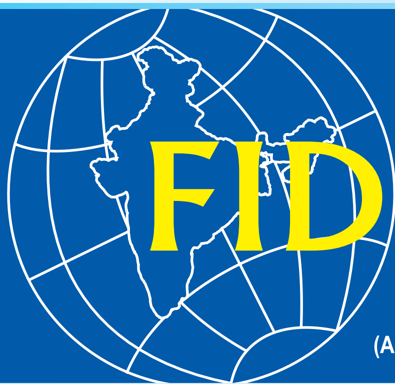

FIDC NEWS

Finance Industry Development Council

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

JUNE-JULY 2009 VOLUME - 1 • NO. - 1 FOR PRIVATE CIRCULATION

A LINE OF COMMUNICATION

We are pleased to place in your hand a revamped version of our newsletter, "FIDC News." It seeks to build up a line of communication with all stakeholders in the Asset Financing NBFC sector (NBFC- AFCs) as also Regulatory Authorities, officials of State and Union Government Departments and our well wishers. It will endeavour to bridge the information gap not only about happenings in the sector but also act as a forum for airing members' expectations. Let this become a medium for close interaction.

FIDC, as you are well aware, has become a recognized voice of the NBFC sector. It has to its credit several significant accomplishments within a short span of four years. The highest authorities in the Regulatory body and in Government are now inviting FIDC for consultations on issues concerning and affecting the AFCs, from time to time. These interactions have provided the NBFC sector a platform to highlight the range of issues confronting the sector and seek redress wherever possible. We have also strengthened our ties with the automotive manufacturing industry at apex level.

FIDC has been in the forefront of the efforts to establish the inalienable rights of NBFCs to repossess their assets from delinquent borrowers. While engaging with the regulator and Government on the one hand, we have also sought redress from the highest court in the land, on the other. FIDC has evolved comprehensive guidelines for repossession of vehicles/assets and is scheduled to be released officially at the FIDC AGM on August 21. It is our earnest hope that this will gain wide acceptance not only amongst NBFCs, but also banks, RBI, police authorities, courts, borrowers and media.

T. T. SRINIVASARAGHAVAN, Chairman

Reserve Bank Directions

Accounting for taxes on income- Accounting Standard 22:

RBI/2008-09/494 DNBS.PD/ CC.No. 142 / 03.05.002 /2008-09 June 9, 2009 To: All NBFCs: Accounting for taxes on income- Accounting Standard 22- Treatment of deferred tax assets (DTA) and deferred tax liabilities (DTL) for computation of capital.
[For details see RBI Website : www.rbi.org.in]

NBFCs with assets over Rs. 100 cr.

The RBI clarified on June 4 that once a NBFC reaches an asset size of Rs 100 crore or above, it shall come under the regulatory requirement meant for "systemically important non-deposit taking non-banking financial company" (NBFC-ND-SI), despite not having such assets as on the date of the last balance sheet. The central bank has advised that all such non-deposit taking NBFCs may comply with RBI regulation issued to NBFC-ND-SI from time to time, as and when they attain an asset size of Rs 100 crore, irrespective of the date on which such size is attained.

AT A GLANCE

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Regulation Of NBFCs*

> *"From a systemic stability perspective, it would be equally, if not more, important to focus on the interconnectedness of the regulated and unregulated/lightly regulated entities."*

> *"It was recognized early that mere acceptance of public deposits would not capture the systemic importance of the entities and hence the focus was shifted to acceptance of public funds in any form."*

Shyamala Gopinath, Deputy Governor, RBI

1. The regulatory perimeter or boundary issue has been engaging the attention of policy makers internationally for quite some time but it was not a central issue associated with the current crisis. Paradoxically the origins as well the severity of impact of the crisis were concentrated in the most heavily regulated institutions. However, in my view, the real issue lay in not recognizing and addressing the dynamic inter-connectedness between entities across regulated, unregulated and lightly regulated domains perpetuated through high leverage. It was a systemic crisis and attributing it to any single component of the system would only be an incomplete assessment.

2. Borrowing from the field of natural ecosystems, sustainability of a complex flow system depends on the optimal balance between efficiency and resilience of its network. While the financial system was considered to be very efficient, the inherent elements for ensuring resilience were obviously inadequate. At the heart of this self-feeding financial ecosystem were entities which had access to liquidity, the banks, which acted as the fulcrum around which the system moved. It is therefore not surprising that the system collapsed once this fulcrum became vulnerable. The peripheral entities, though, were as much an integral part of the system and need to be recognized as such.

3. The basic premise that I will be elaborating upon in my remarks today is that as far as systemic stability is concerned, it is more important to focus on the interconnected linkages amongst all major entities within the system, whether regulated or unregulated. Extending regulatory boundary is a very valid issue to be examined for its own sake, to address the specific contextual concerns. But once having decided the perimeter, it is extremely important to have a framework for hardwiring the perimeter. This is important as regulation creates incentives for certain activities to move beyond the boundary.

4. One of the issues with just focusing on extending the perimeter, apart from issues clearly enunciated in the literature, relates to heterogeneity of regulatory foci across various segments. The boundary itself varies for different regulatory clusters - the focus of a banking regulator would be entirely different from that of a securities regulator, from that of an insurance regulator etc. and all of which may be different from the focus required for regulation of markets. If the entire financial system is looked as a single ecosystem, then in spite of the inherent differences between the various market players, it should be possible to identify the macro drivers of the whole system, the network flows. Using this perspective, it becomes evident that just focusing only on the perimeter would be missing an integral component that may need regulatory attention.

Current crisis – Perimeter Issues

5. As mentioned earlier, the origins of the current crisis lay within the heavily regulated institutions. The impact of the crisis, however, was exacerbated by dynamic interconnectedness between entities across regulated, unregulated and lightly regulated sectors. As some of the recent reports have pointed out, the two concerns relating to 'outside perimeter' entities that contributed to the current crisis were: (i) maturity transformation being undertaken by these entities, which traditionally used to be a function of banks; and (ii) the systemic leverage resulting out of the hugely leveraged positions of these entities, either through direct borrowing from banks or through the funding markets.

6. The central issue in both the above is the interaction between the unregulated entities and the formal regulated funding channels, essentially banks and money markets. The maturity transformation primarily entailed heavy reliance by these entities on short term funds for funding long term assets. The prudential framework for banks placed a significant reliance on management of these ALM mismatches but the unregulated entities, such as SIVs didn't have any oversight and as a business

model, ran huge ALM mismatches. The model just broke down when the funding markets started seizing.

7. Many of the entities, like hedge funds, were consciously left unregulated because of the fact that they managed only private capital pools where the issue of investor protection was not relevant. However, what was not appreciated was the systemic risks these entities were posing on account of the huge leverage positions these were carrying through either the formal banking channel or the funding markets, particularly repo markets. The seamless efficiency thought to be provided by close integration of the underlying asset markets and repo markets proved to be just a chimera. The disaggregated exposures of the regulated clusters at any point of time to the unregulated entities were not available and as the markets collapsed, such exposures became evident.

8. Another critical aspect which was again brought forth during this crisis was the market behaviour and impact of entities, some of them unregulated, having huge trading books and dynamically hedging their huge portfolios. The market makers in the derivative and structured product markets need to normally hedge their portfolio risks, which has a direct impact on the underlying markets. In normal times, such individual action does not have a systemic impact. However, in times of crisis when the views become absolutely uni-dimensional, a large number of such big players tend to hit the market on the same side and the resultant impact on the underlying market is huge. It could, thus, be argued that the efficient markets enabled the unregulated cluster to acquire systemic proportions and reinforced its connectedness with the regulated cluster.

The Indian experience

9. India is unique in this regard as it has a formalized structure for generic non bank finance sector with heterogeneous sub-segments. There some 13000 non banking finance companies (NBFCs) whose assets comprise around one-tenth of the banking sector. The NBFCs in India comprises heterogenous types of financial institutions including All-India financial institutions, development finance institutions, non banking finance companies, etc, with each one of them having its roots at a particular stage of development of the financial sector. All-India financial institutions (AIFIs), and development finance institutions (DFIs), which were largely an offshoot of development planning in India, were created for long-term financing with some of them having sectoral/regional focus. Non-banking financial companies (NBFCs), on the other hand, are mostly private sector institutions, which have carved their niche in the Indian financial system.

The Basic Regulatory Framework

10. The Indian financial system is a predominantly bank intermediated system and accordingly regulation over banks has worked as the basic systemic lever. The non-banking space comprises of heterogeneous entities but not all are regulated by the RBI. Broadly speaking, the RBI regulates all such companies taking public deposits and those non-deposit taking entities involved in asset financing, providing loans and investments. Other non-banking entities such as housing finance companies, mutual funds, insurance companies, stock broking companies, merchant banking companies, venture capital funds etc. are regulated by the respective sectoral regulator and are exempted from the NBFC regulations.

11. Regulation of Non-Banking Finance Companies in India was considered necessary as far back as the sixties as an adjunct to the monetary and credit policy of the country and protection of depositors' interest. The emphasis of regulation was on protection of the interest of depositors and as such directions issued by RBI dealt with acceptance of deposits and matters relating thereto. The unfettered growth of deposits and institutions accepting them outside banking system in the nineties was a matter of concern. Further in the absence of any prudential norms or ceilings, several non-bank finance companies made poor investment choices, leading to high level of NPAs, liquidity crunch and consequent significant default in repayment of deposits. Therefore, some further regulatory action was taken including registration of these companies, for which the statutory powers were given to the RBI through the RBI (Amendment) Act in January 1997. The Act provided for registration of all NBFCs; nevertheless the RBI focused mainly on depositor protection and put in place stringent regulatory requirements for these entities.

12. With the growth of the financial system, it gradually came to be realized that even non-deposit taking entities, which were mostly in asset financing and loan business, could pose systemic risks on account of their interactions with the formal banking system and market based financing. Moreover, many such entities in this lightly regulated segment were essentially indulging in regulatory arbitrage – what was not permitted for banks-was happening through this channel. It was therefore decided in 2006 to put in place an elaborate prudential framework for such identified entities having systemic implications.

13. A gradually calibrated regulatory framework was created to address the issue of systemic risk, which included prudential capital requirements, exposure norms, liquidity management, asset liability management, creation of entity profile and reporting requirements, corporate governance and disclosure norms for non banking finance companies defined as systemically important.

14. It was recognized early on that mere acceptance of public deposits would not capture the systemic importance of the entities and hence the focus was shifted to acceptance of public funds in any form. So, any entity that is accessing public funds, whether through deposits,

inter corporate deposits, debt instruments such as NCDs or CPs, or bank loans, was considered interconnected entity and hence treated as a source of potential risk. The ultimate objective was that such interconnectedness should not result in transmission of risk to banks or the payment and settlement system.

15. In the Indian context, what has provided a huge systemic advantage is the fact that the regulation of key financial markets – money market, Government securities market, forex market and credit market – vests with the banking regulator i.e. the RBI. Thus the channels of interconnectedness between banks and other financial sector entities are not beyond the regulatory purview. From a financial stability perspective, the above framework has proved to be a sound model.

16. Some of the specific provisions which illustrate the effectiveness of the above framework in addressing the inter-connected linkages are briefly mentioned below:

- Prudential limits on bank exposures (funded and non-funded) to non-bank finance companies - individual as well as aggregate;
- Restrictions on bank financing to non-bank finance companies against collateral of shares or for on-lending to capital market intermediaries;
- Prudential limits on bank exposures to equity markets includes exposure to capital market intermediaries such as brokers;
- Prudential regulations on inter-bank exposures of banks to reduce systemic risk;
- Participation in the overnight unsecured money market limited to banks and primary dealers;
- Lending/borrowing by non-banks in the overnight market allowed only through repos or against collateral of government bonds;
- Securitisation guidelines issued to banks in 2006 which provided for, inter alia, credit enhancements to be deducted from capital, profit/premium from sale to be amortised over the life of the securities issued, liquidity support to attract 100 per cent risk weight.

Addressing the inter-connectedness – few pipeline issues

17. The securities firms/investment banks are regulated by the securities regulator, the Securities and Exchange Board of India (SEBI) but such regulation primarily focuses on transparency and discipline in market practices. As these entities are normally not doing fund based business which would require prudential regulation, a decision had been taken that entities registered with SEBI need not normally be registered with RBI. While these entities form part of a separate regulatory cluster, their inter-linkages with the other regulated clusters or other unregulated entities may need to be examined particularly if such entities also undertake fund based business. Therefore a constant evaluation is required of the functioning of institutions under different regulators to address regulatory gaps.

18. While mutual funds are regulated from investor protection angle by the securities regulator, the systemic implications of the inert-linkages became apparent in the post-Lehman scenario of severe risk aversion and liquidity crunch. RBI had to announce a special 14 day repo at for a notified amount of Rs.20,000 crore to enable banks to meet the liquidity requirements of Mutual Funds. The real issue was the over reliance of the money market mutual funds on short term funds placed by the large corporates and banks with redemption facilities on par with current accounts of banks. It has now been decided to jointly work with the securities regulator to identify and address the macro-prudential concerns arising from the current framework.

19. Private Equity/venture capital activity is not a regulated activity per se. However, the issue of bank involvement with such funds has come into focus recently in India. The G30 recommends the large systemically important banking institutions should be restricted in undertaking proprietary activities that present high risks and serious conflicts of interest. Sponsorship and management of co-mingled private pools of capital should ordinarily be prohibited and large proprietary trading should be limited by strict capital and liquidity requirements. Keeping in view the reputational risk involved in such activities, the Reserve Bank had mandated maintenance of certain level of economic capital in some of the cases approved in the recent past. Importantly, all exposures of a bank to a venture capital fund are treated as capital market exposure and counted for the regulatory limit.

A revised regulatory framework–key considerations

20. The broad features of a possible framework to capture the above inter-linkages are outlined below.

(i) Specification of the nature of connectedness between entities that may be considered inducing vulnerabilities in the system;
(ii) Identification, from the haze of the unregulated cluster, the class of entities considered to be either having significant direct connectedness with the regulated clusters or having a significant presence in any market segment where regulated entities are also present;
(iii) Putting in place a reporting system to capture the interconnected flows within the identified sub-system – the regulated clusters and the unregulated entities on a regular basis;
(iv) Prescription of a prudential framework - and this is the key - for the regulated clusters to contain the risks arising from this connectedness.

(v) For the unregulated entities, the most significant aspect would be to contain their leveraging capability in general across major market segments, particularly the funding markets. A simple quantitative limit would be the best suited.

(vi) Some systemically significant entities, though, may still need a formal prudential regulatory structure, including capital adequacy requirement.

21. From a policy perspective, the critical points would be the last two – having effective regulation over the regulated entities, while restraining leverage capabilities of the unregulated/lightly regulated entities. In our case, it proved to be an effective combination since banks' exposure to such entities could be regulated through absolute exposure norms or even tweaking the risk weights applicable to such exposures.

22. I realize the problem would be much more involved in predominantly market based financial systems where direct bank linkages are not very obvious. But even in such regimes, as has been clearly demonstrated, the indirect linkages of banks were enmeshed in the maze. That is why it would be important to ensure that the markets too should not provide leverage capabilities to such entities beyond a limit.

Contingency liquidity provision

23. The recent crisis has again brought to the fore the role of a lender of last resort (LOLR), the extent of central bank intervention and the entities to which such intervention can be extended. The question as to under what circumstances and to what extent should safety nets be extended to non-deposit taking institutions has been widely debated.

24. The basic underpinning of the LOLR philosophy internationally has been that any institution whose failure is conclusively decided to cause broader systemic instability needs to be supported in the interregnum. As long as banks were the only institutions fulfilling this criterion, the case was straightforward. However, with the development of global financial markets and growth on non-banks as alternate media of financial intermediation, the decisions were not so simple as the recent experience has clearly shown.

25. In India, while there is no provision for the Reserve Bank of India to lend directly to any non-bank entities, except a few specified ones, there have been specific instances of workable arrangements being devised in the interest of broader stability to provide liquidity support to some institutions/sectors indirectly. In respect of non-banking finance companies, in the post-Lehman fallout there was severe systemic liquidity crunch and even the non-banking finance sector were stressed. It was apprehended that in a scenario of asymmetrical information and general risk aversion of banks, the strains in non-banking finance sector could eventually pose a systemic risk. It was then decided to provide liquidity to those systemically important NBFCs facing temporary liquidity mismatches through an SPV. The key part was that the liquidity was provided to the SPV by the RBI through purchase of fully government guaranteed bonds. Further, this facility was only meant to tide over temporary liquidity mismatches and not for balance sheet expansion. The aggregate quantum for the facility was around Rs. 200 billion (USD 4 billion) and the interest rate was the LOLR rate for banks.

26. Similarly in case of mutual funds, who were faced with severe redemption pressures, it was decided to have a facility for lending to banks through a 14-day repo to enable the banks to meet the temporary liquidity needs of mutual funds.

27. As regards protection of depositor interests, a comprehensive prudential framework is already in place for all deposit taking companies. Stringent capital adequacy and leverage requirements, exposure norms, and disclosure have been prescribed as part of a structured regulatory framework. Statutorily, such companies are required to invest at least 10 per cent of their outstanding deposits in unencumbered Government bonds. Further, NBFCs have to ensure that at all times there is full cover for public deposits maintained by them. All such companies accepting/ holding public deposits are required to create a floating charge on their statutory liquid assets in favour of their depositors through the mechanism of 'Trust Deed'.

Conclusion

28. The issue of extending the regulatory perimeter has to be a balancing act and it needs to be carefully nuanced in terms of intended objectives. The thrust of regulation may need to be borne by the regulated clusters – particularly deposit taking institutions. However, for the unregulated cluster, the key issues would be to contain their ability for systemic leverage – both directly through banks or indirectly through funding markets and to subject them to an effective reporting arrangement for their inter-linkages with the regulated clusters. From a systemic stability perspective, it would be equally, if not more, important to focus on the interconnectedness of the regulated and unregulated/lightly regulated entities.

*The original title is "Addressing the Regulatory Perimeter Issues - Indian Experience".

[Remarks at the Ninth Annual International Seminar on Policy Challenges for the Financial Sector, co-hosted by The Board of Governors of the Federal Reserve System, The IMF, and The World Bank on "Emerging from the Crisis – Building a Stronger International Financial System", June 3-5, 2009, Washington, D.C.]

Periscope

> *"The overall profitability of the NBFCs in 2008-09 stood higher at 18.90 per cent compared to commercial banks, whose average profitability has been on the lower side of 10.08 per cent."* –ASSOCHAM

> *"Considering the useful role-played by NBFCs, especially to the small and medium enterprises and small truck owners etc, they need to be facilitated."*

Asset financing NBFCs report good profit growth in F Y'09:

In spite of fall in demand for loans from the automobile sector and increased levels of asset quality slippages due to slump in the economy, most of the asset financing non-banking financial services (NBFC) players have attained sizeable growth in net profit. Bajaj Auto Finance [64%], Sundaram Finance[16%], M&M Financial Services[21%] and Shriram Transport Finance[57%], the four prominent NBFCs, have aggregately seen net profit grow by 32 per cent over FY08. The profit growth in 2006-07 over 2007-08 was 58 per cent. Only Chola DBS has seen a decline in profit growth.

The high growth in disbursements that these NBFCs enjoyed during the earlier boom periods now moderated largely due to the meltdown in the automobile sector. The fortunes of these companies predominantly rested on the auto sector (commercial vehicle, two-wheeler, and three-wheeler) which witnessed significant fall in volumes. Though there was slowdown in disbursements, with falling interest rates these NBFCs managed a reasonable growth of 25 per cent in their net interest income on an average, as the borrowing rates continued to fall more rapidly than the yields made from lending.

As with their banking cousins, the asset quality of these NBFCs has seen slippages last fiscal. NBFCs can take heart from the fact that their portfolio is secured in the form of asset financed by them which would help them limit their credit losses. But provisions for bad debts affected their profits. It is expected that asset quality may get worse before getting better. The automobile slowdown that became pronounced between October 2008 and March 2009 may have negative effects on the NBFCs' books for the next couple of quarters. However, the Reserve Bank's recent relaxation in asset repossessing norms may benefit the NBFCs. An auto sector revival (supported by encouraging sales data in over the last couple of months) may boost the disbursements of loans.

NBFCs pay rich dividend:

Despite facing headwinds from a tight liquidity environment, 12 non-banking finance companies (NBFCs) have either increased or maintained their dividend per share for the financial year 2008-09. Out of the 14 companies in the NBFCs space, which have announced dividend so far, eight have increased their dividend payout while four have maintained it at the same level as last year's and two have decided not to declare a dividend. Among asset financing companies, Sundaram Finance has boosted its dividend to Rs 6.50 per share for FY09 from Rs 5 per share in the comparable period last year, while Shriram Transport Finance maintained its payout at Rs 5 per share. Bajaj Auto Finance has increased its dividend by 100 per cent to Rs 2 per share and Mahindra and Mahindra Financial Services hiked its dividend by 22.2 per cent to Rs 5.50 in FY09. Among the NBFCs focused on infrastructure financing, Rural Electrification Corporation has declared a dividend of Rs 4.50 per share for FY09 when compared to Rs 3 per share last year. Industry leader IDFC has maintained its dividend at Rs 1.20 per share.

The NBFCs have posted higher growth in profits in FY09 when compared to commercial banks amid a tight liquidity environment, a survey by industry body Assocham showed. "The overall profitability of the NBFCs in 2008-09 stood higher at 18.90 per cent compared to commercial banks, whose average profitability has been

on the lower side of 10.08 per cent," the chamber's Financial Pulse Study titled 'Indian Banks vs NBFCs: Profitability Analysis' said."Most NBFCs had a good run in the first half of FY09 and the trouble started only in second half, so it was a mixed performance. Companies might have taken into account the improving conditions, but giving an accurate picture might be difficult," T T Srinivasaraghavan, managing director of Sundaram Finance and chairman of Finance Industries Development Council (FIDC), a self-regulatory organisation for asset financing NBFCs, said. "Most of these NBFCs have posted very good results, bucking the trend and there was no question of rolling back on dividend," Ajinkya Dhavale, an analyst at Motilal Oswal, pointed out. [Financial Chronicle, June 8, 2009]

Infrastructure loans: ECB policy for NBFCs simplified:

The Centre has dispensed with what was being perceived as a "non-starter" condition for allowing non-banking finance companies (NBFCs) to avail themselves of overseas funding from multilateral financial institutions for on-lending to borrowers in the infrastructure sector.

This move is expected to ease the difficulties faced by certain NBFCs for obtaining the Reserve Bank of India approval for availing themselves of external commercial borrowings (ECBs) from multilateral/regional financial institutions, say experts in the financial sector. In January this year, the RBI had, as part of ECB policy changes, allowed NBFCs which are exclusively involved in financing of the infrastructure sector, to avail themselves of ECBs from multilateral/regional financial institutions and Government-owned development financial institutions under the approval route. The ECBs could be availed of by such NBFCs only for on-lending to borrowers in the infrastructure sector.

"The latest ECB policy change will lead to better access to ECB funding for NBFCs that are exclusively dealing with infrastructure financing", Mr Ashok Haldia, former Secretary, the Institute of Chartered Accountants of India (ICAI), told Business Line. Mr Hitesh Gajaria, Executive Director, KPMG, said that the Centre's move to do away with the "redundant condition" would not open the floodgates for ECB funding by NBFCs. However, he pointed out that this move would ease the difficulties faced by them in obtaining the RBI approval for availing ECBs from the multilateral institutions. [Hindu Business Line, July 1.]

FIDC's Pre Budget Memorandum:

FIDC has submitted its wish list to the finance minister with main focus on direct and indirect tax issues, funding and recovery mechanisms:

Industry expectations

* Exemption from TDS on interest payment to NBFC-AFCs (Asset Financing Companies) on loans under section 194A (3) (iii) of the IT Act.
* Increase in exemption limit of TDS on interest paid on fixed deposits for NBFC from Rs 5,000 to Rs 10,000 as done for banks last year.
* Extend the benefits under Sec 36 (1) (viia) and Sec 43D of the Income Tax Act, 1961, to NBFC-AFCs in line with banks, financial institutions and housing finance companies where provisions made for non-performing assets (NPAs) should be allowed to be deducted while arriving at the taxable profits of NBFCs.
* Setting up of a new refinance mechanism for NBFCs providing road transport, similar to National Housing Bank (NHB) for HFCs.
* To start an exclusive refinancing window for the NBFCS-AFCs, similar to that of NHB for housing finance companies, to address the problem of funding in the long-term.
* Remove the service tax on hire purchase (HP) and leasing transactions.
* Allow Infrastructure/power financing companies to float tax-free bonds.
* To increase the limit of deduction under Section 24 for interest on housing loan (for self occupied property) from Rs 150000 to Rs 250000.

Outlook

NBFCs have been persistently asking government to treat them at par with banking and other financial institutions with regard to tax benefit, funding and treatment of NPAs. But, the government has not yet accorded this benefit to NBFCs so far. Considering the useful role played by NBFCs, especially to the small and medium enterprises and small truck owners etc, they need to be facilitated. [Capital Market, 25 June]

Legal Eagle

"Service tax is levied on service, not on sale or purchase"

Service tax on hire purchase/lease is not unconstitutional: HC

Madras High Court pronounced verdict on a batch of writ petitions/applications filed by south India based lease and hire purchase associations, i.e. Madras Hire Purchase Association, Association of Leasing and Financial Services Companies (Madras Chapter), South India Hire Purchase Association, the Equipment Leasing Association (India) and others praying to declare Section 65 (10) and 67 of Chapter V of the Finance Act, 1994 (as amended) levying inter alia, service tax on leasing/hire purchase transactions as ultra vires the provisions of Article 14, 19 (1) (g), 265, 366 (29A), Entry 54, List-II, Schedule VII of the Constitution of India and also being beyond the legislative competence of Parliament in so far as the members of the petitioners are concerned. It was also prayed to declare Section 137 of the Finance Act, 2001 and all other provisions in the said Act which affect the rights of the petitioners herein in relation to the business of Hire Purchase and finance leasing as unconstitutional without legislative competence and null and void so far as petitioner is concerned.

It was submitted for the petitioners that the writ petitioners are non banking financial companies engaged in the business of hire purchase and leasing; that 46th Amendment inserted Article 366 (29A), of the Constitution of India, in which clauses a to f, particularly clauses c & d, which are relevant to this case, explain the ambit of the expressions of tax on the delivery of goods on hire-purchase or any system of payment by instalment and also a tax on the transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration; that the said expression is also found in the Entry 54 of List II; that after the said 46th Amendment, hire purchase and leasing transactions are treated as deemed sales and the State had imposed sales tax, now called as VAT, on both transactions and the entire amount paid by way of instalments are liable for sale tax; that the service tax is leviable if any element of service is involved; that hire purchase/leasing are transfer of movable where there is no service element is involved. For the said contention, it was relied on the invoices raised by the members of petitioners associations; that the petitioners are not collecting any charges for service, hence, no service tax can be leviable; that when the constitution under Article 366 (29A) authorises levy of sales tax on hire purchase/leasing transaction and the State levied sales tax, Parliament has no authority to levy service tax; that introduction of Service Tax on hire purchase and leasing transaction by the Parliament is violative of Article 14 and 19 (1) (g), 265, 366 (29A), Entry 54 of List II of Schedule VII of the Constitution of India.

A common Judgment was delivered by the bench on June 9, '09. The bench ruled that the Hire Purchase/Leasing transactions admittedly include the concept of rendering service. Service tax is an indirect tax and it is to be paid on all the services notified by the Government of India. Service tax is levied on service not on sale or purchase of goods. The said tax is on service and not on the service provider. Service tax is made by Parliament under Entry 92C of List I and Article 268-A, which has legislative competence to levy service tax by way of the impugned Act and Entry 54 of List II and Entry 92C of List I operate on different areas. Hence, the plea of the appellant/petitioners that service tax relating to leasing and hire purchase transaction is contrary to Article 265 and 366 (29A) of Entry 54 List II of VII Schedule of the Constitution is rejected.

The court noting the submission of the Additional Solicitor General that all the banking companies, which are carrying on similar hire purchase/leasing transactions are paying service tax without any protest as service element is involved. Court also rejected the averments that levying of service tax on hire purchase/leasing transaction is violative of Article 14 and 19 (1) (g) of the Constitution. The writ appeal as well as the writ petitions were dismissed and connected miscellaneous petition is closed.

Insight

“*It is noteworthy that the NBFC sector is witnessing a consolidation process in the last few years, wherein the weaker NBFCs are gradually exiting, paving the way for a stronger NBFC sector.*”

- Economic Survey, Ministry of Finance

NBFCs-AN ASSESSMENT IN ECONOMIC SURVEY ‘09

Non-Banking Financial Companies (NBFCs) broadly fall into three categories, viz., (i) NBFCs accepting deposits from the public; (ii) NBFCs not accepting/holding public deposits; and (iii) core investment companies (i.e., those acquiring shares / securities of their group / holding / subsidiary companies to the extent of not less than 90 per cent of total assets and which do not accept public deposit).

Until some years back, the prudential norms applicable to banking and non-banking financial companies were not uniform. Moreover, within the NBFC group, the prudential norms applicable to deposit taking NBFCs (NBFCs-D) were more stringent than those for non-deposit taking NBFCs (NBFCs-ND). Since the NBFCs-ND were not subjected to any exposure norms, they could take large exposures. The absence of capital adequacy requirements resulted in high leverage by the NBFCs. Therefore, since 2000, the Reserve Bank has initiated measures to reduce the scope of “regulatory arbitrage” between banks, NBFCs-D and NBFCs-ND.

Registered NBFCs:

Total number of NBFCs registered with the Reserve Bank, consisting of NBFCs-D [Deposit-taking NBFCs], Residual Non-Banking Companies (RNBCs, Mutual Benefit Companies (MBCs), Miscellaneous Non-Banking Companies (MNBCs) and Nidhi companies, declined from 12,968 at end- June 2007 to 12,809 at end-June 2008. The number of NBFCs-D has shown a steady decline to 364 at end-June 2008, mainly due to the exit of many NBFCs from deposit taking activity (see Table bellow). The number of RNBCs declined to two at end-March 2008. Even though the public deposits declined in 2007-08 over the previous year, partly reflecting the decline in number of reporting NBFCs, total assets increased significantly by Rs. 23,019 crore (32.1 per cent), while net owned funds increased by Rs. 3,974 crore (48.0 per cent) during the same period.

Continuing the trend of the preceding year, public deposits held by all groups of NBFCs taken together, declined moderately during 2007-08. The outstanding borrowings by NBFCs increased during 2007-08. Borrowings by NBFCs were mainly from banks and financial institutions and by way of bonds and debentures and “other sources” (which include miscellaneous sources including money borrowed from other companies, unsecured loans from directors/ promoters, commercial paper, borrowings from mutual funds and any other type of funds which are not treated as public deposits). Financial performance of NBFCs improved during 2007-08 due to increases in fund-based and fee-based incomes Continuing the trend witnessed during the last few years, gross Non Performing Assets (NPAs) as well as net NPAs (as percentage of gross advances and net advances, respectively) of reporting NBFCs declined further during the year ended March 2008.

Strong NBFC Sector:

Capital to risk-weighted assets ratio (CRAR) norms were made applicable to NBFCs in 1998, in terms of which, every deposit taking NBFC is required to maintain a minimum capital, consisting of Tier-I and Tier-II capital, of not less than 12 per cent (15 per cent in the case of unrated deposit-taking loan/ investment companies) of its aggregate risk-weighted assets and of risk-adjusted value of off-balance sheet items. The number of NBFCs with less than the minimum regulatory CRAR of 12 per cent increased to 44 at end-March 2008 from 20 at end-March 2007. At end-March 2008,

276 out of 320 NBFCs had CRAR of 12 per cent or more as against 354 out of 374 NBFCs at end-March 2007. The number of NBFCs with CRAR more than 30 also declined to 238 at end-March 2008 from 305 at end-March 2007. Notwithstanding this, it is noteworthy that the NBFC sector is witnessing a consolidation process in the last few years, wherein the weaker NBFCs are gradually exiting, paving the way for a stronger NBFC sector.

With a view to protecting the interests of depositors, regulatory attention was mostly focused on NBFCs accepting public deposits (NBFCs-D) until recently. Over the last few years however, this regulatory framework has undergone a significant change, with increasingly more attention now being paid to non-deposit taking NBFCs (NBFCs-ND) as well. This change was necessitated mainly on account of a significant increase in both the number and balance sheet size of NBFCs-ND segment which gave rise to systemic concerns. To address this issue, NBFCs-ND with asset size of Rs.100 crore and above were classified as systemically important NBFCs (NBFCs-ND-SI) and were subjected to "limited regulations". The NBFCs-NDSI are now subject to CRAR and exposure norms prescribed by the Reserve Bank. The CRAR prescription for such companies has been raised to 12 per cent from March 31, 2009 and further to 15 per cent by March 31, 2010.

SEBI has permitted Fixed Income Money Market and Derivatives Association of India (FIMMDA) to set up its reporting platform for corporate bonds. It has also been mandated to aggregate the trades reported on its platform as well as those reported on BSE and NSE with appropriate value addition. The FIMMDA platform has gone live with effect from September 1, 2007. All NBFCs are required to report their secondary market transactions in corporate bonds in the OTC market on FIMMDA's reporting platform since September 1, 2007.

In the wake of emergent tight liquidity scenario, the Reserve Bank of India had on October 15, 2008 announced, purely as a temporary measure, that banks may avail of additional liquidity support exclusively for the purpose of meeting the liquidity requirements of NBFCs/mutual funds (MFs) to the extent of up to 0.5 per cent of their NDTL. Further, on a purely temporary and ad hoc basis, subject to review, the banks were allowed to avail liquidity support under the LAF through relaxation in the maintenance of SLR to the extent of up to 1.5 per cent of their NDTL. This relaxation in SLR was to be used exclusively for the purpose of meeting the funding requirements of NBFCs and MFs.

Perpetual Debt Instruments :

Taking into consideration the need for enhanced funds for increasing business and meeting regulatory requirements, NBFCs-NDSI were permitted to augment their capital funds by issue of Perpetual Debt Instruments (PDI). PDIs could be issued in Indian rupees only and the aggregate amount to be raised by issue of such instruments has to be within the overall limits of Tier I and Tier II capital. Further as a temporary measure, NBFCs-NDSI have been permitted to raise short-term foreign currency borrowings under the approval route, subject to certain conditions like eligibility of borrowers and lenders, end-use of funds, maturity, etc. The maximum amount should not exceed 50 per cent of the net-owned funds or US$ 10 million (or its equivalent), whichever is higher. [Economic Survey-2008-09, Government of India]

[Sub-headings are supplied]

Number of Non-banking financial companies registered with RBI

End June	No. of NBFCs	NBFCs Accepting Pub.deposits	Col. 3 as a percentage of column 2
2003	13,849	710	5.1
2004	13,764	604	4.4
2005	13,261	507	3.8
2006	13,014	428	3.3
2007	12,968	401	3.1
2008	12,809	364	2.8

Source : RBI

Moves

"Financial products should be treated like medicines and sold to consumers only when they are certified safe to prevent a repeat of last year's financial meltdown."

- Central Banks.

Cibil, TransUnion launch personal loan score :

Credit Information Bureau India Ltd (Cibil) and TransUnion launched a 'personal loan score' to enable lenders to make informed decisions, in the backdrop of rising defaults on unsecured equated monthly instalment (EMI) loans. Two other products, a home loan repository and a fraud repository, are expected to be launched by the second quarter of the current financial year. "Consumers will have access to their credit information records from December 2009. Cibil is in the process of putting up the required infrastructure, such as call centres," said Cibil Managing Director Arun Thukral. He added that the maximum charge permitted by RBI for this is Rs 100.

"The home repository will help in curbing multiple sale of the same property, by allowing buyers to access mortgage details and reduce the cases of fraud in housing," said Thukral. This central registry will help banks, financial institutions and non-banking finance companies get mortgage details of consumers before issuing loans against property. As for the fraud repository, it is meant to list the particulars of anyone found to have tried to cheat or hoodwink lenders in any way.

The Personal Loan Score will provide details on the likelihood of customers becoming 91 days delinquent on a personal or consumer loan over the next 12 months. The score will range between 300 and 900, indicating the levels of default." Although banks are going slow on personal loans, 20 per cent of the enquiries are for this segment," said TransUnion General Manager Satish Pillai. He added that the number of enquiries from public sector banks have gone up in the past one year.

Cibil has 135 million borrower accounts in database and 165 customers. The credit bureau has added 30-40 customers in the past year. "We have 2.7 million commercial accounts and the number is growing fast. The number of SME accounts have seen a rapid increase in recent months," said Cibil Chief Operating Officer Terry McCafferty.

While the Credit Information Company Act allowed Cibil to create a database for telecom and insurance, Thukral said that utility information would also help the industry. Cibil does not see its market share diluting after the entry of three more players in the next six months. "There is enough space for multiple players. We will definitely have an edge over new ones, because we are the first credit bureau," Thukral said. According to the Credit Information Company Act, banks will have to share all information with at least one credit bureau. [Business Standard, May 15.]

Central banks seek rankings for financial products :

Financial products should be treated like medicines and sold to consumers only when they are certified safe to prevent a repeat of last year's financial meltdown, the world's central bankers said on June 29. The Bank for International Settlements (BIS), which acts as a forum for central banks, said government efforts to revive the global economy might have only a temporary impact because banks are not being pushed hard enough to fix their underlying problems Banks' lending and other practices, including the approval of risky mortgages in the United States, led the global economy into the worst recession in decades. Governments have poured trillions of dollars into rescuing the financial system and easing a recession that has cut through company workforces.

The BIS was alarmed by how a collapse in the value of opaque and complex securitised products propelled the world's financial system into crisis. It said in its annual report all financial products should be registered like medicines. The safest instruments would be available to everyone, a second tier only to people with authorisation, like prescription drugs, and a third tier to a limited number of pre-screened individuals and institutions, like experimental drugs are.

[Financial Express,30 June]

FIDC In Action

> "The RBI came out with a guideline saying NBFCs must have a built in repossession clause in the loan agreement with the borrower which must be legally enforceable."

FIDC's efforts to streamline Repossession:

This follows the FIDC office bearers' meeting with the Reserve Bank Governor, Dy. Governor and senior officials in Finance Ministry and subsequent RBI circular issued on April 24 titled 'Clarification regarding repossession of vehicles financed by non-banking finance companies (NBFCs).' The RBI came out with a guideline saying NBFCs must have a built in repossession clause in the loan agreement with the borrower which must be legally enforceable. This was a land mark accomplishment, said a source familiar with development.

NBFCs welcomed this step saying it provides much needed clarification that NBFCs can repossess vehicles in case of default, by satisfying certain requirements as prescribed in the circular. Repossession is the taking back of vehicle/property by the lender from the borrower due to default.

FIDC had pro-actively taken up this issue with the Government and RBI. They had even intervened in one of the cases relating to repossession before the Supreme Court.

Union Budget : 2009-10 :

FIDC submitted a detailed Pre-Budget Memorandum 2009-10 to Union Finance Minister [see item titled "FIDC's Pre-Budget Memorandum" in Periscope section]. Subsequently, FIDC was invited to the meeting held between the Finance Minister along with the team of senior Ministry officials with the Key players from the Financial Sector - banks, Mutual Funds and Insurance for Pre-Budget discussions held in New Delhi on June 05,2009.

FIDC Managing Committee Meeting:

The Managing Committee of FIDC held their quarterly meeting on June 27, 2009 at Chennai. It was decided that the committee on Legal Matters which comprises of experts from the legal departments of some of the leading NBFC-AFCs, be entrusted with the task of drafting a "Guide to Repossession". The meeting was followed by the joint meeting of FIDC Managing Committee with the Governing Councils of ELAI and FIHPA.

Fifth Annual General Meeting of FIDC :

Fifth Annual General Meeting of FIDC will be held on 21st August at IMC, Mumbai. Members who are yet to remit their annual subscription for F Y 2009-10 are requested to do so.

Money Lenders Act- question of applicability to NBFCs :

FIDC has decided to take up the issue of Money Lenders Act prevalent in various states, of late being applied to registered NBFCs especially in the state of Gujarat and some other states. In a case of complaint filed against Shriram Transport Finance Company Limited[STFL] in Karnataka under the provisions of Karnataka Money Lenders Act, 1961[KML Act], a submission was made by STFL that section 45 Q Chapter III B of Reserve Bank of India Act,1934 has over-riding effect over KML Act or any other law having inconsistent provisions therewith. The Registrar of Money Lenders [In Charge] Bangalore has given a verdict that Karnataka Money Lenders Act does not apply to respondent company. FIDC has decided to fight the matter again at various state levels along with Regional Chapters of FIDC.

Views expressed herein are not necessarily the views of FIDC.

Published by :

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- Editorial Committee

Strict security code prohibits 30 items...Scissors included!

[Coutessy : Times of India]

Printed by : Aditya Print Shop (Ph.) 079-26579959