

Ref.No.: FIDC/172/0506

December 7, 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 2006-07 - 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 2006-07.

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

Pre-Budget Memorandum

ROLE OF NBFCs IN SERVING THE SOCIO ECONOMIC OBJECTIVES

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

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 set by RBI in the matters of capital adequacy (12% as against 10% for the banks), credit/investment norms, asset-liability management, income recognition, accounting standards, asset classification, provisioning for NPA and several disclosure requirements. ALM Guidelines and KYC norms have also been extended to the NBFCs. Besides, RBI also supervises the functioning of NBFCs by conducting annual inspections through its own officers. Such a rigorous regulatory framework ensures that, in all respect the monitoring of NBFCs is similar to or in some case more stringent than banks.

1. Contributions to the Society by Funding The Road Transport Sector

NBFCs, as an entity, play a very useful role in channelizing funds towards acquisition of commercial vehicles and consequently aid in the development of the road transport industry. Over 90% of NBFCs are engaged in creation of assets like financing transportation and infrastructure construction equipments and projects. 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.

Road Transport Sector today is the lifeline of our economy. As stated earlier, the Road Transport Industry carries a major chunk of freight and passengers. Recently, Government has accorded a very high priority to this sector. It is a well established fact that NBFCs provide 80% to 90% of funding for the Road Transport Sector.

Some of the facts related to Commercial Vehicles and their financing are as follows:

- ?? Indian economy is becoming more dependent on Road than Rail. Heavy government outlay for mega road projects like the Golden Quadrangle.
- ?? Sale of Commercial Vehicles growing to over 30%.
- ?? 95% of the Commercial Vehicles covered under financing.
- ?? Heavy replacement demand anticipated on account of Modernization of old Commercial Vehicles.

- ?? According to a Study, total funds requirement in the year 2000 for road transport financing was Rs. 7000 crores, out of which used vehicle funding was around Rs. 1100 crores.
- ?? Surface Transport Ministry expects demand to translate into 30 lacs commercial vehicles by the year 2005 with additional investment of Rs. 5000 crores to meet commercial vehicles demand.
- ?? It is estimated by various study groups that each commercial vehicle manufactured sold & financed in this country gives direct & indirect employment to minimum 6 persons, thereby providing employment generation to several lakhs of people all across the country. It is the most geographically well spread network accessing the remotest village in India.
- ?? The potential of the commercial vehicles financing industry is estimated at Rs. 15000 crores and is growing fast. Another Rs. 6000 crores would be required for phasing of commercial vehicles, which are more than 15 years old.
- ?? Borrowers Profile: Mainly Retail with minimum individual/group exposure and therefore, concentration risk is reduced.
- ?? Priority of Repayment: Being an earning asset, it ranks high in priority.
- ?? Ticket value of each transaction: Rs. 6 to 10 lacs for new vehicles and 1.5 to 5 for used vehicles.
- ?? CRISIL in its study has placed commercial vehicle financing under the “low risk” category, in its Risk Continuum.

2. Asset Creation

NBFCs have demonstrated their strength has been in creation of productive national assets through leasing and other modes of financing. In fact, most developed economies have relied heavily on lease finance route in their developmental process. NBFCs have been played a major role in promoting leasing, hire-purchase, loan disbursals etc. in different economic activities, be it infrastructure creation or developing key support services for such infrastructure. Most developed countries exhibit impressive market penetration of leasing (a measure of leasing in capital creation). US (31.1%), Canada (20.2%), Australia (20%), UK (15.3%), Sweden (13%) and France (12.9%) enjoy double-digit penetration rates followed by Japan, Germany and Italy with near double-digit rates. Compared to these nations, India’s market penetration in leasing stands at somewhere between 2-3%. Even developing economies like Russia, Mexico, Turkey have better market penetration when compared to India. This clearly reflects the conducive legislative and regulatory regime that the respective governments have created towards promotion of leasing.

For a developing nation like India where infrastructure creation has been presently accorded highest priority, leasing has immense potential. More particularly in the case of small and medium enterprise (SME) sector which accounts for the lion's share of the entire economic activities in our country, leasing offers tremendous advantages and hence needs to be promoted in a big way.

3. Observations made by RBI and various Government Committees :

A. *Observations made in the RBI's latest report titled "Report on trends on progress of banking in India 2003-2004"*

"Notwithstanding their diversity, NBFCs are characterized by their ability to provide niche financial services in the Indian economy. Because of their relative organizational 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 adds,

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

B. *Observations made by the Parliamentary Standing Committee on Finance in their 45th Report on The Financial Companies Regulation Bill, 2000*

- a) NBFCs have higher level of customer orientation, fewer pre and post sanction requirements and provide simple and speedy tailor made services.
- b) NBFCs have become an integral part of the Indian Financial System in view of their complementary as well as competitive role.
- c) Non-Bank credit cover 70% of the requirements for the Trading activity and more than 50% of the requirement of unregistered manufacturing.

C. *Observations of the Task Force on NBFCs (Vasudev Committee) appointed by Government of India in 1998.*

- a) Financial intermediaries like NBFCs perform the function of being a link between savers in the society and users of the savings.
- b) NBFCs have greater reach and flexibility in tapping resources and they provide retail services to small and medium level business and road transport operators.

- c) NBFCs constitute an important link between banks and the requirer of services and are an important component of a diversified financial market.

Direct Tax Issues

1. Sec.36 (1) (viiia) / 43D Of The Income Tax Act, 1961

Under the existing provisions u/s 36(1)(viiia) in the Income-Tax Act, a provision for bad and doubtful debts made by banks and financial institutions is allowed as a deduction to the extent of 7.5% from the gross total income. NBFCs are also compulsorily required to make provisions for NPAs. However, provisions made by NBFCs in line with such prudential norms fixed by RBI are disallowed by tax authorities when assessing their income tax liabilities. These provisions made against NPAs are in the nature of business expenses incurred wholly and exclusively for business operations by an NBFC.

Therefore, these provisions should be allowed to be deducted while arriving at the taxable profits of NBFCs. Any recovery made against these allowed provisions could be made taxable later on.

Banks / HFCs / FIs enjoy tax benefit on income deferred as per RBI directives on NPA. NBFCs are also required to follow these prudential norms as per RBI directives, but they are the only segment of the financial sector denied this tax benefit.

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, 1961 applicable 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 relief insofar as its investments in the specified infrastructure projects through lease, hire purchase or loan transactions are concerned.

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.

4. Proposed amendment in Section 194-I of Income Tax Act [vide Taxation Laws Amendment bill 2005]

Section 194-I of the Income Tax Act deals with TDS on rent payments. The present TDS rate is 22.44% (20% TDS + 10% surcharge + 2% education cess).

In this section, the definition of 'rent payment' has been enlarged to include lease, sub-lease, tenancy or any other agreement or arrangement for use of machinery, plant, equipment etc. besides land and buildings.

The implications are grave as this can spell the death of the NBFI sector in India as their mode of financing is primarily leasing.

As explained in previous paragraphs, NBFCs operate on very thin margins. On that, if a 20% TDS is applied on lease rentals, this will result in negative cash flows. It must be pointed out that unlike renting, leasing is a mode of financing and major portion of lease rentals includes repayment of principal just like a loan repayment. If TDS is deducted on entire lease rental, it means not only will the TDS be deducted on the interest, but also on the principal amount. This can spell disaster for the NBFC sector in India leading to its extinction.

Suggestions:

- 1. Subjected 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 are extended to NBFCs also.**
- 2. If an appropriate environment for development of infrastructure is to be created, govt. must provide incentives for all kinds of investments and participants in the listed infrastructure projects irrespective of their types or categories.**
- 3. Exemption should be granted from TDS on interest payment to NBFCs u/s 194A (3)(iii) of the I.T. Act.**
- 4. Lease and sub-lease should not be included in Section 194-I of Income Tax Act.**

Indirect Tax Issues

1. Service Tax on Hire Purchase/ Lease Transactions

- i) *Service Tax levied on Processing Charges and Interest/Finance Charges in case of Lease & Hire Purchase Transactions*

Union Budget 2001 (Finance Act, 2001) levied Service Tax on Financial Leasing Services, including Equipment Leasing & Hire Purchase Transactions. Service tax in case of Financial Lease & Hire Purchase Transactions has been levied on:

- a) The Lease Management Fee/Processing Fee/ Documentation Charges (recovered at the time of entering into the agreement) and
- b) On the Finance/Interest Charges (recovered in monthly installments)

- ii. *Service tax levied on Processing & other Charges in case of Loan Transactions (Interest is exempted from the levy)*

Union Budget 2004 had levied service tax on the processing fee/documentation fee in case of Loan Transactions. However, the interest component has been clearly exempted from the levy of service tax.

- iii. *Service Tax on Interest/Finance Charges in case of Lease/Hire Purchase Transactions is unjustified.*

- a) Nature of Lease & Hire Purchase Transactions

Lease and Hire Purchase transactions are in substance deemed “sale” transactions as per the 46th Amendment to the Constitution of India. The lease rentals / hire purchase installments are the sale proceeds (for the concerned asset) received on monthly basis over a period of few years.

- b) Components of lease & Hire Purchase Transactions

An asset given under Hire Purchase/Lease Transaction has three financial components:

- ?? Cost of the Asset (Principal)
- ?? Interest at a pre-determined rate – since the cost of the asset is recovered over a period of few years
- ?? Lease Management fee/Service Charges/Processing Charges/Document Charges

The Hirer/Lessee (User) to whom the asset is given pays back in monthly (or any other such frequency as may be agreed) installments called Hire Purchase/Lease Rentals over a mutually agreed period of time. These Hire Purchase/Lease Rentals consist of both the principal (cost of the asset) and the interest element.

Lease Management Fee/Service Charges/Processing Charges/Document Charges is a upfront charge recovered at the time of signing the agreement and ranges from 0% to 3% of the total amount.

c) Interest Component includes our Borrowing Cost and Operational Cost

The above said interest component in a lease rental/hire purchase installment is our income. However, it has to be kept in mind that this interest component charged by us from the hirer/lessee includes our cost of borrowing from banks and public in the form of Fixed Deposits. In addition to this, there are operational costs and delinquencies in the form of making provisions for non-performing assets as per RBI guidelines.

Suggestions:

Interest/Finance charges in case of Lease & /Hire Purchase Transactions should be exempted from the levy of service tax. As such service tax in case of lease & hire purchase transactions should be levied only on lease management fee/processing fee/documentation fee.

This shall be in tune with the levy of service tax in case of loan transactions where interest component has been clearly exempted from the levy of service tax.

2. Treatment of Hire Purchase & Lease Transactions – Multiplicity of Taxes

- (i) As per the 46th Amendment to the Constitution of India, Hire Purchase & Lease Transactions are defined as deemed 'sale' activities. As such, they were subject to sales tax @ 4 to 14% in different states and are now subject to Value Added Tax (VAT) in all the states.
- (ii) Finance Act, 2001 defined Hire Purchase & Lease Transactions as "service" and as such, the interest component in these transactions is subject to service tax @ 10%.
- (iii) The Lease Rentals /Hire Purchase transactions are also subject to Tax Deduction at Source (TDS).
- (iv) There are also many instances where Interest tax Demands have been made on these transactions.

- (v) Tax Department looks at all the Lease Transactions with suspicion. As such Depreciation benefits to the lessor (who is the owner of the asset) are often denied.

At various instances, the same transaction is being treated as Sale Transaction, Finance and Service simultaneously. This anomaly and confusion has created enough regulatory problems, which will compound further in future and will be severely detrimental to the interest of every player in the economy. As a result of multiple taxation, Hire Purchase/Leasing are being killed by making them economically unviable.

Suggestion:

There is an urgent need to establish clarity on leasing. A clear definition and as such a clear tax treatment of Hire Purchase/leasing needs to be stated.
