FIDC

Finance Industry Development Council

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

April 03, 2012

To
Dr. D. Subbarao
Governor
Reserve Bank of India
Central Office
Central Office Building
Shahid Bhagat Singh Road
Mumbai 400 001

Sir,

We thank you very much for the opportunity given to us to discuss various issues concerning NBFCs-AFCs at the Pre-credit Policy Meeting held on April 03, 2012.

We are giving hereinbelow the isummary of ssues discussed at the Meeting.

I. ISSUES ARISING OUT OF USHA THORAT COMMITTEE REPORT:

While we are in agreement with the broad approach adopted by the working group, there are a few areas which require moderation and in other areas, total reconsideration is warranted, due to their likely adverse impact on the NBFC sector. These are enumerated below for your kind consideration.

1. **Minimum Net Owned funds & Registration with RBI**

The committee has recommended that the minimum net owned fund (NOF) requirement for all new NBFCs wanting to register with the Reserve Bank could be retained at the present Rs. 2 crores till the Reserve Bank of India Act is amended. The Reserve Bank of India should, however,

insist on a minimum asset size of more than Rs. 50 crores for registering any new NBFC. Existing NBFCs below this limit may deregister or be asked to seek a fresh certificate of registration at the end of two years;

The report fully acknowledges that NBFCs meet the credit needs of the unbanked segment of the society. Also, the small NBFCs **DO NOT** pose any major risk to the system. But in order to reduce the cost of regulation, the Committee has recommended that NBFCs having asset base of less

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than **Rs.50 crores** should be de-registered. The report also acknowledges that, “the very act of registration with the RBI confers certain legitimacy to the NBFC as a regulated entity and may give lenders to that NBFC a sense of unwarranted comfort.”

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 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. If this recommendation is implemented, almost 90% of the number of NBFCs shall have to be de-registered, since they have an asset base of less than 50 crores.

d. This will lead to a situation where there shall be a number of companies who shall be carrying on NBFC activities without RBI registration. This will in our view increase the risk in the system which is not desirable

e. The Working Group recognizes the need to amend The RBI Act in order to raise the entry level NOF. But by increasing the asset base to minimum of 50 crores along with a CRAR of 15%, the minimum NOF required automatically increases to more than 6 crores. Thus the working group has indirectly raised the entry level NOF which is not possible without amending The RBI Act.

f. Small NBFCs once de-registered shall be denied bank lending as the “legitimacy” aspect shall be taken away and this will in probability lead to generation of Public deposits as most likely source of funding for such NBFCs which in itself may bring into existence its own addendum issues.

g. Ministry of Road Transport and Highways had constituted an 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.

   As such, if the working group recommendations are implemented then 90% of the NBFCs who shall be de-registered shall be forced to close shops as no lien can be marked in their favour in the RC book of the vehicles financed by them.

Suggestions:

The Entry level norms should be maintained at the existing levels and recommendation of de-registration for small existing NBFCs specially Asset Finance Companies having Asset base below 50 crore should not be accepted and status quo should be maintained.

2. **NBFCs not accessing Public Funds**

NBFCs not accessing public funds may be exempted from registration provided their assets are below Rs. 1000 crores

Suggestion:
The points mentioned under Para 1 above is applicable under this point as well.

3. **Mandatory Rating & reduce the deposit acceptance limit to 2.5 times of NOF for rated AFCs (from 4 times at present)**

Likely Difficulties:

a. Recommendation of Working Group to make rating mandatory & 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 rating is not viable for the SME sector due to high fee charged by the credit rating agencies which is unaffordable by the small AFCs besides lack of understanding by them of the ground realities in which SME sector operates.
c. 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.
d. NBFCs have been in full compliance with this requirement of RBI & 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) SMERA should be asked to rate small AFCs so that small AFCs can approach an agency which understands the ground realities of small scale sector.

4. Tier-I Capital Norm

The report of the working group has stipulated Tier I capital for Capital to Risk Weighted Assets Ratio (CRAR) purposes to be specified at 12 per cent to be achieved in three years for all registered deposit taking and non-deposit taking NBFCs;

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 three 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. 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%**.

5. 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.

Suggestion:

It Is submitted that similar permission be extended to AFCs.

6. External Commercial Borrowing

In recommending the twin criteria of 75% assets and income for AFCs, reference has been drawn to NBFC-IFCs in the report. Extending the same analogy to the borrowing side, we submit that AFCs should be allowed to access the External Commercial Borrowings. 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 society 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, suitable limits on quantum, all-in cost, hedge and end use of assets may be prescribed in the case of AFCs as well.

7. Asset Classification & Provisioning Norm

The committee has recommended that the NPL provisioning guidelines for NBFCs should be in line with those of banks.

Likely Difficulties:

a. 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.

b. The cash flows for NBFC customers are more often than not seasonal in nature and thus 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.

c. 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.

d. 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 provisioning norms are sufficient, considering the fact the assets are productive in nature and the repayments are self liquidating.

II. ISSUES ARISING OUT OF M V NAIR COMMITTEE REPORT:

1. Clause 3.12 – Lending to non-bank financial intermediates for on-lending

The Committee Recommendation in brief is as follows:

Keeping in view the role of NBFCs in extending the financial services to the last mile, bank loan sanctioned for on lending to specified segments may be reckoned for classification under priority sector upto a maximum of 5% of the ANBC. Further, banks currently having portfolio of on-lending, buy-outs and securitization in excess of the proposed 5 per cent of *ANBC*, the Committee proposes stipulation of reducing such

portfolio by at least 1 per cent of *ANBC* every year for reckoning under priority sector such that at the end of 5 years not more than 5 per cent of ANBC will be reckoned for priority sector classification. It is also stipulated that any new on-lending, buy-outs and securitisation by such banks would not be reckoned for priority sector purpose, until such time their portfolio of on-lending, buy-outs and Securitisation is reduced to 5 per cent of ANBC.

Portfolio buy-out, securitization and loans to intermediaries for on-lending would be classified as priority sector provided the underlying asset is eligible for classification under priority sector advances. However, loans extended against gold jewelleries by NBFCs and other intermediaries may continue to be excluded as a part of priority sector classification.

FIDC View:

It is welcome that the Committee recognises the role played by the NBFCs in the last mile connectivity for credit delivery. We would like to submit that to achieve the end objective of financial inclusion, the banks and NBFC - AFCs have a specific role to play. The objective in our view can be achieved faster and in a desirable manner if the banks and the NBFC -AFCs act in a collaborative manner.

The Committee, while recognizing the role of the NBFCs in financial inclusion and development of new lending products, has suggested that the intermediary channel being used by banks should be phased out in a time bound manner. The Banks presently operate through their own branch networks, lend to the different customers through unregulated third party intermediaries, as also lend through the regulated intermediaries like NBFC –AFCs.

Inspite of branch presence, banks make extensive use of third party agents for sourcing, processing as well as for collection of loans. Use of such agents, who are most often unregulated, leads to mis-selling of loans as well as other issues like frauds, wherein the efficacy of making credit available to the desired section of society gets impacted. On the other hand, lending through the NBFC-AFCs, that are registered with the RBI and are hence strictly regulated, have their own systems, processes, corporate governance policies etc. in place ensures that the objective of financial inclusion is met and at the same time the credit is delivered to the deserving end customer in a transparent and efficient manner. Further, these entities are specialised players who operate in their niche markets and have been able to develop innovative models to ensure availability of credit directed at specific segments in an efficient manner. That they have been able to do so even in areas which are widely banked clearly shows the need for such entities to be

included in an on-going manner in the entire scheme of priority sector lending. Hence the true concept of Direct Lending by banks to the Priority Segment of the customers need have no unregulated intermediaries whether for sourcing or collecting and in the alternate the credit delivery through the NBFCs-AFCs need to be encouraged and the collaborative efforts of the Banks and the NBFC-AFCs in this regard have been quite well demonstrated in the past.

Banks need to draw comfort from the fact that NBFCs are a unique class of financial intermediaries who have been regulated by the same regulator (as banks) for the last 15 years. NBFC regulations have undergone regular evolution and today NBFC regulations are almost at par with banking regulations in matters pertaining to providing retail credit.
It may also be noted that Prof. Raghuram Rajan Committee on Financial Sector Reforms recommends that the focus in priority sector lending should be on increasing the access to services for the poor irrespective of the channel or institution that does it. As such, whether the credit is provided by banks or by NBFC-AFCs should not matter provided the credit is being made available to the desired segment in a regulated manner.

We would, therefore, like to add that from the present norm of no grant of PSL benefit for on lending by NBFC-AFCs to allowing the same as recommended by the Nair Committee is a step in the right direction.

The committee has recommended an overall cap of 5% for all types of PSL exposures to NBFCs (i.e. includes On-lending + Securitisation + Buy outs). It is our view that the 5% norm appears inappropriate considering that the credit delivery in the rural locations is essential for the growth of the economy as well as for meeting PSL objective of providing credit to those segments which have higher employment potential and can help in making a large impact on poverty alleviation and NBFC-AFCs have clearly, for decades, made such credit available in an efficient manner. Within priority sector, the focus is on ensuring adequate credit to the critical segments such as Small and Marginal Farmers (SFMF), micro enterprises, weaker sections etc and as pointed out by the Nair Committee, although the credit to these segments have gone up, there are still significant gaps that need to be addressed. The committee, in an effort to increase credit to these segments, has recommended separate sub limits within the overall PSL norms. NBFC-AFCs have been able to reach out to these segments quite effectively and in fact a significant portion of their advances are to these segments. In our view, providing credit to such segments should be the priority irrespective of the fact whether such credit is being provided by banks or by NBFC-AFCs especially since both are regulated entities.

Suggestion I

The 5% norm is suggested to be removed. In our view, so long as the end usage of the funds is clearly established to be for the priority sector, there appears no merit in imposing a ceiling for such on-lending. In this background, any credit availability to the needy segment, whether provided by banks or by NBFC-AFCs, should be welcomed without any restriction what so ever.

Suggestion II

If at all there needs to be a limit prescribed, then it is suggested to be limited only to bank's exposure through on-lending to NBFCs and should exclude securitisation and buyouts. Further, this limit should be earmarked specifically to NBFC-AFCs only. Further, it is added that considering the need to deepen the credit delivery to SFMF, micro enterprises and weaker sections within the overall ambit of the priority sector lending, there is suggested to be no restrictions for bank's on-lending through NBFC-AFCs to these needy segments of the society. Hence, even if the RBI chooses to accept the recommendation of the Committee as regards to a prescribed limit then, exclusion of securitisation / buy outs / on-lending by NBFCs to SFMF, micro enterprises and weaker sections is requested.

2. Clause 4.2 – Lending through non-bank financial intermediaries

The Committee Recommendation in brief is as follows:

An NBFC should maintain a minimum threshold requirement of 65 per cent of its total Assets under Management on its Balance Sheet (of the last financial year) as also on an average throughout the financial year. This minimum threshold criterion is specified to prevent originations by NBFCs with the primary intent to sell.

FIDC View:

We would like to point out that the strength of NBFC-AFCs lies in reaching out to the priority sector target customer, bringing them within the realms of organised credit segment umbrella and servicing them. Needless to mention, the expertise of the NBFC-AFCs is best utilised in credit delivery to the needy segment of the society in rural and semi-rural territories and the banking segment is best positioned to collaborate to enable this. Such collaboration has been in existence for the past several decades, wherein the banks have made credit available to the needy segments of the society by on-lending

through the NBFC-AFCs, and by purchase of Priority Sector Loan Portfolios from the NBFC-AFCs, which has furthered the cause of Financial Inclusion in its true sense. This in our view is playing to the strength of each entity and enables the ultimate objective of the RBI to ensure credit delivery to the vulnerable and needy segments of the society. Moreover, Portfolio sale has been one of the limited channels of funding available for NBFC-AFCs.

The Nair Committee has also referred to the Usha Thorat Committee recommendations on NBFC sector as regards capital adequacy / asset size requirements etc. In this background, in our view there is no cause made out for bringing in another restriction of a norm of 65% of the overall AUM being on balance sheet to be eligible for the PSL lending benefits. The intent of the Nair committee as visualised from its recommendations is to prevent the supposed practice of "originate to sell". We would like to state that the so called practice of originate to sell does not compromise on the asset quality and the compliance to the regulatory norms, as it is common sense that "best quality fetches best price". Further, In our view, the existing capital adequacy norms, as also the superior inspection and supervisory mechanisms implemented by the RBI during the past several years is sufficient enough to prevent any concern in this regard.

Suggestion

It is suggested that a new norm as recommended, requiring that atleast 65% of the AUM be on the NBFCs balance sheet, be omitted.

3. ***Clause 4.2 – Interest rate spread cap on the underlying loans extended by the NBFCs***

The Committee Recommendation in brief is as follows:

The interest rate spread cap on the underlying loans provided by the NBFCs for eligibility under priority sector is 3.5% for NBFC – HFCs and 6% for NBFCs – AFCs.

FIDC View:

The interest rate cap is not required to be prescribed as each customer while borrowing and each lender while lending works on the principle of viability and as long as it is viable to service a loan at a specific price, it works. The profile of customers falling under the PSL category is such that they are rated as a higher risk category. Further, it will, in our view, be impossible to monitor the same operationally as it will not be possible to allocate

a specific funding to a specific asset type in an entity's portfolio. Also, prescribing a spread cap will be akin to penalising entities who are able to better manage their cost of funds vis-à-vis those entities whose cost of funds is higher.

Suggestion:

In our view, instead of imposing an arbitrary cap on spreads, it is suggested that RBI identify and implement measures as would encourage NBFC-AFCs to lend to the priority sector at competitive rates.

We hope you will carry the concerns of NBFC- AFC sector at appropriate levels.

Thanking you,

Yours sincerely,

For **FINANCE INDUSTRY DEVELOPMENT COUNCIL**

MAHESH THAKKAR
Director General