted in a sharp decline in retail bond issuances in the current financial year. According to data from the SEBI, retail bonds, primarily issued by NBFCs, dropped 78 per cent to Rs 7,818 crore till January in 2012-13. In 2011-12, non-banking financial companies (NBFCs) and infrastructure developers and financiers such as the National Highways Authority of India and Housing & Urban Development Corporation had raised Rs 35,611 crore by issuing bonds to retail investors. NBFCs which issued retail bonds every year, such as Shriram Transport Finance, Shriram City Union Finance and Religare Finvest had reduced their offerings. Issue arrangers say this was because of the economic slowdown, due to which their need for funds had come down."Investors were not interested as the coupon rate came down. In FY12, the response was good because the coupon rates were attractive and the amount of issuances were also lower, compared with FY13," said an issue arranger.

Take the RBI draft guidelines on agenda of Parliamentary Standing Committee on Finance

FIDC Director General, Shri Mahesh Thakkar had a meeting and the discussion with Shri Yashwant Sinha, Chairman, Parliamentary Standing Committee on Finance. He brought to his notice recent regulatory developments for NBFCs, especially the draft guidelines based on Usha Thorat Working Group Report on Issues and Concerns in NBFC Sector issued by RBI on 12th December 2012. He followed up with a letter bringing to his attention very adverse effect on NBFC sector and possibility of 70% of the small NBFCs likely to be closed down. Even the working and profitability of the surviving companies would be severely impacted, he indicated.

He pleaded to include said RBI draft guidelines as an item of Agenda for consideration and recommendations by the Parliamentary Standing Committee on Finance.

He also drew attention to 45th Report of The Parliamentary Standing Committee on Finance of June, 2003 with reference to The Financial Companies Regulation Bill, 2000 which had made some far reaching recommendations that are to address some of the long standing demands of the NBFC sector in matters relating to Funding, Taxation and Recovery. The report, however, was never implemented since the said bill lapsed with the change in government, he stated. ■

DIALOGUE WITH AUTHORITIES

The Indian Merchants' Chamber's Finance & Banking Committee and Finance Development Council [FIDC] organized a Discussion Session on January 7 on "RBI's Draft Guidelines based on Usha Thorat Committee Report on Issues and Concerns in the NBFC Sector". Mr. Anand Sinha, Deputy Governor, Reserve Bank of India was the Chief Guest and Mrs. Usha Thorat, Guest of Honour at the Session.

NBFC body asks RBI for same benefits as banks

Non-banking finance companies (NBFCs), in a discussion with Anand Sinha, deputy governor of RBI on Jan 7, have asked the RBI to put them on par with banks on areas such as risk weights as per the asset class, tax relief on provisions made for NPAs and permission to raise ECBs. Finance Industry Development Council (FIDC), an industry body for NBFCs held discussions with Sinha and Usha Thorat, chairperson of the working group that proposed the draft guidelines for the NBFC sector.

Mahesh Thakkar, director general, FIDC said, "As per the draft norms, if a particular installment is due for 90 days, you have to classify it as an NPA. Currently NBFCs do not write it off, as the loan will be paid later (upto 180 days). Therefore as per the current tax laws, income-tax is charged on it (provisions) on an accrual basis. However, the enabling provisions Section 36[1][viia] and Section 43 D for banks, housing finance companies and financial institutions exempt them and allow them to claim it as a deduction." "Every year we write to the finance ministry to not recognise income as NPA but the taxman taxes income on an accrual basis," added Thakkar.

TT Srinivasaraghavan, managing director, Sundaram Finance said, "The RBI's objective is to bring us on par with the banks, but lack of access to Sarfesai Act, absence of tax benefits and funding institutionality are issues of regulatory reverse arbitrage. Therefore, the same benefits extended to banks should be made available to us." "For the last 10 years we are asking for risk weights inherent of the assets held. We finance low risk assets such as trucks, construction equipment and others for which the risk weight is 100 per cent while the same assets when held on a bank's book has to make 30 per cent risk weight," added Srinivasaraghavan. "We need an institutionality for funding like the way National Housing Bank does for HFCs. Also we are not allowed to raise ECBs despite being in the business of capital formation, even micro-finance companies are allowed to raise funds through ECBs," added Srinivasaraghavan. Sinha said that he will look into the areas of tax concerns while stating that banks are subject to many more restrictive regulations. [Financial Chronicle, Jan 07]

NBFC body opposes stricter RBI norms

Non-banking finance companies (NBFCs) have objected to the more stringent provisioning norms proposed for them by the Reserve Bank of India. At present, NBFCs need to classify a loan as a non-performing asset (NPA) if the borrower defaults for 180 days. Banks must do once 90 days have passed and RBI has suggested this same rule apply for NBFCs. The latter say this will hit them hard for two reasons. One, their borrowers generally come from the unorganised and informal sections of the economy. There often are some difficulties in repayment due to issues like fuel cost increase, insurance and so forth but this doesn't essentially translate into default. Second, NBFCs don't get any tax benefit on their provisioning, while banks do. If the same rule is to apply to them, says the Finance Industry Development Council (FIDC), a body of NBFCs, this benefit should, too, from the coming Union budget.

And, if RBI insists on tightening the provisioning norms to 90 days, says FIDC, it should allow NBFCs to use the stringent loan recovery law, the Sarfaesi Act, as banks can. And, implement the new norms over three years, rather than the two years in the draft norms.

FIDC's representation also says the existing tier-I capital ratio should be maintained, given the difficulties in raising equity. RBI's draft norms had prescribed the tier-I capital be raised to 10 per cent from the existing 7.5 per cent. For captive NBFCs, it was proposed to be raised to 12 per cent. FIDC notes RBI has over the last four years increased the total capital adequacy ratio floor from 10 to 15 per cent, due to which NBFCs have been consistently raising capital for the past three years. "To raise any further capital, NBFCs will perforce need to absorb the capital already raised and exhibit appropriate returns to their stakeholders before being able to access the capital market," went FIDC's representation. If RBI wants to raise the tier-I capital ratio, then it should lower the risk weightage in productive and low-risk assets such as construction equipment or commercial vehicles to 50 per cent from the existing 100 per cent, it has said.

The draft norms say NBFCs having an asset size less than Rs 25 crore need not be registered with RBI and should be out of the regulatory ambit, as they don't create any systemic risk. FIDC says 70 per cent of NBFCs will be deregistered and thrown out of the business if this goes through and urged RBI to maintain the rule.

It also urged RBI to open the external commercial borrowing window for asset financing in NBFCs.[Business Standard, Jan.9]

RBI dispels NBFCs' fears of closure

The Reserve Bank of India (RBI) on Jan.7 dispelled fears of the NBFC sector that the proposed recommendations of the Usha Thorat committee to maintain an asset size of Rs.25 crore will lead to the closure of small and mid size NBFCs in the country. "They (NBFCs having less than Rs.25 crore asset size) will neither be registered nor be regulated, but, because they are already registered, they will be given sufficient time to come to that standard," said Anand Sinha, deputy governor, RBI, addressing the seminar organised by the Indian Merchant Chamber on the issues concerning the NBFC sector. [Hindustan Times, Jan. 7]

Rs 25-crore criterion only for deposit-taking NBFCs

RBI Deputy Governor Anand Sinha tried to allay fears of smaller non-banking financial companies (NBFCs) which fear that they will be out of business if new regulations are notified. "NBFCs will not go out of business if they do not adhere to the Rs 25-crore asset size. "To conserve regulatory resources, we will not register an NBFC till it attains Rs 25-crore balance sheet. If such NBFCs are already registered, then we will give them time to meet this criterion," Sinha said at a seminar on NBFCs organised by the Indian Merchants' Chamber.

This Rs 25 crore-balance-sheet criterion is only required to be adhered to by deposit-taking NBFCs, he clarified. Other NBFCs will not be regulated if their balance-sheet size is Rs 500 crore or less, Sinha said. Clarifying that the non-performing-asset classification, to be cut to 90 days from 180 in phases, Sinha asked NBFCs to adjust the payment cycle to meet their clients' requirements. [Business Line, Jan 7]

There was no question of treating NBFCs on a par with banks

The discussion on new RBI guidelines on NBFCs was organised by the Finance Industry Development Council (FIDC), an umbrella body of NBFCs on Jan. 7 at IMC-FIDC seminar. NBFCs said they felt the draft norms were very difficult to comply with and have requested these be relaxed. FIDC has requested RBI to provide tax benefits, access to asset restructuring companies, etc, before the final norms are in place.

Anand Sinha, deputy governor, RBI said the central bank would look into the concerns raised by NBFCs. But he said there was no question of treating NBFCs on a par with banks, as banks had more stringent regulatory norms. Mr. Sinha said the norms were in line with global norms and India, as a G-20 nation, was obliged to follow other such nations. Global norms stipulate regulators to reduce the gap between capital adequacy ratios of banks and NBFCs. [Business Standard, Jan.8]

Meeting with Hon'ble Union Finance Minister Shri P. Chidambaram and his team from MOF as well as RBI was held under FIDC banner with a few selected NBFCs on February 09, 2013 at Mumbai.

FIDC takes up NBFC cause proactively

In the first Quarter of 2013 Finance Industry Development Council [FIDC] proactively took up with top authorities the issues haunting NBFCs due to new regulatory guidelines proposed by RBI based on Mrs. Usha Thorat Panel Report. Since the formal representations at operative level did not yield result FIDC knocked the doors of highest authorities. Initiative and actions brought some fruits in successfully articulating the woes of NBFCs. Some highlights:

- Meeting with Hon'ble Union Finance Minister Shri P. Chidambaram and his team from MOF as well as RBI was arranged on Feb.9 at Mumbai where issues-regulatory, fiscal and legal-were raised by FIDC top brass and leading NBFCs. Removal of tax uncertainty on PTCs created for Securitisation of assets became immediate gain as it figured in Union Budget Proposals for 2013-14 on 28th Feb.
- A Discussion Session on "RBI's Draft Guidelines based on Usha Thorat Committee Report on Issues and Concerns in the NBFC Sector", with Mr. Anand Sinha, Deputy Governor, Reserve Bank of India and Mrs. Usha Thorat at IMC-FIDC organized event on Jan.7.
- Plea to Shri Yashwant Sinha, chairman of Standing Committee of Parliament to take up the RBI draft guidelines on NBFCs issued on 12-12-12 on agenda of Parliamentary Standing Committee on Finance.
- Submitted a Pre-Budget memorandum to Hon'ble Finance Minister by Raman Aggarwal, Director, Member Managing Committee [see details in item titled: "NBFCs likely to get tax treatment parity with banks" on this page]

It is interesting and noteworthy that media lent whole hearted support to the cause of NBFC sector by generously giving wide coverage to these Interactions/events/issues. Raghu Mohan of famous financial weekly, Business Week brought out a cover story on "RBI's draft guidelines threaten to shake up the NBFC universe" was a landmark among them.

FIDC In Action

FM accepts NBFC plea on securitisation

NBFCs could draw favourable attention of Mr. P Chidambaram, finance minister on two tax issues faced by the sector. The first was relating to the stand taken by income tax authority to tax interest on Pass Through Certificate (PTC) in the hands of Trust as the trusts holding PTC are not permanent/ business entities. They are facilitating the transaction as a neutral agency. This has affected such transactions in the market adversely and Mutual Funds have stopped investing in such papers. Mr. Chidambaram responding to Mr. Rajiv Lall, Vice-Chairman and Managing Director of IDFC said that he 'shall discuss with small group of companies impacted by this separately'.
The second one was about need to remove anomaly in applying Section 43D of Income-Tax Act, 1961 where income accrued on NPA accounts has to be offered for tax even though the same is not added in the revenue statement (P & L account) of the NBFCs as this is not the case with housing finance companies and the banks. Responding to the suggestion of Mr. T.T.Srinivasraghavan, MD Sundaram Finance, Finance Minister said that 'he will look into this' issue. These were among some of the issues raised at a meeting with Union Finance Minister Mr. P. Chidambaram and senior officials from MOF as well as RBI held under FIDC banner with a few selected NBFCs on February 09 at Mumbai. It is gratifying that FM has accepted the plea on securitisation in his Budget proposals 2013-14.[see for details on page-10]

NBFCs likely to get tax treatment parity with banks

The finance ministry is likely to extend the favourable tax treatment currently given to banks, public financial institutions, state finance corporations and housing finance companies on their income from non-performing assets (NPAs) to non-banking financial companies (NBFCs) as well, making them taxable only in the year of receipt [only when it is received or credited to the profit and loss account, whichever is earlier].

Sources said the department of financial services and the banking regulator have favoured the extension of the accounting benefit under Section 43D of the Income Tax Act to NBFCs too at pre-budget consultations within the finance ministry. NBFCs are bank-like institutions with the exception that these do not offer savings accounts. Like other lenders, NBFCs too follow the RBI's prudential norms and defer income regarding their NPAs and make provisions for the same. However, income tax authorities do not recognise these norms and tax NBFCs on such deferment of income on accrual basis resulting in tax on unrealised income. Sources in the department of financial services said the government is "positively inclined" to offer tax parity to NBFCs and the other lenders describing it a "reasonable demand" and hinted that the Budget could announce this change. The issue came up for discussion during a meeting in Mumbai on February 9 between industry representatives and officials including finance minister P Chidambaram, and senior officials from the department of financial services and the RBI.

"The tax authorities must accept this principle of income deferral also for NBFCs registered with RBI. NBFC is the only segment of the financial sector which is denied this tax benefit," Raman Aggarwal, director (member, managing committee), Finance Industry Development Council (a self-regulatory organisation for asset financing NBFCs) and senior vice-president, Srei Equipment Finance, said.

According to Fitch India Rating, the gross NPAs of NBFCs may grow from 1.9% to 3 % of their gross advances in the next 12-18 months and provisioning for these will grow to Rs 345 crore in the same period from the current Rs 172 crore, the report said.

Another disadvantage suffered by the NBFCs are regarding provision for NPAs under Section 36(1)(vii a) of the Income Tax Act. Under this Section, provisions for bad and doubtful debts made by banks are granted deduction of 7.5% from the gross total income and 10% of aggregate average rural advances made by them. Alternatively, the banks also have an option to claim a deduction of 10% (up from the earlier 5%) on any provision made for assets classified by the RBI as doubtful / loss assets. However, this benefits is not given to NBFCs. Sources said the finance ministry is examining if parity could be accorded to NBFCs on this front too. A finance ministry panel on NBFCs has also recommended tax parity to both banks and NBFCs on both taxation of income from NPAs in the year of receipt and on deductions under Section 36(1)(viia). [Financial Express, Feb 21]

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