

## The time's ripe for financial sector reforms

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The financial sector deserves special focus, as it drives growth in the real economy. While a number of issues will undoubtedly compete for the finance minister's attention, there are a few relating to the financial sector that we hope will receive consideration.

The banking sector always has and will continue to have an increasingly significant role to play in supporting and fueling growth — both generally, and in a socially inclusive manner. The growth in the balance-sheet size of banks will require larger amounts of capital.

For state-owned banks, the capacity to augment capital could be constrained by the government's inability to contribute its share in any capital expansion; and if the government does not dilute its ownership, that could become a hard constraint for such banks.

The Reserve Bank of India (RBI) permits banks to raise capital through innovative financial instruments. Conceptually, these are quasi-equity instruments, which do not have all the rights attached to an equity instrument. Such instruments could provide a mechanism for raising further capital.

However, the taxation of such instruments is not entirely clear, and it would help if special provisions were included to provide clarity.

The other area for consideration could be to align the accounting and tax treatment in relation to loan provisioning. Provisioning norms are stipulated by RBI, and must be followed by every scheduled bank. However, for tax purposes, much of the provisioned amount may not be tax deductible.

With events that have occurred in the global financial economy, increased prudence and caution will be the byword — considering that banks and financial institutions have a critical role in maintaining the stability of the real economy. Accordingly, if sound provisioning requirements are imposed, denying a deduction for such provisions for tax purposes serves as a disincentive. Besides, aligning accounting and tax treatment generally, in the case of loan provisioning, has no overall impact on tax revenues other than the timing difference.

Another point related to provisioning is that of non-performing assets (NPAs). With a view to helping banks clear balance sheets and at the same time, bring specialist focus on realising NPAs, the government formulated the SARFAESI Act and licensed a number of asset reconstruction companies. To date however, the efficacy of ARCs has been somewhat limited. While there are a number of policy issues contributing to this that go beyond tax, the taxability of investors participating in trusts established by ARCs needs to be unambiguously clarified. One overall observation that even the limited preceding discussion suggests is the need for the income tax law to incorporate a specific set of provisions to deal with different aspects relating to the financial services sector. Presently, there are some specific provisions (e.g taxation of foreign institutional investors, taxability of mutual funds and distributions by mutual funds, deductibility of loan provisions etc).

However, as our financial markets become more sophisticated, there is a need to continually evolve tax framework to address new instruments and financial transactions such as derivative transactions in stock, interest rates or currency, deep discount bonds, financially engineered instruments such as warrants attached to equity or debt securities, which could be stripped and traded separately, stock lending and borrowing transactions, Indian depository receipts, etc.

The tax treatment of interest on loans received by Indian branches of foreign banks from their head offices and service tax implications on foreign exchange transactions also need to be clarified. Specific clarifications in these areas would be far more desirable rather than to have the tax treatment discovered through a long-drawn process of litigation. The costs and time associated with this process stifle innovation; in many cases, initiatives announced remain still-born.

Commenting on the financial crises in the US, the failure in part was attributed to the fact that a supervisory and legislative framework born in the aftermath of an early 20th century crisis proved inadequate in coping with the sophistication, scale and speed of the 21st century financial economy. From a narrower, tax perspective, this also applies to India's income tax legislation and needs remedy.

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(Views expressed are personal)