Significance of the NBFC Sector

What is the issue?

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The significance of non-banking financial companies (NBFCs) calls for measures to revive the sector, in the backdrop of the recent crisis.

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How did NBFCs evolve?

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- There were days when moneylenders were charging exorbitant interest rates and dictating terms to the borrower.
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- Unlicensed moneylenders used to inhabit the rural neighbourhood without any regulation, leading to pricing inefficiencies.
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- Eventually, chit fund companies (regulated by states) and Nidhi companies (regulated by Ministry of Commerce) came up.
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- For the past decade or so, this space had been occupied by the RBI-regulated non-banking financial companies (NBFCs).
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- **NBFC** - An NBFC is a company registered under the Companies Act, 1956.
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- It engages in the business of
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i. loans and advances
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ii. acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature
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iii. leasing, hire-purchase, insurance business, chit business, etc
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- It, however, does not include any institution whose principal business is that of -

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i. agriculture activity
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ii. industrial activity
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iii. purchase or sale of any goods (other than securities)
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iv. providing any services and sale/purchase/construction of immovable property
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- NBFCs largely depend on market based funds.
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- They aim at bridging the gap in pricing inefficiency based on perceived risk.
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- **Now** - As of March 2018, there were 11,402 NBFCs registered with the RBI, of which 156 were deposit accepting (NBFCs-D).
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- There were 249 systemically important non-deposit accepting NBFCs (NBFCs ND-SI).
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- The aggregate balance sheet size of the NBFC sector as on March 2018 was Rs 22.1 trillion (around 15% of the banking system balance sheet size).
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- The financial performance of NBFCs-D has been quite impressive.
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- Their assets size has increased by 21.8% (CAGR - compound annual growth rate) in five years.
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- Their loans and advances have increased by 27.7% (five-year CAGR).
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What is the recent crisis?

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- India has been witnessing a huge surge in consumer leverage in recent years.
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- The non-bank intermediaries i.e. NBFCs have been growing this lending faster than banks.
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- In this backdrop, the IL&FS first defaulted on its obligations, drawing attention of the economic analysts.
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- Eventually, fund house DSP group offloaded Rs 200-300 crore worth of commercial papers of housing finance company DHFL at higher yields.
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- These sparked fears among the investors, and rumours spread about a systemic liquidity problem in the NBFC space.
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- From then on, NBFC stocks have been on a free fall.
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- A kind of contagion then spread to other financial stocks, and the benchmark indices crashed, creating wider impacts.
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- Following the credit crunch after IL&FS crisis, RBI provided special incentives to banks to enable the flow of funds to NBFCs.
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Why is the NBFC sector significant?

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- Certainly, the contribution of NBFCs is key to India's growth.
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- These companies played a critical role in the core development of infrastructure, transport, and employment generation.
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- It also contributed to wealth creation opportunities and financial support for economically weaker sections.
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- NBFCs also make a huge contribution to the state exchequer.
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- Significantly, NBFCs provide an alternative source of funding and liquidity.
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- Non-bank entities with specialised expertise provide an alternative source of

credit and certain functions in the credit intermediation chain more cost-efficiently.
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- As such, NBFCs represent a unique success story in financial innovation and last mile connectivity.
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- **Crisis** - Following the crisis, the NBFC sector was compared with shadow banking in India.
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- However, it might be immature to draw such a comparison.
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- Evidently, the size of the NBFC sector in India is around $0.4 trillion with a share of only 0.9% in the global shadow banking space.
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- In contrast, in China it has expanded to at least a $7 trillion business involving financial institutions.
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- Even in small jurisdictions such as Cayman Islands and Luxembourg the size of shadow banks is much larger than that in India.
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- NBFCs in India are also RBI-/SEBI-regulated.
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- The RBI has been quite farsighted in slowly migrating NBFCs to a Basel-like prudential regime structure.
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What lies ahead?

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- NBFCs still are a valuable alternative and can hardly be ignored.
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- So it is imperative that NBFCs are supported and the financial system is kept with adequate liquidity.
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- A combination of mid-course corrections by NBFCs themselves and regulatory changes could be effective.
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- Some of the investment and small finance companies have a large fixed asset base (including capital work in progress).
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- But finance companies need to be asset light so that they can improve their return on equity (RoE).

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- So asset heavy companies that have low yielding assets may now pursue an asset light model.
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- In fact, emphasis on consolidated numbers (*below*) remain key factors from a stakeholder's perspective:
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i. financials
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ii. quality of receivables
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iii. return on equity (RoE)
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iv. cash flow from operations
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v. portfolio mix
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vi. asset and liability management (ALM)
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- ALM needs to be straightened and a holistic touch in sub-sectors such as housing finance could be an ideal regulatory intervention.
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Source: Economic Times, Business Standard

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