News Article

NBFCs find the PFI way to SARFAESI Act

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News Update

Recently, using the newly amended guidelines, some Non-Banking Financial Companies (NBFCs) have found their way to the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI), 2002 as some have been notified as Public Financial Institution (PFI). The SARFAESI Act is not applicable to NBFCs, however it is applicable to PFIs.

The Ministry of Corporate Affairs has laid down guidelines for declaring financial institution as Public Financial Institution under Section 4A of the Companies Act, 1956 vide General circular no. 34/2011 dated 2-06-2011[1]. Hence every financial institution applying for declaration as PFI shall fulfill the following criteria:

- It should be established under a Special Act or Companies Act being Central Act
- The net worth of the Company should be rupees one thousand crore
- Their main business should be infrastructural or industrial financing
- It must be in existence for at least 3 years also their income from industrial/infrastructure financing should be exceeding 50% of their income
- The company is registered as Infrastructure Finance Company with Reserve Bank of India(RBI) or as an Housing Finance Company with National Housing Bank(NHB)

While issuing the guidelines, the Ministry laid down that in case of Central Public Sector Undertakings (CPSUs) and State Public Sector Undertakings (SPSUs), the restriction with respect to financing specific sectors and net worth shall not be applicable.

Prior to the amendment, the Central Government notified institutions as PFIs if it satisfied any of the following conditions stated under 4A(2) of the Companies Act, 1956:

- It has been established or constituted by or under any Central Act;
- Not less than 50% of the paid up share capital of such institution is held or controlled by the Central Government.

Section 4A(1) of the Companies Act, 1956 defines Public Financial Institutions as:

"(1) Each of the financial institutions specified in this sub-section shall be regarded, for the purposes of this Act, as a public financial institution, namely:-

> i. *the Industrial Credit and Investment Corporation of India Limited, a company formed and registered under the Indian Companies Act, 1913 (7 of 1913);*

[1] http://www.mca.gov.in/Ministry/pdf/Circular_34-2011_02jun2011.pdf

ii. the Industrial Finance Corporation of India, established under section 3 of the Industrial Finance Corporation Act, 1948 (15 of 1948);

iii. the Industrial Development Bank of India, established under section 3 of the Industrial Development Bank of India Act, 1964 (18 of 1964);

iv. the Life Insurance Corporation of India, established under section 3 of the Life Insurance Corporation Act, 1956 (31 of 1956);

v. the Unit Trust of India, established under section 3 of the Unit Trust of India Act, 1963 (52 of 1963);

vi. the Infrastructure Development Finance Company Limited, a company formed and registered under this Act."

Impact of the amendment

The recent guidelines for PFI were amended by the Central Government permitting private companies, principally engaged in infrastructure funding, to be categorized as PFIs, vide Notification No. S.O.1355 (E), dated 10-6-2011[2]. Pursuant to this notification, L&T Infrastructure Company Limited, being one of the private NBFC, has attained the status of a PFI under section 4A(2) of the Companies Act, 1956.

Other NBFCs falling under this category are as follows:

- Sicom Limited
- Gujarat Industrial Investment Corporation Limited
- Andhra Pradesh Industrial Development Corporation Limited
- Karnataka Urban Infrastructure Development and Finance Corporation Limited

Implications of being a PFI

It is discernible that NBFCs are not covered under the SARFAESI Act. However, by virtue of being classified as a PFI u/s 4A of the Companies Act, 1956, they get covered under the definition of financial institution for the purpose of the SARFAESI Act. Consequently upon getting the status of PFI, they have found a way to recover debts and to foreclose the security. Hence, these developments will further strengthen the recovery capabilities of the company. It is only a few among the total number of NBFCs that have been covered under the SARFAESI Act, 2002. Most of the NBFC are unable to recover bad debts. Hence, the working group of RBI, headed by Smt. Usha Thorat rightly recommends that the Act should be extended so as to cover the NBFCs within its ambit.

[2] http://www.mca.gov.in/Ministry/notification/pdf/S.O.1355(E)_10jun2011.pdf

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Besides the aforementioned implications, NBFCs notified as PFIs, will now enjoy certain benefits under the Companies Act, 1956, Income Tax Act, 1961 and Recovery of Debts due to Banks and Financial Institution Act, 1993.

As per the Companies Act, 1956, a PFI may issue Shelf Prospectus (Section 60A). Also under Section 224A, incase not less than 25% of the subscribed share capital is held by PFIs, they are required to appoint auditor of the company by special resolution.

There are several important implications of being a PFI under of the Income Tax Act, 1961 as well.

Under Section 43B Clause (d), in case the borrower defaults in the payment of interest on any loan or borrowing, borrowed from a PFI, a deduction shall not be allowed to the borrower in respect of delayed payment of interest. This becomes a very significant demotivator for a borrower who has borrowed from a PFI in defaulting, and will ensure timely payments of dues to PFIs.

Under Section 36 (1) (viia) (c), deduction shall be allowed in respect of any provision for bad and doubtful debts made by PFIs, upto an amount not exceeding 5% of the total income (computed after making any deduction under this Section and Chapter VI A). This is quite an important benefit, since in case of NBFCs, deduction for provisions for bad/doubtful debts is not allowed as a deduction. You may refer to Supreme Court judgement in the case of Southern Technologies limited vs JCIT, on 11th January 2010[3]. We are also of the view that the limit of 5% of total income may be sufficient to allow PFIs the benefit of the deduction.

Also under Section 43D, the income by the way of interest in relation to categories such as bad or doubtful debts, based on subsequent recovery, shall be chargeable to tax in the previous year in which it is credited by the PFIs.

There is also a very significant benefit to PFIs in terms of ability to offer bonds and other securities. Bonds issued and certain other liabilities of PFIs are treated as eligible investment for insurance companies, Residuary Non-Banking Finance Companies (RNBCs), Provident Funds (PFs) and Mutual Funds (MFs).

[3] http://www.indiankanoon.org/doc/1689806/

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