FIDC

Finance Industry Development Council

(A Representative Body of NBFCs in India)

101/103, Sunflower, 1st Floor, Rajawadi Road No.2, Ghatkopar (East), Mumbai – 400 077

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November 06, 2024

The Chief General Manager,
Department of Regulation (DoR),
Reserve Bank of India (RBI)
Central Office Building
Shahid Bhagat Singh Road
Mumbai-400 001

Sub: Request: clarification on Supply Chain Finance by NBFCs

Respected Sir,

Finance Industry Development Council (FIDC) wishes to place on record its appreciation for effective guidance and supervision of RBI which has allowed NBFCs to grow and provide accessible finance to different sections of society.

As you are aware, NBFCs have been at the forefront of providing finance to **MSMEs** (Micro, Small & Medium Enterprises). MSMEs are one of the most credit deprived section of our economy which are often not able to access formal channel of finance due to multiple factors. NBFCs with their innovative models, products and reach have ensured that funding needs to MSME sector, particularly Micro and Small sector, are met and have provided them with different credit products to meet their term loan and other business requirements.

Current Issue:

We understand from some of our member institutions that the RBI DoS has advised some of them on cessation or modification of supply chain finance product which has sector wide ramifications. We wish to submit the following for consideration by the RBI as well as to seek guidance and clarification on these issues.

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MSMEs in general are not capital-intensive business but are always in need of working capital to ensure smooth functioning. Banks in general provide working capital facilities in the form of revolving credit lines such as cash credit or overdraft facilities to such entities, based upon past financial data and on the basis of assessed average working capital requirement. MSMEs especially the ones which operate in seasonal/cyclical businesses approach NBFCs for fulfilment of peak requirements or short-term liquidity needs in the form of short-term supply chain finance loans to the extent not catered to by banks.

Supply Chain Finance is extended by NBFCs in the form of a series of term loans (with a fixed repayment schedule and a fixed date of maturity) of periods typically ranging from 30 days to 180 days. Each tranche is a distinct term loan by itself within an overall limit determined by the NBFC.

We understand that the RBI's concern stems from a view that NBFCs should not fund revolving credit lines since such facilities are akin to revolving facilities under credit cards for which separate mechanism has been provided in the NBFC Master Directions.

Key Features of Short-term working capital and supply chain finance:

1. Working Capital Support: Meet running financial needs of MSME business such as seasonal procurement of raw materials, fuel, insurance, and maintenance expenses such as engine refurbishment, tyre replacement and FASTag costs etc. for transport based MSMEs
2. Productivity and Growth Enhancement: Enable businesses to scale operations during key periods such as festive season, increase efficiency, and invest in growth opportunities,

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3. Supply Chain Financing (such as Vendor Finance/Purchase Finance/Sales Invoice Discounting etc.) which facilitate seamless transactions between businesses, vendors, and suppliers,
4. Comparable to Established Products: Credit either in demand loan or in term loan format (through multiple tranches of draw down and repayment option) is similar to widely accepted financial instruments, such as vendor financing, purchase order financing and sales invoice discounting,
5. Reduction in cost of borrowing: In the case of invoice discounting, the repayments are received directly from the drawees of the bills, or sales proceeds are deposited by the borrowers into the NBFC's bank account which results into better cash management and saving of interest on the borrowings.
6. End-use of Funds: The above modes of financing ensure better and more transparent end-use of funds.

Economic Benefit

Such financing stimulates economic growth and aids MSMEs by meeting immediate cash flow requirements and:

- Fosters growth in supply chain financing and vendor financing segments,
- Empowers Micro, Small, and Medium Enterprises (MSMEs) to compete effectively with bigger players who have well established lines of credit from bigger financial institutions.
- Enable Corporates to expand their businesses, which also supports smaller business entities who do not have direct access for procurement or ultimate marketplace.

Differences between supply chain finance and Credit Card

We submit that supply chain finance products are not revolving credit products like credit cards. The major differentiating points are as below:

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- Credit cards allow for further purchases even when loan is overdue / delinquent upon payment of just 5% of the outstanding amount – this is not the case with supply chain finance line issued by NBFC where delinquency / overdue are closely monitored and new credit is held back on sign of stress. Each tranche is monitored for overdue and even if one tranche becomes delinquent and not repaid as per schedule, the entire credit exposure becomes delinquent. There is no facility to just service interest and/or pay a part of the due and roll over the balance.
- End-Use – Credit card is for personal consumption purposes whereas the revolving credit line is for business / productive economic activity

Thus, the revolving credit line product of NBFCs is different than credit card.

Mitigating Measures for Financial Discipline: Responsible Lending Practices

To ensure responsible lending and mitigate potential risks, we propose the following measures:

I. Facility Structuring

1. Tenure Limitation: Minimum 1 year,
2. Prudential Requirement: Previous facility must be Standard Asset before renewal.
3. Performance-Based Renewal: Assess past credit facility performance before renewal. Loan
4. Agreements – there should be a Master loan agreement for the facility under which individual tranches are disbursed with the drawing power under the facility being restricted to the limit sanctioned *minus* the outstanding loan amount

II. Loan Documentation and Monitoring

5. Loan Agreements – there should be a Master loan agreement for the facility under which individual tranches are disbursed with the drawing power under the facility being restricted to the limit sanctioned *minus* the outstanding loan amount. Clear Repayment Terms: Clear identification of "Due-Date" and "final repayment date" either through Instalments or bullet repayment schedules,
6. Collateral Registration: Where required, with verification and registration through CERSAI if immovable property taken,
7. End-Use Monitoring: Implement a robust end-use mechanism to ensure funding is for business purposes.
8. Tracking of SMA/NPA: Each tranche should have a specific tenure starting from date of disbursement called Tranche Due Date. Tracking and reporting of SMA and NPA would be done from the due date based on DPD of each tranche. If multiple tranches are outstanding in any account, IRAC classification will be done based on the oldest outstanding tranche.

III. Risk Management

9. Capital Adequacy Maintenance: Ensure sufficient capital is maintained as per extant norms,
10. Loan-to-Value (LTV)/Margin Ratio: Establish industry/sector-specific limits in the event of secured loans,
11. Credit Limit Review: Regular reviews to monitor borrower's financial health,
12. Early Warning Systems: Detect early signs of borrower distress

V. Governance

13. Approved Product – Product should be approved by Product Committee as per extant norms,
14. Risk Appetite Framework: Establish risk tolerance guidelines for product,

15. Review – review of product performance at various forums including at Risk Management Committee level.

These measures aim to promote financial discipline, responsible lending, and mitigate potential risks associated with revolving lines of credit.

Request for Continuation of Supply Chain Finance

In light of the significant benefits and comprehensive mitigating measures outlined, we respectfully request clarification to Non-Banking Financial Companies (NBFCs) to continue offering supply chain finance to MSMEs on the lines suggested above

We shall be happy to present our submissions to RBI officials in person and also understand the RBI's concerns towards such funding to better understand this issue and articulate a solution which is both regulatorily sound and beneficial to MSMEs. We appreciate your consideration and look forward to a favorable view.

Thanking you,

Yours Faithfully,

For **FINANCE INDUSTRY DEVELOPMENT COUNCIL**

MAHESH THAKKAR
DIRECTOR GENERAL
9820035553