Article

RBI goes for truth-in-lending: bars suppliers subvention financing

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Analytical Speaking

The notification of the RBI, dated 17th September 2013, on vendor subvention loans, zero-cost credit card EMI loans, and so on , will go a long way to create an environment for truth-in-lending regulations in India. Truth-in-lending laws, found in many countries world-over, ensure that lenders make a truthful disclosure of their rates of interest, and do not try to attract borrowers with misleading rates of interest. Truthful disclosure of rates of interest is as important as fair disclosures made by a vendor selling goods.

There was a time when there was no truth in lending in India at all. A lender could get away with disclosure of what was called "flat rate of interest", which was almost like half of the actual interest rates. Leading housing finance lenders would show what was called "annually declining rate of interest", which was also was deceptively lower than the actual interest rates. It was sometime in 2009 that the RBI required disclosure of the actual rates of interest in case of loan transactions.

Supplier subventions:

The financial press commented on the RBI notification of 17th September. Most comments focused on the credit card EMIs. Credit card issuing banks quite often promise an interest-free EMI loan if a particular card is used for a particular purpose- saying, booking of a travel. There are no free lunches in life; neither is there any interest free credit in the world of banking. It is just that the bankers are getting merchant commissions from the respective merchants offering the services - in this, the airline or the travel company, from which the interest is being made up.

However, the financial world has not been able to see or stress on another part of the RBI notification, which pertains to supplier subventions in asset-backed financings. This pertains to financing of assets like cars, commercial vehicles, construction equipment, infrastructure assets, and so on. Typically, subventions come in two ways:

- A supplier interest-free credit, for a certain period, say 6 months
- A supplier commission – these are typically based on volumes achieved, and may go up several percentage points

The arrangement is, when a bank or NBFC gives asset-based financing to a client, the supplier may provide a credit, or commission or both. Thus, the lender charges a lower interest rate from the borrower, and makes up for the same by way of credit, or commission or both.

The table below gives a view of the impact of the commission and credit:

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Tenure of funding	36	months	
	months	Actual Yield	Customer cost
Supplier's credit	1	13%	12.25%
	2	13%	11.50%
	3	13%	10.75%
	4	13%	10.01%
	5	13%	9.27%
	6	13%	8.54%
Supplier commission	1%	13%	12.30%
	2.00%	13%	11.59%
	3.00%	13%	10.88%
	4.00%	13%	10.17%
	5.00%	13%	9.45%
	6.00%	13%	8.73%

As may be seen from the above table, an actual implicit interest cost of 13% may be dressed up as only 8.54%, if the lender is a getting a supplier's credit of 6 months.
And this may sound tempting enough. Not that the borrowers are not aware that banks will not be willing to lend at 8.54%, and there is something which is not meeting the eye – however, the opacity is all that clouds decision-making, and breeds unfair practices in the market.

Who all are doing it:

Supplier subventions are common place all over the world of asset-backed financing – manufacturers of automobiles, commercial vehicles, construction equipment, even IT sector – all actively try to promote the sales of their products through subventions. And interestingly, this practice is not limited to India – it spreads all over the world.

RBI dictat against subvention-based funding:

The RBI's notification puts a curb on subvention-based financing. In very strong words, the RBI says: "If there is a discount offered in the price of a product, the loan amount sanctioned for the purchase should be after taking into account the discount, rather than giving effect to the benefit by reducing the RoI. Similarly, if there is a moratorium period for payment available, the benefit should be passed on to the customer by ensuring that repayment schedule, including the interest servicing, commence after the moratorium period only rather than adjusting it in the RoI. Thus in principle, banks should not resort to any practice that would distort the interest rate structure of a product as this vitiates the transparency in pricing mechanism which is very important for the customer to take informed decision."

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Advantage captives:

The RBI's notification is addressed to banks, but hopefully, this may soon be extended to NBFCs as well. In fact, if it remains limited to banks, there will be a huge arbitrage between banks and NBFCs, since NBFCs can still do what banks are now prohibited from doing.

However, one of the issues which may perhaps not have attracted the attention of the RBI is that prohibitions currently cast against banks, and prospectively against captives, will put captives to a huge competitive advantage. Captives are finance entities which finance products of their parents. Most of the manufacturers of capital assets today have their own captive finance companies as well – in which case, it may not even be necessary for them to pass on the benefit directly in form of credit or commissions, since, after all, the captives are financed by the parent by way of equity or debt funding. In other words, a parent may finance a captive in different ways – equity, cheaper debt, or otherwise, or may simply participate in the losses of the captive, without having to pass on a specific credit or commission at all.

This was create a non-level-playing field between captive finance companies and others.

Impact of the RBI notification:

The intent of the RBI – in ensuring that truth prevails in business of lending – is surely very laudable. However, it could not have come at a worse time. Asset-based financing is languishing. Defaults and delays are mounting; NBFCs are facing the toughest time over last decade or so. At this stage, anything which affects business will soon worsen into an existential question.