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NEWSLETTER

on Developments in Banking and Insurance Law

This newsletter is an initiative by the Centre for Banking and Insurance Laws, National Law University, Odisha, in furtherance of its aim to advance education, research and analysis in Banking and Insurance Laws.

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EDITORIAL- MARGINING MANDATE FOR INDIA'S OTC DERIVATIVES: REINFORCING SAFEGUARDS, EXPLORING PATHWAYS

Akhil Raj

INTRODUCTION

In 2020, the Central Bank of the country indicated towards establishing margining requirements for financial contracts including over-the-counter (OTC) derivatives that are not centrally cleared. However, this is something which cannot be called to be a novel step taken by the Reserve Bank of India (RBI) as the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO) proposed to develop the standards for margin requirements. Moreover, the Working Group on Margining Requirements (WGMR) was established in October 2011 by BCBS and IOSCO with input from the Committee on Payment and Settlement Systems (CPSS) and the Committee on the Global Financial System (CGFS) in order to develop a proposal on margin requirements for non-centrally cleared derivatives that would be available for public comment by the middle of 2012.

After introducing the Reserve Bank of India (Variation Margin) Directions in 2022 and the draft Directions establishing guidelines for the exchange of initial margin for non-centrally cleared derivatives in 2022, which served as the foundation for the recently released MD 2024, the RBI gradually moved toward bringing the Master Direction – Reserve Bank of India (Margining for Non-Centrally Cleared OTC Derivatives) Directions, 2024 (MD 2024).

To understand the rationale behind the implementation of MD 2024, we need to first grasp the concept of over-the-counter (OTC) derivative transactions and the necessity of margining for non-centrally cleared OTC derivatives.

DEMYSTIFYING OTC DIRECTIVES AND MARGINING

OTC derivatives are, at their core, financial contracts that are exchanged directly between two parties as opposed to via a centralized exchange. These agreements are made in a way that allows for customization and tailoring to the particular requirements of the parties. Interest rate swaps, credit default swaps, and foreign exchange forwards and options are examples of over-the-counter (OTC) derivative contract. Because they are private

events involving two parties, not traded on exchanges, and lack a central clearing procedure, these OTC derivative transactions are known as non-centrally cleared OTC derivative transactions. An interest swap agreement between Company ABC and XYZ, for example, would be referred to be a non-centrally cleared OTC derivative if it is made directly between the two parties without the use of a central clearing house or exchange. On the other hand, in a system that is centrally cleared, a central counter-party functions as both the buyer and the seller for each other, thereby guaranteeing the fulfilment of contractual obligations and mitigating counterparty risk.

The main queries, though, are: Why did the RBI think that margining rules for OTC derivatives were necessary, and what are margining restrictions exactly?

So basically, by requiring the exchange of initial and variation margins between covered entities—the players in the OTC derivatives market—the RBI established the margining regulations, which aim to fortify the risk management framework for the non-centrally cleared OTC derivatives and promote overall financial stability in the Indian derivatives market.

Variation margin is the collateral that is used by counterparties to offset the current exposure triggered by changes in the market value of the derivative. It may be described as a security deposit that changes from time to time to represent the daily change in value of the particular derivative contract. If a gain is realized with respect to the value of the derivative contract for one of the two contracting parties, then the counterparty will be obligated to pay variation margin. On the other hand, if the value declines for one of the parties (a negative amount), that the party will need to bring variation margin to the other party.

The initial margin essentially refers to a kind of premium or safety swap against future value fluctuation on the derivative contract. It is determined with the use of models likely to forecast the possible future exposure over a particular period of time say 10 days and is agreed between two counterparties at the time of inception of the contract and may be revised from time to time by changes in the possible future exposure.

Hence, variation margin is the current variation in the cover for the current gross exposure, while the initial margin refers to the initial amount of cover for the future potential gross exposure.

Nonetheless, there are clear disadvantages as well as possible advantages to this standardised strategy using margin exchange.

MARGINING: PAVING THE WAY FOR RESILIENT MARKETS

The rules governing margining that the RBI has put in place have quite a number of possibilities that may be beneficial to the Indian financial system as well as everyone within the market.

By prescribing initial and variation margins to be swapped the rules provide added bonus to the risk management practices of its players especially in regard to counterparty credit risk and potential future risks. Margining has significance in fulfilling commitments through lock-in of collateral, and the stronger margining forms managed to significantly enhance the general resilience of the global financial system, while preventing the build-up of systemic risk and subsequent effects for other counterparties in the case of default.

These Directions which are consistent with the BCBS and IOSCO Recommendations ensure that India meets international standards and compliance so as to encourage cross Border transactions. This has brought more clarity in the OTC derivatives market because there is compliance with unified guidelines as to how margining will be done, management of collateral and in case of a disagreement on the margins. Hedging with initial and variation margins can also address the counterparty credit risk concerns where market participants can limit the possible damages when a counterparty defaults.

MARGINING ROADMAPS: RECOGNIZING THE SPEEDBUMPS

To begin with, adopting the margining requirements entails stringent operational and compliance challenges. Establishing reliable methods and procedures for assessing the margin requirements, exchanging margins, and managing the exposures and legal paperwork can be time-consuming and expensive for smaller participants. This may require significant commitment of resources on technology platforms, information systems and human resources.

For instance, firms may require complex technology solutions on the calculation of initial margin as this involves calculation using quantitative portfolio margin models that relies on historical data, model validation and performance check. Also, solving complex legal and regulatory issues that may vary between jurisdictions can be complicated, and thus, may require establishing separate compliance

divisions and strict documentation procedures. The ability of exchanging initial margin impacts the liquidity of the players in the markets particularly during periods of stress on the markets or volatilities. Specified initial margins can correlate with immobilization of considerable cash collateral or other high quality liquid assets to finance the market risks which can restrain market participants from fulfilling their other liquidity demands or other opportunities. However, the costs related to acquiring and managing eligible collateral might be high in terms of funding cost of money and custodial fees, among other operational issues. These costs may be pushed to end-users of derivatives that may result in hedging solutions becoming expensive.

Furthermore, various risks related to initial margin requirements include the availability of eligible collateral and the impact of concentrating on specific types of collateral. Particularly, the choice of a haircut for different types of collateral can affect their efficiency as a risk mitigator and applying low haircuts can increase potential liquidity problems.

In the context of collateral management and margining, a haircut is a specific percentage that is deducted from the market value of an asset when it is given as collateral. The haircut that will be assigned to a particular type of asset will depend on the perceived risk and volatility of the different kind of assets available in the market. The haircut brings down the value of other assets that can be used to meet margin calls.

FORGING AHEAD: EMBRACING REFORMS, MITIGATING RISKS

The margining mandate for non-centrally cleared OTC derivatives is a reform agenda of central importance to enhancing the safeguards and enhancing financial stability of its OTC derivatives markets in India. The future benefits that will be derived from the implementation of the rules, though, make it worth pursuing despite the operational obstacles that need to be surmounted and the compliance issues that need to be addressed.

The decision to fix minimum initial and variation margins has enabled the RBI to bring the country at par with international norms and practices. This also facilitates international business and makes sure that the Indian markets are healthy, strong, and conducive for other international players. Margining is one of the essential aspects of risk management that help in managing counterparty credit risks and containing potential fallout from actual defaults.

Future challenges include a focus on risk management such as collateral, model risk for initial margin, legal and impact on liquidity. Lack of preparation may affect participation by limiting it because of operation challenges or high hedging costs.

It also means that the focused nature of the demand for high-quality security and potential risks associated with procyclicality in periods of stress require constant supervision and possible changes to the haircut regulation. Thus, it will be only through this continuous interaction between the RBI and industry that incremental changes that maintain the marginal risk reduction benefits, but at the same time offer the required flexibility for market dynamism, can be achieved.

Ensuring Transparency in Digital Lending Platform Aggregation: RBI's Proposed Guidelines

Ekta Gupta

Recently, the Reserve Bank of India (RBI) has released the 'Draft Guidelines on 'Digital Lending'- Transparency in Aggregation of Loan Products from Multiple Lenders' (Draft) which attracted everyone's attention to RBI's last year statement on Developmental and Regulatory Policies. In that statement RBI announced that it will create a regulatory framework to provide objectivity and transparency to Web Aggregators of Loan Products (WALP). Digital platforms or applications that aggregate and display loan offers from several lenders on a single website or app are referred to as WALP. These platforms are the bridge between the borrowers and the lenders/lending institutions.

Now, to understand the Draft, we need to understand the terms and conditions mentioned in the previous Guidelines i.e., 'Guidelines on Digital Lending' (Guidelines) released by the RBI on 22nd September, 2022. According to these Guidelines, the borrowers were only directly involved with the Regulated Entities (REs) i.e., the financial institutions that are directly controlled or regulated by the RBI, without getting to know about the actual lender or Lending Service Provider (LSP). This happened because various LSPs were registered with different NBFCs and Banks due to which they were displayed through different institutions at different place but the borrower could know only about the Bank or NBFC through which it was being displayed. Thus, the borrower was unaware of the actual lender.

RBI in its draft has mentioned the same reason as to why the Draft has been released and how to ensure more transparency in the digital lending space which is very much necessary in this digitalised era. The Draft mentions the new disclosures rules for the LSPs and REs which includes:

1. The LSPs to clearly provide all loan offers that are currently available from different lenders, giving consumers a complete picture to help them make well-informed decisions.
2. In order to ensure consistency across all queries, aggregators must implement and openly show systems that indicate lenders' willingness to give loans.
3. Crucial data has to be easily available, including the names of the lenders, the loan amount, the tenure, the Annual Percentage Rate (APR), and other parameters.
4. In addition, every loan offer needs to have a direct link to the Key Facts Statement (KFS) so that potential borrowers may get more specific information.

5. LSPs are trained to provide loan products objectively, without favouring any one lender over another or using deceptive methods.

By giving consumers thorough information about their loan alternatives, the guidelines enable them to make educated decisions. On a fair and impartial platform, borrowers may evaluate different loan options, encouraging smarter financial decisions. Further, it provides for better accountability as the borrowers will have the knowledge of the actual lender.

Furthermore, in order to offer their financial products openly and consistently with loan information, lenders are obliged to collaborate with LSPs. Lenders must update their online marketing plans and digital strategies in order to comply with these regulations. But at the same time, the Draft possess significant challenges on the RBI as the requirement of displaying all the loan offers in a standardized format in a fair way may require technological upgradation on the part of LSPs and also increase their operational costs. Also, the standardized display of the products will reduce the product differentiation which creates problem for the borrowers. It further reduces the data privacy that was earlier protected as the LSPs are now required to share borrower data to various lenders to solicit loan offers. Lastly, it creates regulatory burden on RBI and could become a lost cause if not implemented properly.

The Draft issued by RBI suggests how the digital lending sector has boomed over the years and there is a requirement for evolving laws to regulate the same. It shows that transparency and consumer protection are equally important with the technological advancement in the sector and are the key aspects which the RBI wants to focus while making the laws. The Draft is a good approach by RBI which needs to be implemented properly to be effective.

SEBI Issues Consultation Paper Allowing Indian Mutual Funds to Invest In Overseas Funds

Snigdha Dash

OVERVIEW

Recently, the Securities and Exchange Board of India (SEBI) recently released a consultation paper on facilitating investments by Indian mutual funds in overseas funds that allocate a portion of their assets to Indian securities. The purpose of the consultation paper is to facilitate the possibility of Indian mutual fund investments in foreign mutual funds or unit trusts (MF/UTs) that have exposure to Indian securities. Currently Indian mutual funds are limited in their investment options and this proposal aims to expand their avenues while addressing related concerns. This article will discuss the background reasoning proposal and implementation details of this measure.

BACKGROUND

Under existing SEBI regulations Indian mutual funds are allowed to invest in various eligible foreign securities such as American Depository Receipts/Global Depository Receipts stocks of foreign companies, debt securities money market instruments and derivatives. ADRs and GDRs are two types of depositary receipts with other types including European Depository receipts (EDRs), Luxembourg Depository receipts (LDRs), and Indian Depository Receipts (IDRs). While ADRs are shares of a single foreign company issued in the U.S, GDRs are shares of a single foreign company issued in more than one country as part of a GDR program. However, there is no specific provision for investing in overseas MF/UTs with exposure to Indian securities. As a result, many mutual funds are hesitant to make such investments due to regulatory ambiguities. India's promising economic growth prospects make its securities attractive to foreign investors. International indices and funds allocate a portion of their assets to Indian securities. For example, the MSCI Emerging Markets Index has a significant weightage to Indian securities. However, the lack of clarity regarding investments in overseas funds with Indian exposure hinders diversification efforts by Indian mutual funds.

PROPOSAL

After consulting with industry stakeholders and the Mutual Fund Advisory Committee (MFAC), the proposal suggests allowing Indian mutual funds to invest in overseas MF/UTs with exposure to Indian securities subject to certain conditions. The total exposure to Indian securities by such foreign funds should not exceed 20% of their net assets. This limit aims to strike a balance between facilitating investments and

preventing excessive exposure.

When investing in foreign MF/UTs, Indian mutual funds must ensure equal pooling of contributions from all investors, pro-rata rights, independent fund management, public disclosure of portfolios, and avoid any advisory agreements. Non-compliance with the 20% limit will result in consequences such as restrictions on further investments, liquidation of current investments, and penalties for the mutual fund or asset management company.

RATIONALE OF THE PAPER

The proposed 20% limit is justified by the increasing allocation of foreign funds/indices towards Indian securities. It aims to balance facilitating investments while limiting excessive exposure. The implementation details ensure transparency, autonomy in investment decisions, and alignment with regulatory norms.

The proposed initiative allowing Indian mutual funds to invest in foreign funds with Indian exposure could significantly impact Indian banks in various ways. Firstly, it may intensify competition for funds as investors attracted by the potential returns from international markets may shift their deposits from banks to mutual funds that offer this exposure.

Moreover, banks may need to adapt their liquidity management strategies to accommodate changes in depositor behaviour. A shift of funds from bank deposits to mutual funds could affect banks' ability to manage liquidity efficiently, requiring them to re-evaluate their asset-liability management frameworks and perhaps increase their reliance on alternative funding sources such as wholesale funding or interbank borrowing.

However, this initiative also presents opportunities for banks to diversify their investment portfolios. By investing in foreign funds through mutual funds, banks can indirectly gain exposure to Indian securities, potentially enhancing the risk-return profile of their investment portfolios. This could be particularly beneficial for banks looking to optimize their returns while managing risk in a dynamic market environment. Furthermore, collaboration between banks and mutual fund companies could emerge as a strategic option. Banks can explore partnerships with mutual fund companies to offer innovative investment products that provide exposure to Indian securities.

Such collaborations can leverage banks' distribution networks and mutual fund companies' expertise in portfolio management, creating value-added

solutions for customers and enhancing the competitiveness of both parties in the financial services industry.

However, this proposed initiative may also lead to increased regulatory scrutiny, with regulators closely monitoring the impact on financial stability, investor protection, and systemic risk. Banks will need to ensure compliance with regulatory requirements and keep up to date with any changes in guidelines governing investment activities and risk management practices.

CONCLUSION

The proposal allows Indian mutual funds to invest in foreign MF/UTs with exposure to Indian securities provides an opportunity to diversify investment portfolios while taking advantage of India's economic growth prospects. Feedback from stakeholders is crucial for fine-tuning the proposal and addressing any concerns. Implementation of this initiative can enhance the efficiency and competitiveness of the Indian mutual fund industry while providing investors.

RATIONALISING MSMEs THROUGH MSME LOAN SCHEME.

Suhani Sharma

INTRODUCTION

"In today's competitive market, the importance of Micro, Small, and Medium Enterprises (MSMEs) is undisputable. If elected again, the Modi government intends to give priority to enhance and simplify MSME incentive schemes. The roadway to achieve the same includes incentivizing domestic procurements from MSME's through the revamped PLI schemes. The government plans to consolidate various MSME subsidy and credit-linked schemes in order to broaden their scope and simplify the claim process.

For small-scale businesses, getting a loan is one of the greatest challenges out there. It would improve working capital availability if export credit guarantees could be enhanced as recommended by the NITI Aayog report. In addition, it suggests the establishment of a competitive single market for exporters' credit providers to lower financial charges for MSMEs. The Interest Equalization Scheme put into place since 2015 may be reconsidered post elections with an aim of increasing its impact on the MSME exporters.

Currently, there is no stipulation requiring PLI schemes to create a domestic supply chain. Nonetheless, Credit Guarantee Fund Trust for Micro and Small Enterprises has been doing wellhaving hit over Rs 1.5 trillion guaranteed amounts by February FY24 which represents an increment of 50% against Rs 1.04 trillion in FY23. This scheme helps MSMEs by availing collateral-free credit facilities up-to Rs 5 Crores.

Moreover, to further strengthen enterprises, the Government of India has launched the MSME Competitive (Lean) Scheme, which aims to improve their operational efficiency and market presence through Lean management principles.

This article provides an overview of the Lean Scheme, detailing its structure, the Lean tools it incorporates, its objectives, available subsidies, and the benefits it offers to MSMEs seeking to boost their competitiveness."

STRUCTURE OF THE MSME LEAN SCHEME

The Lean Scheme is a strategic initiative by the Ministry of MSME aimed at boosting the competitiveness of MSMEs through the application of Lean manufacturing principles. It encourages MSMEs to improve operational efficiency

by reducing waste and optimizing processes. This scheme enables businesses to manage resources, cut costs, and enhance service delivery, ensuring the evolving demands of both local and international markets.

Structured into three tiers namely Basic, Intermediate, and Advanced, the scheme provides subsidies for Lean implementation at different levels. At the Basic Level starting at a period of 2 years, MSMEs are launched on Lean initiatives and offered free training and consultancy to equip them with knowledge of Lean concepts. Moving to the Intermediate Level, enterprises are awarded a subsidy that covers up to 90% of consultancy fees, limited to ₹1,20,000 for a long intensive 6-month program. The Advanced Level provides even more support with subsidies covering 90% of consultancy fees up to ₹2,40,000/ – for the incorporation of lean advanced techniques throughout the course of 12-months. In doing so, MSMEs can build up their Lean skills and improve their operations incrementally over the periods specified in different levels.

Central to the Lean Scheme is a set of Lean tools aimed at enhancing the efficiency and quality of the operation in the MSMEs. These tools are very crucial for the improvement of various facets of production and operations. Some of these tools include 5S, Kanban, Kaizen, Value Stream Mapping, Poka-Yoke, and the rest are also aimed at specific aspects of improvement within the enterprise. Such tools can therefore be applied in the operations of the MSMEs to cut costs, as well as enhance productivity and quality. Further, the scheme has other broader objectives such as encouraging the use of Industry 4.0 technologies, improvement in quality of learning and skill enhancement and environmental sustainability.

OBJECTIVES AND BENEFITS

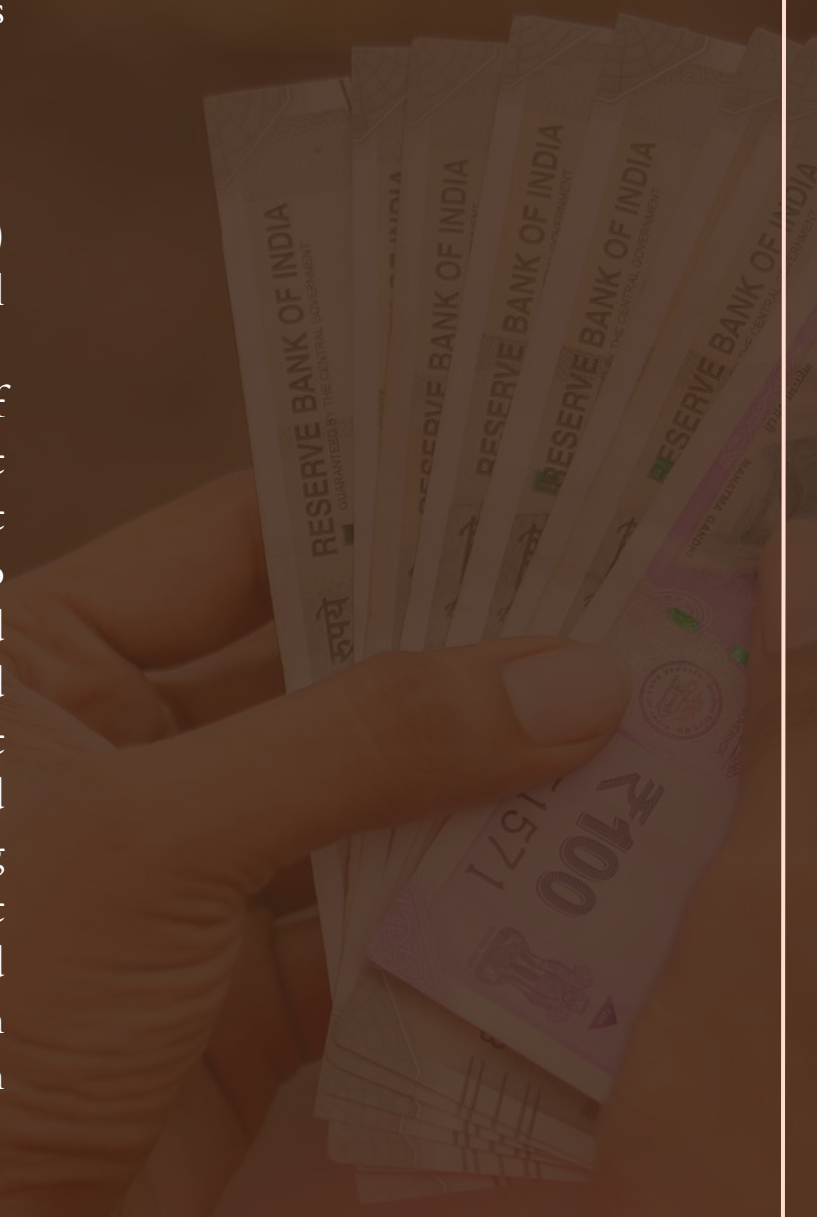
The Lean Scheme focuses on optimizing resources, improving quality, and the integrating industry with 4.0 technologies. This, in turn, increases productivity by reducing skill gaps and thus lowering rejection rates. Consequently, it improves profitability which is an impetus to MSMEs' digitalisation and a key driver for their growth and competitive edge.

It has been stated that the MSME Competitive (Lean) Scheme offers many benefits. Apart from upgrading overall operational efficiency to reduce costs, it ensures better quality in products as well as an inclusion of all employees on the route to continuous improvement. Participation on this note also ensures that there is long-term cooperation with suppliers at all times. Additionally, it allows those who

are involved in the MSMEs to innovate, manage risk factors as well as address them in a proper and effective manner so that they can keep up with the rapidly growing business environment currently.

CONCLUSION

The MSME Competitive (Lean) Scheme pushed up the operational competency significantly and impels The MSMEs to a higher level of competitiveness. A tiered support system for Lean management principles, starting from basic to advanced techniques like 5S and Kanban, optimizes resource use and enhances production quality. It supports continuous development and incremental innovation, allowing MSMEs to have a 'road' for growth that is currently leading to sufficient sound competitiveness in markets both domestically and internationally, which today's economic situation demands.



INTEREST-FREE LOANS BY BANKS TO EMPLOYEES NOW TAXABLE AS FRINGE BENEFITS: RULES SUPREME COURT

Vvanshika Singhal

A division bench of the Supreme Court comprising Honourable Justice Sanjiv Khanna and Honourable Justice Dipankar Datta while hearing an appeal in the case of 'All India Bank Officers' Confederation v. Regional Manager, Central Bank of India, and Others'[2024 SCC OnLine SC 803] ruled that interest-free/concessional benefits like that of a loan as granted by the banks to its employees is a taxable source as a perquisite under Section 17(2)(viii) of the Income Tax Act, 1961 (the Act). Additionally, the bench also ruled that the said provisions do not constitute any 'excessive delegation of essential legislative functions' and Rule 3(7)(i) of the Income Tax Rules, 1962 (the Rules) does not violate Article 14 of the Constitution of India.

FRINGE BENEFITS AND PERQUISITES UNDER THE INCOME TAX ACT

Any additional compensation given to their employees by their employers apart from the regular salary received by the employee is referred to as a fringe benefit. Such benefits are used to attract employees to the firm and at the same time retain and motivate the existing employees to work efficiently. Certain fringe benefits may include a tax implication while others may not, depending upon the type and value of the benefits offered to the employee.

Perquisites are such fringe benefits or amenities that are received by the employees over and above their salary. Section 17(2) of the Act, defines and provides the valuation of the various perquisites which may be offered by the organisation to their employees for tax purposes. The value of such perquisites is the cost which is incurred by the organisation in providing them.

THE MAIN CHALLENGES BEFORE THE COURT

The Appellants have challenged the vires of Section 17(2)(viii) of the Act, which provides that perquisites defined under the section includes a clause stating "any other fringe benefit or amenity as may be prescribed". Additionally challenging Rule 3(7)(i) of the Rules, which provides that the interest-free loans given to bank employees would be taxed if the rate of interest that the bank is charging is less than the rate of interest that the State Bank of India (**SBI**) is charging as per its 'Prime Lending Rate' (**PLR**).

The issue raised before the court dealt with the fact that firstly, Section 17(2)

(viii) of the Act leads to 'excessive delegation of the essential legislative functions' to the Central Board of Direct Taxes (CBDT), and secondly, Rule 3(7)(i) of the Rules is ultra vires of Article 14 of the Constitution on the grounds that the PLR of SBI is regarded as the benchmark of taxability rather than the actual rate of interest which is the bank is charging to its customers.

COURT'S OBSERVATIONS ON THE TWO MAIN ISSUES

The apex court gave a two-fold reasoning concerning the effect of rule 3(7)(i), firstly, the benefit of interest-free loans is regarded as "other fringe benefit or amenity" under section 17(2)(viii) of the Act, thus, would be taxed. Secondly, the court has prescribed a method for the valuation of such interest free loans provided by the banks for taxation purposes.

The court observed that the legislature while performing its function of enacting any law or statute, does put forth a specific meaning for the terms in the statute by providing a straightforward definition of the same. Such meanings are allocated to ensure accuracy and prevent any loose meanings for the terms. The court explained that section 17(2)(viii) is a 'residuary clause' added by the legislature to ensure flexibility and the law-making authorities have purposefully inserted such a clause and left it to the discretion of the tax authorities. Ultimately, in furtherance of the power provided under the said clause, the CBDT had enacted Rule 3(7)(i). There were two main questions/issues raised before the court:

(I) Are the 'essential legislative function' delegated to the CBDT under Section 17(2)(viii) and/or Rule 3(7)(i)?

As observed by the court in 'Municipal Corpn. of Delhi v. Birla Cotton Spg. and Wvg. Mills', the essential legislative functions must be preserved with the legislative authorities. This indicates the fact that once a legislative policy has been declared by the legislature, and the standard rules have been laid through such legislation, it can then leave the remaining task in the hands of the subordinate legislation. The court also clarified that any such power with the subordinate legislation under section 17(2)(viii) should not be considered as an unlimited power, as the same would be restricted because of the terms mentioned under section 17 of the Act.

The court opined that it is within the rule-making power of the subordinate legislation as granted under Section 17(2)(viii) of the Act to impose tax on the interest-free loans granted to bank employees. This clarifies that both Section 17(2)(viii) of the Act and Rule 3(7)(i) fall within the scope of the permissible delegation and ultimately not ultra vires to the Act. Therefore, the

'essential legislative function' is not excessively delegated to the CBDT under Section 17(2)(viii) of the Act.

(II) Does Rule 3(7)(i) violate Article 14 of the Constitution by arbitrarily using the SBI PLR as the standard?

In the issue raised before the court regarding the violation of Article 14, it was opined by the court that fixing 'SBI's interest rate i.e. the PLR as the benchmark rate' is not arbitrary and the same does not lead to the exercise of power in an unequal manner. It was observed by the court that such a benefit enjoyed by the bank employees is unique in nature, and it is of the nature of any other perquisite received by the employees and therefore the same is liable to be taxed.

Moving to the issue as to why taking SBI's rate of interest as the benchmark rate is not arbitrary, it is essential to consider that SBI is the largest public sector bank and ultimately the rate of interest as set by the bank would affect the rate of interest which is charged by other banks. It is to prevent any discrimination between the customers of different banks who may be charged with differing interest rates that such a clear benchmark had been set by the law-making authority. The court observed that Rule 3(7)(i) of the Rules would also ensure consistency in application and would provide clarity and certainty to both the revenue department and the assessee regarding the amount to be taxed. Therefore, the apex court observed that their intention is not to interfere with the legislation in question.

Therefore, any interest-free or any such concessional loan granted to bank employees would be taxed as a fringe benefit under Section 17(2)(viii) of the Act and Rule 3(7)(i) of the Rules and the same is intra vires of Article 14 of the Constitution.

'REVENUE NEUTRALITY' SINE QUA NON FOR PENALTY EXEMPTION U/S 78 OF FINANCE ACT: CUSTOMS EXCISE AND SERVICE TAX APPELLATE TRIBUNAL (CESTAT)

Kushagra Keshav

INTRODUCTION

The present case revolves around a significant issue regarding the applicability of the revenue neutrality principle in service tax issues specifically concerning the reverse charge mechanism. In the present appeal by the company challenging the order passed by the Commissioner of Central Goods and Service Tax (Appeals) Noida, the crux of the issue is the revenue authorities' demand for service tax, interest, and penalties on certain services received by the appellant, like rent-a-cab services, legal consultant services, cloud services, and software licenses. The appellant asserted that these services were input services, and that any service tax paid on them would have been accessible as Central Value Added Tax (CENVAT) credit, resulting in a revenue-neutral position.

The appellant, a Special Economic Zone (SEZ) unit engaged in software development, was registered for service tax. During an audit from April 2013 to June 2017, it was discovered that the corporation did not pay service tax of Rs. 91,46,357/- on some input services acquired through the reverse charge method. These services comprised rent-a-cab services, legal consultancy services (as indicated in Notification No. 30/12-ST), cloud services from Amazon Web Services (located overseas), and software licenses from Advent Software (located abroad). A show cause notice was issued, and the Additional Commissioner confirmed the demand for Rs. 91,46,357/-, plus interest and penalty.

On appeal, the Commissioner (Appeals) dismissed the demand for notice pay recovery but sustained the remaining demand of Rs. 79,44,489/-, plus interest and penalty. The company filed an appeal with the CESTAT, Allahabad Bench, alleging that because all of these were input services, the service tax paid would have been accessible as CENVAT credit, resulting in a **revenue-neutral** position. Therefore, no demand should have been made.

WHAT IS REVENUE NEUTRALITY?

In lieu of the foregoing, it is indispensable to understand the term 'Revenue Neutral'. It refers to a situation where the changes in tax laws in different countries or states do not result in a transaction escaping or not being taxed at both ends due to a change in total revenue coming into the system; the government's treasure. In other words, a

state in which the government does not make or lose any revenue. This concept is most common in the case of indirect taxes. Revenue neutrality is not a legal requirement. The theory is based on international principles and developing jurisprudence.

OUTCOME OF THE CASE

The CESTAT Allahabad Bench agreed with the appellant's claim of revenue neutrality. It determined that service tax was payable on all four services - legal services, rent-a-cab services, clouding services, and the acquisition of a Geneva product license - using the reverse charge mechanism.

The appellant was a registered service tax assessee qualified for CENVAT credit, and all the aforementioned services were input services, therefore the service tax paid would have been available as CENVAT credit to the appellant. As a result, the government had no actual revenue gain. Based on previous decisions of the court as in the case of Jet Airways and Coca-Cola, the Tribunal determined that when credit is accessible to the assessee himself, resulting in a revenue-neutral situation, no demand is sustained.

The Tribunal further stated that when the demand is not sustainable due to revenue neutrality, interest and penalties under Section 78 of the Finance Act of 1994 cannot be applied, citing case references of CCE, Pune v. Coca-Cola. As a result, the Tribunal granted the appeal, reversed the impugned decision, and determined that the appellant was entitled to consequential benefits under the legislation.

KEY TAKEAWAYS

1. **Broader application of the revenue neutrality principle:** This judgment reinforces the principle of revenue neutrality in cases where service tax is payable under the reverse charge mechanism, and the service recipient is eligible to avail CENVAT credit of the tax paid. It may encourage other assessees to claim the benefit of revenue neutrality in similar situations, leading to a reduction in demand, interest, and penalty liabilities.

2. **Clarity on interest and penalty implications:** The judgment establishes that when the demand itself is not sustainable due to revenue neutrality, interest and penalty under Section 78 of the Finance Act, 1994, cannot be imposed. This provides clarity to assessees and tax authorities on the implications of revenue neutrality cases.

3. **Increased emphasis on proper documentation:** Assesses would need to maintain proper documentation and records to establish the availability of CENVAT credit and the revenue neutrality aspect, as the burden of proof will lie on them to claim the benefit of this judgment.

CURRENT TRENDS IN GOLD LOANS IN INDIA: RBI'S WATCHFUL EYE

Subhashmin Moharana

INTRODUCTION

Banks' loans against gold jewelry have seen a dip in year-on-year growth, reducing from 26% in June 2023 to 15% in February 2024. The surge in gold prices has led individuals . In the past, gold loan outstanding soared by 77.4% (Rs 27,223 crore) to Rs 62,412 crore by July 2021 on a year-on-year basis. Gold loan interest rates remain reasonable, making them an attractive option for borrowers.

A gold loan is a secured loan where one pledges one's gold assets (such as jewelry or coins) as collateral. Typically, one can borrow up to 75-80% of the total gold value based on the current market value and gold quality. Gold loans generally attract lower interest rates compared to other types of loans. The processing fees and other charges for gold. There are no restrictions on how one uses the funds obtained through a gold loan. Gold loans do not offer specific tax benefits unless used for home improvement or property-related purposes.

A personal loan, on the other hand, is an unsecured loan, meaning one doesn't need to provide collateral. Personal loans typically offer higher borrowing limits compared to gold loans. Personal loans come with higher interest rates due to their unsecured nature. The processing fees and charges for personal loans may be higher. Personal loans have no restrictions on how one uses the borrowed amount. Personal loans are approved based on one's credit score and monthly income.

Recently, the Reserve Bank of India (RBI) has increased its scrutiny of the gold loan business conducted by Non-Banking Financial Companies (NBFCs). This move comes after discovering that some NBFCs, like IIFL Finance, were violating regulatory norms. These violations include lending amounts exceeding the 75% loan-to-value (LTV) ratio, inaccurate gold valuation, and irregularities in the auction process for defaulted loans. The RBI aims to enforce stricter compliance to ensure the gold loan business remains sustainable and to mitigate potential systemic risks.

This growing demand for Gold Loans roots from the impact of COVID-19, as gold loan is affordable credit. Therefore, the economic repercussions of the pandemic led to an increased demand for gold loans. Households and small businesses turned to gold loans to finance needs related to health, education, and

marriage. Gold loans provide a convenient source of credit for individuals who may not have access to traditional forms of lending. Banks and NBFCs offer gold loans at competitive interest rates.

RBI'S REGULATORY MEASURES

1. Loan-to-Value Ratio (LTV):
   - The RBI strictly regulates the LTV ratio for gold loans.
   - Lenders are permitted to give up to 75 per cent to 90 per cent of the gold jewelry's value.
   - This ensures responsible lending practices and prevents excessive exposure to gold-backed loans.

2. Purpose-Specific Usage:
   - The RBI mandates that gold loans be used for non-agricultural purposes.
   - Borrowers cannot divert the funds for speculative or agricultural activities.

3. Gold Monetization Scheme (GMS):
   - The GMS aims to mobilize gold held by households and institutions.
   - Under this scheme, individuals can deposit their idle gold with banks and earn interest.
   - The RBI encourages banks to implement the GMS to reduce the country's reliance on gold imports.

4. Gold Loan Market Growth:
   - Despite regulatory actions, the gold loan market continues to thrive.
   - Data from the RBI reveals a 15% growth in the gold loan market to ₹1 lakh crore in FY24.

4. Demand from MSMEs and Individuals:
   - A comprehensive report by Bajaj Markets highlights a surge in demand for gold loans.
   - Both MSMEs and individuals are availing gold loans due to low losses from Non-Performing Assets (NPAs) and attractive interest rates.

THE EVERGREENING PRACTICE

One common practice that the RBI aims to curb is "evergreening". Imagine a borrower avails a gold loan when the jewelry is valued at ₹1 lakh. Over time, if the price of gold increases, the value of the pledged jewelry also rises (e.g., to ₹1.50 lakh). When borrowers haven't paid the interest properly on their existing gold loan, they may seek an upgrade. They approach the bank, seeking to open a new loan account with the increased value of the jewelry (e.g., an additional ₹50,000). The RBI rules explicitly prohibit evergreening. Banks are not allowed to renew or upgrade existing gold loans based on increased gold prices.

RBI'S INSTRUCTIONS TO BANKS

1. Strict Compliance:
   - Post-audit inspections by the RBI have led to clear instructions to banks to ensure that gold loans are repaid and closed, not renewed or upgraded.
   - This move aims to prevent borrowers

from perpetually rolling over loans without proper repayment.

2. Transparency and Responsibility:

- While it's understandable that the regulator wants existing gold loans to be repaid, banks should transparently communicate this to customers.
- Customers need to be aware that they must repay their gold loans rather than relying on continuous renewals.

CONCLUSION

In recent years, gold loans have gained popularity in India due to their simplicity, minimal documentation, rapid availability of funds, and flexible repayment options. Borrowers can pledge their gold as collateral and borrow based on the gold's purity, weight, and market rate. However, the RBI is closely monitoring this sector to ensure responsible lending practices and prevent systemic risks. Gold loans continue to be a lifeline for many individuals and businesses. As the glitter of gold captivates borrowers, the RBI's watchful eye ensures that responsible lending practices prevail. Whether for emergencies, education, or business needs, gold loans play a crucial role in India's financial landscape. Remember, gold loans are not just about collateral; they represent a cultural legacy and a financial safety net for those seeking timely support.

EXTENSION OF ON-TAP LICENSING TO SFBS BY THE RBI

Pooja Reddy

The extension of the on-tap licensing policy to Small Finance Banks (SFBs) by the Reserve Bank of India (RBI) marks a significant shift in the Indian banking sector. This gives rise to the expectations that financial inclusion will enhance and the economy will witness a boost.

BACKGROUND

Small Finance Banks (SFBs) were introduced by the RBI in 2014. Currently, there are only 11 SFBs in India. Its introduction aimed to improve financial inclusion and address the needs of the marginalized sections of society, including low-income households, small businesses, and the unorganized sector.

In contrast to the unique concept of SFBs, the most common banking mode is Universal banking. The distinction between them lies in their customer base and branch location requirements. Universal banks can serve any type of customer without restrictions, while SFBs are specifically targeted towards small businessmen, unorganized workers, micro, small, and medium enterprises, and small farmers. Additionally, universal banks can establish branches anywhere, whereas SFBs must open 25% of their branches in rural areas during their first three years. Although both types of banks offer loans, SFBs must allocate 75% of their loans to the priority sector. Overall, while both Small Finance Banks and universal banks play crucial roles in the financial ecosystem, SFBs have a distinct mandate to enhance financial inclusion by serving the needs of marginalized communities. Hence, to tap into its benefits the on-tap licensing policy was extended to the SFBs.

THE ON-TAP LICENSING POLICY

The on-tap licensing policy is a regulatory framework that allows eligible entities to apply for a banking license at any time, as opposed to the previous approach where the RBI issued licenses during specific periods. This approach was adopted to increase transparency in the licensing process, ensure efficiency, and create a competitive environment.

It was initially introduced in 2016 exclusively for the convenience of universal banks. Later, in 2019, the scope of this policy was broadened to include SFBs mainly to achieve two objectives, i.e., enhanced financial inclusion and an expansion in credit availability by high-technology and low-cost operations.

This transition can yield several advantages for investors, such as enhanced operational flexibility and

profitability. A stronger and more diversified bank may increase SFB share prices and access to several regulatory benefits. This would also result in the permission to maintain a lower capital adequacy ratio of 11.5% rather than 15%, freeing up capital for other uses. The obligation of 75% priority sector lending would decrease to 40%, giving them more flexibility to pursue profitable lending opportunities. These benefits represent only a fraction of the overall scenario.

KEY CHANGES

The extension of on-tap licensing to SFBs comes with several key changes. The minimum requirement for paid-up voting equity capital or net worth is set at ₹200 crore. For Primary (Urban) Co-operative Banks (UCBs) wishing to transition voluntarily into SFBs, the initial net worth requirement is ₹100 crore, which must be increased to ₹200 crore within five years from the start of operations. Upon commencing operations, SFBs will receive scheduled bank status immediately and have permission to open their banking outlets from that date. Payments Banks will become eligible to apply for conversion into SFBs only after five years of operations, provided they meet the other criteria outlined in the guidelines.

The extension of on-tap licensing to SFBs is expected to have far-reaching implications. It will encourage more entities to enter the banking sector, thereby increasing competition, and access to financial services, and improving the quality of services.

Furthermore, the provision for Payments Banks to convert into SFBs after five years of operations provides a growth pathway for these entities. However, for these benefits to be fully realized, the RBI must ensure effective supervision and regulation of these banks to protect depositors' interests and maintain financial system stability.

CALCUTTA HC RULING EXEMPTS CO-OPERATIVE BANK EMPLOYEES FROM ELECTION DUTIES

Soumya Dubey

The Calcutta High Court, in a significant ruling, held that the employees of cooperative banks are not mandated to perform the election duties as prescribed by the Election Commission of India (ECI) under the Constitution of India and the Representation of People Act, 1951 (RPA). The judgement by Justice Sabyasachi Bhattacharyya, addresses the legal interpretation of "public servant" under Section 21 of the Indian Penal Code, 1860 (IPC) concerning election responsibilities.

The case involved petitions from the Malda District Central Cooperative Bank Employees Association and the Mugberia Central Cooperative Bank Employees Association who were assigned the role of polling officers for parliamentary elections under Section 26 of the RPI Act, 1951. The appointments were contested by the petitioners on the ground that the cooperative banks, registered under the West Bengal Cooperative Societies Act, 2006 are neither funded nor controlled by the government, thereby not being public servant or government employees. Consequently, the petitioners should not be requisitioned for election duties under Section 159(2) of the RPI Act. The petitioners also contented that Article 324 of the Constitution, which gives broad powers to the Election Commission, does not override the specific provisions of Section 159 of the RPI Act. Moreover, the definition of "public servant" in Section 21 of the IPC does not extend to cooperative bank employees.

The respondents, on the other hand, argued that authority granted under Article 324 extends in the present context too, along with the fact that the term "public servant" under Section 21 of IPC includes cooperative bank employees.

The court ruled in favor of the petitioners, highlighting the fact that co-operative banks are not government-funded or controlled and as a result are beyond the purview of Section 159(2) of the RPA in context of staff requisition. The court also held that the absence of prior requisition under Section 159 invalidated the appointments of cooperative bank employees as Polling Officers. It was emphasized that the broad powers illustrated under Article 324 of the constitution must be exercised in consonance with Section 159 of the RPI. The bench, in its analysis of cooperative banks as under the 2006 act also concluded that it is imperative to take into consideration the fact whether the said bank in question was established

by or under a 'Central, Provincial, or State Act'. In this case, such a requirement remained unfulfilled. Reliance was placed on previous rulings of the Supreme Court, notably Dalco Engineering Private Limited vs. Satish Prabhakar Padhye and others, and N.K. Sharma vs. Abhimanyu, which distinguished between a corporation established by or under an Act and a body incorporated under an Act, thereby rejecting ECI's argument of control of State over cooperative societies under Article 243 of the Constitution.

The ECI derives the power of appointing public servant for election duty from Article 324 of the Constitution so as to ensure free and free elections. However, the scope of getting exempted is narrow as Representation of the People Act, 1951, allows exemptions from election duties only under specific circumstances such as illness or unavoidable causes, non-compliance of which can lead to disciplinary actions. Hence, the present ruling has far-reaching implications for these bank employees, especially as it comes amid ongoing general and state elections across India. It reaffirms the legal boundaries within which Election Commissions can exercise its powers by holding cooperative bank employees beyond the definition of "public servants", provided their institutions are not government-controlled.

Hence, the Calcutta High Court's judgement sheds light on who can be considered a "public servant" under the IPC, especially in the context of lections, and reinforces the need for proper requisition procedures under the Representation of the People Act, 1950 (RPA).

IDFC BANK SHAREHOLDERS APPROVE MERGER : UNIFIED GROWTH AND EXPANDED OPPORTUNITIES

Dewansh Raj

INTRODUCTION

Infrastructure Development Finance Company (IDFC) First Bank has declared that its investors and non-convertible debenture (NCD) holders have approved the amalgamation resolution with its parent organization, IDFC Limited. This resolution came during the latest shareholder meeting which was ordered by the NCLT on May 17, 2024. Before this, the Board of Directors unanimously approved the proposed merger in a meeting held on the 3rd of July 2023. The shareholder approvals came as one of the last hurdles that the company had to cross before officially amalgamating into its parent company.

ABOUT THE BANK

IDFC Limited started its operation as an infrastructure lender in the private sector in 1997. The company stepped foot in the banking sector after receiving approval from the Reserve Bank of India (RBI) in April 2014 and in regards to the same subsequently established IDFC Bank. This is not for the first time that IDFC Bank is going through a merger but, in December 2018 IDFC Bank merged with Capital First, a non-banking financial company focusing on consumer and micro, small, and medium enterprises (MSME) lending which ultimately led to, to the formation of the IDFC First Bank. IDFC First Bank is one of the most recognizable entities in the banking sector with its revenue and operating income reaching Rs. 36,257. In 2024, the company's operating income also rose to ₹6,239 crore, while net income reached ₹2,942 crore (US$370 million) in 2024. Its total assets touched the mark of ₹296,210 crore and as of March 2020, IDFC First Bank employed 20,222 people.

SCHEME OF MERGER

The current scheme of the merger is a one-of-a-kind two-step merger process where IDFC Financial Holding Company Limited (IDFC FHCL) will first merge with IDFC Limited, and following this merger, IDFC Limited will amalgamate into IDFC First Bank.

In the shareholder meeting that was called and presided over by Mr. Varadharajan, the Director designated by the NCLT, shareholders' majority was not met because of the non-presence of the requisite number of shareholders. Subsequently, the meeting was dismissed and reconvened 30 minutes after the same and , the imperative majority was available. As per the administrative filings by IDFC First Bank, the resolution was passed by 99.95% of the equity investors,

who hold more than three-fourth value in the company and had the opportunity to, vote using e-voting practices. Besides, the proposition was also approved by an unprecedented 99.99% vote of the NCD holders.

After the shareholder approval, the NCLT granted its approval for the amalgamation. Following which the IDFC obtained all necessary approvals from various government agencies, including RBI which also gave the No Objection Certificate to IDFC first bank last December.

The merger is aimed to consolidate IDFC FHCL, IDFC Limited and IDFC First Bank into a single entity to simplify the corporate structure. The merger is anticipated to increase the value of IDFC's first bank by 4.9% based on the audited financials as of 31 st March 2023.

Once the merger is through and completed, the IDFC shareholders will receive 155 shares of IDFC's first bank for every 100 shares they hold in IDFC..

ANALYSIS

The merger comes just a few months after India's largest bank HDFC decided to merge with its parent company, these mergers are done so as to reduce the management burden and help streamline the accounting and regulatory compliances. The proposed merger will consolidate both entities into a single major public trading business, simplifying their corporate and organizational structures.

IDFC Limited shareholders will be granted shares of IDFC First Bank, resulting in ownership of a greater publicly listed company with multiple growth opportunities. IDFC First Bank will continue to be professionally managed when the Scheme takes effect, and it will solely have public shareholders.

The merger will also help to de-clutter and improve its finances at the same time benefiting the shareholders and the company. IDFC First Bank will be in a better position to take advantage of and contribute to the expected growth opportunities in the Indian banking system. The bank has a solid depository franchise and an established history of expansion. Further, the solid depository will help the bank expand profitably over the long term. It will also present a long-term opportunity for value creation and maximization of shareholders' value and returns.

CONCLUSION

The merger comes at a crucial juncture with the banking companies seeing exponential growth driven by the expansion of banking facilities to the newer untapped markets of rural India. The IDFC merger brings new hope for growth to the investors with the bank as now it will be having access to greater capital to expand and improve its services. Although the newly formed entity could hide the true picture of the banking side of things it is now only

obligated to submit a consolidated financial statement and hence should be more keenly regulated and looked into before investing.

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