FIDC

Finance Industry Development Council

(A body incorporated as a Self Regulatory Organisation for Registered NBFCs – AFCs)

January 07, 2013

To

Ms. Uma Subramaniam
Chief General Manager-In-Charge
Reserve Bank of India,
Department of Non Banking Supervision,
Central Office, World Trade Centre, Cuffe Parade,
MUMBAI 400 005.

Madam,

Sub: Representation on the Draft Guidelines based on Usha Thorat Committee Report on Issues and Concerns in NBFC Sector issued by RBI on 12 12 12.

As you are aware, the Asset Financing NBFCs (NBFC-AFCs) registered with Reserve Bank of India have joined hands and formed a Self Regulatory Organization (SRO) under the name of **Finance Industry Development Council (FIDC).**

NBFC-AFCs have been recognized for their role in credit delivery in remote corners of India and have carved a niche for themselves in the semi-rural and rural segments of the country. NBFC-AFCs are also playing a vital role in furthering the cause of Financial Inclusion and in credit dispensation to the poor states/credit starved areas for over 5 decades. Based on the discussions at various meetings with our members and based on the feedback received, would like to place before you certain areas of concern that will have adverse impact on the NBFC sector. These are enumerated below for your kind consideration.

At the outset, we would like to **thank** Reserve Bank of India for bringing out draft guidelines which would help strengthen NBFC sector and facilitate greater convergence within the financial system.

The draft guidelines cover various areas like corporate governance and disclosures, entry point norms, principal business criteria, prudential regulations, liquidity management etc. This representation seeks to focus on a few proposed guidelines which in our view need to be relooked at considering their impact on the NBFC sector. These are enumerated below for your kind consideration.

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1. Tier-I Capital Norm

The draft guidelines stipulate that Tier I capital for Capital to Risk Weighted Assets Ratio (CRAR) purposes be enhanced to 10% (12% for captive NBFCs and those lending to sensitive sectors). Existing NBFCs have to achieve the same within 3 years from the date of notification.

Likely difficulties:

a. The role being played by most NBFC-AFCs is in the semi urban and rural parts of the country and their contribution to the cause of Financial Inclusion is immense. Any increase in Tier 1 capital, considering equity capital is scarce to come by, will result in reduction of the business by the NBFCs and hence will consequently impact the cause of deepening credit delivery in remote parts of the country.

b. The RBI has increased the CAR by 50% during the last four years from 10% to 12% and then to 15%. This is now applicable for both deposit taking and non-deposit taking NBFCs. Keeping in view this requirement, most NBFCs have raised capital consistently over the past three years. To raise any further capital, the NBFCs will perforce need to absorb the capital already raised, exhibit appropriate returns to their stake holders before being able to access the capital market.

c. The draft guidelines propose to increase the risk weights for Capital Market Exposures and Commercial Real Estate Exposures. Just as these segments are justifiably considered as high risk , there are other segments which are considered as low risk segments, based on the studies published by credit rating agencies. It is essential that the Risk weight assigned to productive and real assets such as Commercial vehicles / Construction equipments / Tractors / Multi utility vehicles and Cars are appropriately reduced to 50% levels considering that the actual underlying risk is low as also to address the growing credit needs of the Transportation segment in the country.

d. The fact of lending by NBFCs to such productive assets being least risky is also validated by a study report published by leading Credit rating agency " CRISIL"

Suggestion:

The Capital requirement for tier I Capital be maintained at existing level of **7.5%**. If it is enhanced to 10%, then the risk weight assigned to productive and real assets such as Commercial vehicles /

Construction equipments / Tractors / Multi utility vehicles and Cars be appropriately reduced to 50% levels.

2. Asset Classification & Provisioning Norm

The draft guidelines stipulate that the asset classification and provisioning norms of all registered NBFCs be made similar to banks including classifications of loans into NPAs post 90 days past due.

Likely Difficulties:

a. It is an accepted fact that NBFCs largely cater to the "unbanked" segment of the society who over the years use their track record with NBFCs and mature to become "bankable" borrowers. It is therefore imprudent to bring the asset classification norms of NBFCs at par with banks.

b. The customers funded by NBFCs generally belong to the informal/unorganised segment and the average loan sizes of the NBFCs are between Rs 3 lacs and Rs 6 lacs. Almost all assets funded are productive assets and are impacted by various causes like accident, increase in fuel and insurance costs without any corresponding increase in freight rates etc. It may hence not be appropriate to equate the provisioning norms for banks which are largely into whole sale lending with the NBFCs which are completely into retail lending.

c. Although, NBFCs have freedom to fix the repayment schedule, as pointed out during the discussion held with your good self in the meeting held on December 26, 2012, the cash flows for NBFC customers are more often than not seasonal in nature and thus unforeseen slippages do occur, which however does not tantamount to default. Such delays are a function of the fact that the AFCs cater to retail rural & semi-rural market where borrowers' repayment capacity is often impacted by the environmental conditions, which is an unlikely situation for Banks as Banks' portfolio mostly comprises of large ticket size, organized & urban borrowers.

d. As per various reports published by rating agencies, as also by experience, the recovery efficiencies of NBFCs are superior to that of Banks and more so it is reflected in the percentage recoveries made by NBFCs in write off assets.

e. There will be an adverse impact driven by increased provisioning as it will substantially affect the profitability and the subsequent return on asset of NBFCs (this read with the

increased tier 1 requirement will compound the concern, as, if, NBFCs do not produce returns, capital is not going to be easy to come by)

Suggestion:

The existing asset classification and provisioning norms are sufficient, considering the fact the assets are productive in nature and the repayments are self liquidating. Further, if the asset classification and provisioning norms of NBFCs have to be brought at PAR with banks, then the following reliefs available to banks should also be made available to NBFCs –

- Banks get income tax relief on provisions made against NPAs while no such relief is currently available to NBFCs
- Banks are covered under SARFAESI while NBFCs cannot make use of SARFAESI to recover their loans
- The 90 day provisioning norm be implemented over 3 years instead of 2 years

The request here is to RBI to play an active role as a "developer" in addition to being the regulator and thus go an extra mile in strongly recommending to the Ministry of Finance to grant these tax benefits to NBFCs in the next Union Budget for the year 2013-14.

3. Minimum Net Owned funds & Registration with RBI

The draft guidelines recommend that the minimum net owned fund (NOF) requirement for all new NBFCs wanting to register with the Reserve Bank be retained at the present Rs. 2 crores. Further, the minimum asset size of Rs 25 crores is required for registering any new NBFC. Existing NBFCs below this limit may deregister or increase their asset size to Rs 25 crores or above within 2 years.

The guidelines mention that small non-deposit taking NBFCs do not contribute to any major systemic risks or major disruptions in the market. We would also like to add that the Usha Thorat committee report fully acknowledges that NBFCs meet the credit needs of the unbanked segment of the society. But the guidelines recommend the above steps to 'focus regulatory resources where the risks lie'.

Likely Difficulties:

a. Deregistering or refusing registration of the companies just because they are small, that too, with a view to reduce the cost of regulation is in our view not justified.

Needless to mention these companies are complying with all the regulations and do not pose any systemic risk.

b. This is in conflict to the Government's Agenda on Financial Inclusion as small companies cater to the unbanked segment and provide last mile connectivity.

c. This is also in conflict to the Government's stated agenda of promoting SMEs and MSMEs where being "Small is Beautiful".

d. If this recommendation is implemented, almost 70% of the NBFCs shall have to be de-registered, simply because they prefer to remain "small".

e. This will lead to a situation where there shall be a number of companies who potentially shall be carrying on NBFC activities without RBI registration. This will in our view increase the risk in the system which is not desirable. This shall take us back to the pre-1997 era of unregulated entities engaged in financial activities, which could once again encourage mushroom growth of such high risk entities. *It is perhaps a one of its kind scenario where the smaller players want to be registered and regulated, but the regulator wants them to be outside the ambit of regulation.*

f. Small NBFCs once de-registered shall be denied bank lending as one of the requirements of bank lenders is that the NBFC be registered with RBI and as a consequence thereof, of the most likely source of funding for such NBFCs would be public deposits which in itself may bring into existence its own addendum issues.

g. During the last 15 years of effective regulation by RBI, changes in rules / regulations for allied activities have evolved so as to include "RBI Registration Certificate" as a basic requirement for any NBFC to function. Examples can be drawn from Ministry of Road Transport and Highways constituted expert committee under the chairmanship of Mr. S. Sunder to Review The Motor Vehicles Act, 1988. The committee in their report dated January, 2011 (Chapter – III, Para 36) has recommended that in case of vehicles financed, the lien in the RC shall be marked only in favour of banks and NBFCs which are registered with RBI. Further, police, courts and tax departments demand RBI Registration Certificate as a mandatory requirement to accept applications submitted by NBFCs.

As such, if the working group recommendations are implemented, then 70% of the NBFCs shall be de-registered and shall be forced to close shops, for no fault of theirs, but simply because they are "small".

Suggestion:

The Entry level norms should be maintained at the existing levels and draft guideline of de-registration for small existing NBFCs, specially Asset Finance Companies having Asset base below 25 crores should not be implemented and status quo should be maintained. The entry norms may be raised to the suggested levels for the new entrants only.

4. Principal Business Criteria (PBC) for AFCs

The draft guidelines state that the PBC for AFCs is being modified so that a minimum of 75% of assets of AFC should be in asset financing activities and at least 75% of total income should be from these asset financing activities. Existing AFCs should conform to the revised PBC within 2 years in stages.

Suggestion:

In this regard, questions have recently been raised with regard to inclusion of motorcars and two wheelers financed to customers and intended for own use by them, for the purposes of calculating "productive Assets". We wish to submit the following for your consideration:

The existing definition of NBFC-AFC states that "AFC would be defined as any company which is a financial institution carrying on as its principal business, the financing of physical assets supporting productive / economic activity, such as, automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments moving on own power and general purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real / physical assets supporting economic activity and income arising there from is not less than 60% of its total assets and total income respectively".

A plain reading of the above would show that in order to be classified as an AFC –

"The financing should be for real / physical Assets" and the assets should be such that they support productive / economic activity. The interpretation that such assets should be used for commercial purposes or generate income is without any basis. It is pertinent to note that over 80% of all automobiles sold in the country are financed and a narrow interpretation of this nature would virtually bring automobile sales in the country to a grinding halt.

It is well accepted that financing of tangible assets is safer since, irrespective of their end-use, they are quickly realizable, without much erosion in value. Assets like commercial vehicles and motorcars etc. are real assets and have a clear identity, which is established through Registration Certificates. Thus the ownership and identity of motorcars can be demonstrated legally and therefore should be appropriately classified as real assets.

In addition, many NBFCs provide finance against residential / commercial property (Loan against Property or Home Equity loans) with the funding being used in such cases primarily for business purposes thereby supporting economic activity. Such loans are primarily taken by small business owners / SMEs. Thus, in such cases, while the financing is not for purchase of the underlying asset, the underlying asset is a real tangible asset while the funds provided are utilised mainly for working capital purposes by these businesses.

We therefore request that a broad view should be taken and it be clarified that financing for personal use cars, two wheelers as well as against property where the funds are used for business purposes be included for the purpose of determining the 75% PBC of AFCs.

5. Liquidity Coverage

The draft guidelines stipulate that there should not be any liquidity gap in 1-30 days bucket and NBFCs should maintain high quality liquid assets in cash, bank deposits available within 30 days, money market instruments maturing within 30 days, investment in 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 net cash inflows and outflows over the 1 to 30 day time bucket as a liquidity coverage requirement.

Suggestion:

As NBFCs generally have bunched up liabilities and recovery on monthly basis, there is a systemic mismatch in their cash flows. Hence, the existing 15% tolerance be continued. However, considering RBI's experience, if the present 15% mismatch limit needs to be tightened, then we suggest the following:

- The 15% mismatch limit be brought down to 10%
- Considering that NBFCs normally enjoy undrawn bank lines to manage the liquidity gap, the same be considered in computing the mismatch.

6. Corporate Governance & Disclosures for NBFCs

The draft guidelines stipulate various revised guidelines on Corporate Governance and Disclosures for NBFCs. While any effort to further improve the good corporate governance practices in NBFCs is laudable, there are certain aspects of the guidelines which need to be reconsidered / clarified as below:

A) Transfer of Shareholding

The committee has recommended that any transfer of shareholding, direct or indirect, of 25 per cent and above, change in control, merger or acquisition of any registered NBFC should have prior approval of the Reserve Bank of India.

Likely difficulties:

a. Currently there are enough regulations in the country governing transfer of shares, merger, acquisition and some of these aspects also require the approval of the High Court concerned.

b. The SEBI norms for fit and proper test and other Laws / norms as are applicable regarding money laundering (leading to share acquisition or control etc.) are sufficient to address any undesirable profile of share holders.

c. Moreover, the recommendations do not also prescribe any time frame within which the approval or otherwise from the RBI would be made available.

d. The Lenders to the NBFCs, (constituted by Banks / Institutions / Mutual Funds / Insurance companies and the like, prudently protect their rights in the eventuality of any further issue of shares / change in control and in the eventuality of Mergers etc.

Suggestion:

With a view to avoiding duplicity in approvals of this nature, status quo is requested to be maintained.

B) The draft guidelines suggest several regulations, many of which are already covered under the Companies Act and Listing Agreement with SEBI. For instance,

- Para 5.1 of Annex 1 specifies that the number of Directorships held by a single Director may not exceed the maximum number prescribed under Sec 275 of the Companies Act 1956 and NBFCs are required to comply with Clause 49 of the listing agreement on Corporate Governance including induction of Independent Directors.

- Listed or unlisted NBFCs with Assets size of Rs 1000 Cr. and above will need to comply with mandatory disclosure under clause 49 of the SEBI listing Agreement.

-Further, Companies Bill 2012, which has been approved by the Lok Sabha, already contains several provisions like Nomination Committee, fit and proper criteria for independent directors, code of conduct for directors etc. Hence, prescribing similar provisions by RBI would only amount to duplication.

Hence, it is our suggestion that instead of repeating all the regulations once again for listed NBFCs, RBI may prescribe additional provisions, if any, which are not covered either under Companies Act or listing agreement.

C) Para 6.1 to Annex 1, requires NBFCs to submit a quarterly statement on change of directors.

Suggestion:

It is suggested that instead of a quarterly statement, submission of this statement is made applicable only when there is a change in the Directorship. Further, the role of Auditor in certifying this is not relevant in our opinion. We suggest that as and when there is a change in Director, the Compliance Officer of the NBFC should submit a statement to RBI.

D) Para 8.1 to Annex 1 – The reference to 'Executives' in this paragraph should be limited to 'Directors'.

E) Para II to Annex 3 – Under clause a, please clarify the term 'connected', as to whether it means an employee, borrower, shareholder, depositor etc. Further, in respect of all other clauses under Para II, please confirm that the reference is only to the Director and not to the relatives.

F) Para IV to Annex 3 – If the points covered under this Para were to be true, the Director would be disqualified from continuing as a Director. Further, at the time of appointment/ periodically, under Sec 274 of Companies Act, the Directors provide an undertaking that they do not suffer such disqualifications. We therefore suggest that this Para may be deleted.

G) Annex 4 – deed of covenants with a Director – Most of the covenants are required to be provided by the Director under the Companies Act. Hence, prescribing those as a part of the covenants may be avoided.

H) Para 3 (iv) to Annex 4, prescribes two business days to prepare and circulate the minutes of the Board meeting. We suggest that the provisions of the Companies Act in this regard (30 days) may be followed.

I) Annexure 5, disclosures required under Para 6.4.2, 6.4.3 and 6.4.4. – We suggest that these be mandated in the form of a return / at the time of annual inspection. Disclosures such as Top 20 exposures etc. in the public domain would act as information to the competitor, which may be to the detriment of the NBFC. Such information should not be in the public domain.

7. Mandatory Rating and reduction of the deposit acceptance limit to 2.5 times of NOF for rated AFCs (from 4 times at present)

Likely Difficulties:

a. The draft guidelines making rating mandatory and reduce the deposit acceptance limit to 2.5 times of NOF for rated AFCs (from 4 times at present) is not desirable as CRAR regulates the total borrowings.

b. It has been brought to the notice of RBI many a times earlier also that all the approved credit rating agencies use the same rating model for rating big and small NBFCs. As such, it is practically impossible for a small NBFC to obtain even an investment grade credit rating.

c. Generally, credit rating is used as a referral tool for the investors to take a call before investing. But for NBFCs, credit rating is used as a regulatory factor and as such, the difficulties being faced by small NBFCs have to be resolved.

d. Vide notification No. DNBS (PD) CC No.47/02.01/2004-05 dt Feb 7th 2005, the RBI has mandated NBFCs accepting public deposits that such NBFCs should ensure that all times, there is full asset cover available for Public deposit accepted by them.

e. NBFCs have been in full compliance with this requirement of RBI and hence currently, deposits raised by NBFCs are fully secured by means of Asset of the NBFCs.

Suggestions:

Status-quo should be maintained.

1) Create a Refinance window. Since RBI is discouraging deposits, there has to be an alternative source of funding for small NBFCs.

2) Rating agencies like SMERA or M-CRIL should be approved and asked to rate small AFCs so that small AFCs can approach an agency which understands the ground realities of small scale sector.

8. Perpetual Debt Instruments

We are of the opinion that AFCs should be allowed to access the debt market to augment their capital requirements in the form of perpetual debt instruments. This would benefit AFCs substantially in meeting their business growth aspirations, without diluting the equity. RBI in Oct 2008 permitted NBFCs-ND-SI to issue Perpetual Debt Instruments. This came immediately after issuing guidelines to them in August 2008, increasing their Capital Adequacy Ratio to 15%, effective March 2011. Further, such Perpetual Debt Instruments were eligible for inclusion as Tier I Capital to the extent of 15% of total Tier I capital, as at end of the previous year. It is submitted that similar permission is extended to all AFCs.

9. External Commercial Borrowing

Fund Raising by NBFCs is becoming more and more difficult with avenues for funding getting restricted. The request is to have a pragmatic approach. If there are concerns on some fund raising sources for NBFCs, then the need is to open alternate sources for funding. We submit that AFCs should be allowed to access the External Commercial Borrowings. Institutions such as NBFC IFCs, NBFC MFIs are permitted to raise money through ECBs but AFCs are still not allowed the same. We submit the following points to further strengthen our request-

-This would help diversify the source of borrowing.

-This would enable AFCs to raise funds at cheaper rates, which in turn would benefit the weaker sections of the economy, wherein such funds are deployed.

-Such long-term borrowings would lend stability to the Asset Liability profile of the AFC.

-This would reflect real convergence, as Banks are allowed to raise ECBs.

Suggestion:

We suggest that as in the case of IFCs, ECBs be permitted for AFCs and suitable limits on quantum, all-in cost, hedge and end use of assets may be prescribed.

We once again thank the RBI for the steps being taken to ensure a stable and strong Non-Banking Financial system in the country and hope the above suggestions will be taken into consideration before bringing out the final guidelines.

We hope the above receives your favourable consideration.

It will be our pleasure to be present in person and offer our views on the above, should you consider it necessary.

Thanking You

Yours sincerely,

For **FINANCE INDUSTRY DEVELOPMENT COUNCIL**

MAHESH THAKKAR
Director General