Ref.No.: FIDC/227/0405 January 12, 2005

To,
Mr. P. Chidambaram,
Finance Minister,
Government of India,
North Block,
New Delhi - 110 001.

Hon'ble Finance Minister Sir,

SUB: PRE-BUDGET MEMORANDUM 2005-06 - ISSUES RELATING TO NON-BANKING FINANCIAL COMPANIES (NBFCs)

The Non-Banking Finance Companies (NBFCs) , spread all over the country, and registered with Reserve Bank of India and authorized to accept public deposits, have joined hands and formed a **Self Regulatory Organization (SRO)** under the name of **Finance Industry Development Council (FIDC).** FIDC is **registered** as a Company U/s. 25 of Companies Act, 1956. Our main objective is to work towards bringing discipline amongst our members by enforcing a model code of conduct, besides presenting a unified face of this sector.

We are pleased to **enclose** herewith the issues and concerns of the NBFC sector for your consideration in the forthcoming Union Budget 2005-06.

We trust that our representation would merit your favourable consideration. We would be glad to supplement any other information in this connection.

We would like to discuss some of the important issues, resolution of which is very important for the industry to survive and contribute effectively in economic development of the country.

For this purpose, we would request you to kindly grant us a suitable appointment to meet you at your Chamber at New Delhi to discuss our concerns at one of your Pre-Budget Meetings and consider them appropriately in the coming Union Budget.

Let us keep the lines of communication open.

We look forward to an **immediate positive response** and are confident that we are in the process of a **long and beneficial relationship**.

Thanking you,

Yours Faithfully,
For **FINANCE INDUSTRY DEVELOPMENT COUNCIL**

MAHESH THAKKAR
DIRECTOR GENERAL

Encl. As above

I. ROLE OF NBFCs:

A robust banking and financial sector is critical for activating the economy and facilitating higher economic growth. Financial intermediaries like NBFCs have a definite and very important role in the financial sector, particularly in a developing economy like ours. They are a vital link in the system.

After the proliferation phase of 1980s and early 90s, the NBFCs witnessed consolidation and now the number of NBFCs eligible to accept deposits is around 600, down from 40000 in early 1990s. The number of asset financing NBFCs would be even lower, around 350, the rest are investment and loan companies. Almost 90% of the asset financing NBFCs are engaged in financing transportation equipments and the balance are in financing equipments for infrastructure projects. Therefore, the role of non-banking sector in both manufacturing and services sector is significant and they play the role of an intermediary by facilitating the flow of credit to end consumers particularly in transportation, SMEs and other unorganized sectors. NBFCs due to their inherent strengths in the areas of fast and easy access to market information for credit appraisal, a well-trained collection machinery, close monitoring of individual borrowers & personalized attention to each client as well as minimum overhead costs, are in a better position to cater to these segments.

Now, unlike in the past, NBFCs are very well regulated and supervised. Just like banks they are required to be registered with RBI, follow stringent prudential norms prescribed by RBI in the matters of capital adequacy, credit/investment norms, asset-liability management, income recognition, accounting standards, asset classification, provisioning for NPA and several disclosure requirements. Besides this, RBI also supervises the functioning of NBFCs by conducting annual on-site audits through its officials. Such a rigorous regulatory framework ensures that NBFCs function properly and follow all the guidelines of RBI. Thus in all respect the monitoring of NBFCs is similar to or in some case more stringent than banks.

The role of NBFCs in creation of productive national assets can hardly be undermined. This is more than evident from the fact that most of the developed economies in the world have relied heavily on lease finance route in their developmental process, e.g., lease penetration for asset creation in the US is as high as 30% as against 3-4% in India. A conducive and enabling environment has been created for the NBFC industry globally, which has helped it grow and become an essential part of the financial sector for accelerated economic growth of the countries. This is not the case in our country. It is, therefore, obvious that the development process of the Indian economy shall have to include NBFCs as one of its major constituents with a very significant role to play.

NBFCs, as an entity, play a very useful role in channelising funds towards acquisition of commercial vehicles and consequently, aid in the development of the road transport industry. Needless to mention, the road transport sector accounts for nearly 70% of goods movement and 80% of passenger movement across the length and breadth of the country and the role of NBFCs in the growth and development of this sector has been historically acknowledged by several committees set up by the Government and RBI, over the years. In fact, RBI's latest report titled "Report on trends on progress of banking in India 2002-2003" observes:

"Notwithstanding their diversity, NBFCs are characterised by their ability to provide niche financial services in the Indian economy. Because of their relative organisational flexibility leading to a better response mechanism, they are often able to provide tailor-made services relatively faster than banks and financial institutions. This enables them to build up a clientele that ranges from small borrowers to established corporates. While NBFCs have often been leaders in financial innovations, which are capable of enhancing the functional efficiency of the financial system, instances of unsustainability, often on account of high rates of interest on their deposits and periodic bankruptcies, underscore the need for reinforcing their financial viability."

The report further adds,
"The regulatory challenge is, thus, to design a supervisory framework that is able to ensure financial stability without dampening the very spirit of manoeuvrability and innovativeness that sustains the sector."

II. TAXATION ISSUES:

1. SEC.36 (1) (viia) / 43D OF THE IT ACT:

We would like to state that, like banks, NBFCs play a crucial and prominent role in the rural and social sectors of the economy by providing finance for the acquisition of trucks, buses and tractors, which operate mainly in rural and semi-urban India. In fact, our exposure to the rural / social sectors is direct and pronounced, since financing for acquisition of vehicles provides a spin-off benefit by creating jobs and opportunities in the rural parts of our country. It is pertinent to note that a significant part of the priority sector lending done by banks is to the road transport sector. In fact, banks' lending to NBFCs, for onward lending to the road transport sector, is also considered as part of their priority sector lending by RBI. On the other hand, the major portion of lending by NBFCs goes directly to the road transport sector. Subjected, as we are, to all the prudential norms on provisioning and income recognition, it is only fair and equitable that the benefits already available to Banks & FIs under the captioned sections of the IT Act be extended to NBFCs also.

2. EXTENSION OF INCOME TAX BENEFITS UNDER SEC.10(23G) & 36(1)(viii) TO NBFCs:

The benefits available under the existing provisions of sec. 10(23G) and 36(1)(viii) of Income Tax Act, 1961applicable to infrastructure funding by various institutions are not available to NBFCs. As of now, an Infrastructure Capital Company (ICC) or Infrastructure Capital Fund (ICF) as defined under section 10(23G) is entitled to tax exemption in respect of all its earnings arising out of its investments (equity or debt) made in infrastructure projects listed under section 80-IA. Similarly under section 36(1)(viii), notified Companies, who are engaged, among others, in providing long term finance for construction or for purchase of houses for residential use can claim deduction up to 40% of their profits for creating a special reserve. However, an NBFC is not entitled to the same tax reliefs insofaras its investments in the specified infrastructure projects through lease, hire purchase or loan transactions are concerned. It is imperative to extend these benefits to NBFCs also as long as the objective of channelling investments in certain designated infrastructure projects are met. Any investment in infrastructure sector should be welcome to meet the country's requirements since it is key to the development of the entire economy. If an appropriate environment for development of infrastructure is to be created, one must provide incentives for all kinds of investments and participants in the listed infrastructure projects irrespective of their types or categories.

We, therefore, strongly urge that the benefits provided under section 10(23G) and sec.36 (1)(viii) of Indian Income Tax Act, 1961 be extended to NBFCs also.

3. EXEMPTION TO NBFCs FROM TDS REQUIREMENTS U/S 194A(3)(iii) OF THE I.T.ACT:

As per Section 194A of the Income Tax Act 1961, tax has to be deducted out of the interest payments made by specified borrowers to the lender at the rates in force. The rates vary depending on the constitution of the payee (lender). For the category of domestic companies in which NBFCs fall, the rate of TDS is presently 20.91% including surcharge of 2% and the newly introduced educational cess of 2%.

Banking companies, Cooperative societies engaged in banking business, public financial institutions, LIC, UTI, Insurance companies and some other notified institutions are exempted from the purview of this section, implying that if the payment of interest is made to these entities, the borrower is not required to deduct TDS out of the interest payment. This is not available to NBFCs even though they are in similar lending activities. Consequently, their margins and cash-flow are severely affected as further explained here.

In a typical case of lending by an NBFC charging interest, say, @ 16% p.a. and borrowing, say, @ 13%, it gives a gross spread of 3% p.a. The interest income of the NBFC is subject to TDS of 20.91%, implying 3.35% out of 16% will go for TDS, which is more than the total margin available. This hardship puts NBFCs in a disadvantageous position compared to the other similar players.

It is thus essential that the TDS anomaly explained above be rectified immediately, in order to reduce the cost of intermediaries and ensure flow of capital to infrastructure and road transport sectors of the economy, which is the direct focus area of Asset Financing NBFCs. This will also ensure uniformity in taxation of similar businesses.

It is, therefore, submitted that exemption should be granted from TDS on interest payment to NBFCs u/s 194A(3)(iii) of the IT Act. To prevent misuse of the exemption, CBDT may stipulate that only NBFCs registered with RBI shall be entitled to the exemption. This will provide a level playing field to the NBFCs.

III. REFINANCING:

NBFCs have a proven track record in financing the acquisition of vehicles in rural India for over six decades. Any finance for a second hand or used vehicle is, in reality, working capital finance and the borrower who avails such finance often deploys it towards improving business in the rural sector. The security is the vehicle in question and this is the comfort factor for NBFCs to lend to the prospective borrower who is very often an agriculturist. It is relevant to note that trucks are often referred to as 'Mobile factories', providing direct employment to at least 20 persons per vehicle, besides many more on an indirect basis. NBFCs are also involved in financing earthmoving equipment, which aid the development of infrastructure and in the process, provide employment to thousands of persons in the rural sector. The reach and location of these entities in remote corners of the country has enabled them to stay in close touch with the customers and they have the necessary knowledge and skills in credit appraisal and understanding the needs of the borrowers.

The report of the Standing Committee of Parliament on Finance on The Financial Companies Regulation Bill, 2000, which was tabled in the Lok Sabha, acknowledges, in more than one place, the laudable role played by NBFCs and in *Para 1* of the report, it states ... ...

" ... ... ***Further, higher level of customer orientation, fewer pre and post sanction requirements and simple and speedy tailor made services assured them a loyal clientele notwithstanding higher costs. Besides, the higher rate of return offered by NBFCs have drawn a large number of small savers to them. Thus they work like quasi banks and provide fund to the sectors where a credit gap exists. NBFCs have become an accepted and integral part of the Indian financial system in view of their complementary as well as competitive role.***"

There is today a crying need to provide adequate funding support to these entities, similar to that being provided by the National Housing Bank to

HFCs. It is suggested that a 'Transportation Financing Fund' be created by SIDBI to refinance NBFCs engaged in financing the road transport sector.

IV. RECOVERY MECHANISMS:

1. SARFAESI ACT:

Banks and Financial institutions have been notified under the Act, giving them the ability to move against defaulting borrowers and secure their assets. Subsequently, specified housing finance companies, (HFCs), have also been notified under the act. NBFCs are the only segment of the financial sector that have not been notified under the Act. It is submitted that in order that the interests of investors be protected, NBFCs may also be brought within the purview of the SARFAESI Act. As per the Act, RBI can do this by way of a notification.

2. DEBT RECOVERY TRIBUNALS (DRTs) :

We request you to grant access to NBFCs to DRTs. We also request you to increase the number of DRTs if the existing set-up is found inadequate. This would fulfil a long felt need of the NBFCs and lead to speedier realisation of their dues.

What We Demand:

To sum up, we wish to reiterate the representations as under:

1. **Taxation Issues:**
   a. Deductibility of Provisioning norms as per the provisions of Sec.36 (1) (Viia)/ 43D of the IT Act
   b. Extension of Income Tax Benefits for financing of infrastructure projects under Sec.10(23G) & 36(1)(viii) to NBFCs
   c. Exemption to NBFCs from TDS Requirements U/S 194A(3)(iii) of the I.T.Act

2. **Refinancing:**
   Separate Funding Institution/Fund.

3. **Recovery Mechanisms:**
   a. Extension of provisions of SARFAESI Act to Registered NBFCs.
   b. Access to Debt Recovery Tribunals (DRTs)

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