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The Big Picture - What Ails NBFCs

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A string of defaults at Infrastructure Leasing and Financial Service Ltd's (IL&FS) have triggered sharp falls in Indian stock and debt markets amid fears of contagion within the rest of the country's financial sector. In October 2018, the government took control of IL&FS to protect the financial system and markets from potential collapse, and replaced its board. The new board has submitted a plan to revive the debt-laden firm.

The Department of Economic Affairs (DEA) fears significant default from large non-banking finance companies and housing finance companies in the next six weeks if no additional liquidity support is provided to these firms. Nearly 2 trillion rupees of NBFC and HFC debt is due for redemption by the end of December, the DEA said in its letter. It said it estimates a

funding gap of as much as 1 trillion rupees by the end of the year. The DEA, in a letter to the Ministry of Corporate Affairs, described the financial situation as "still fragile" when discussing the financial stability impact of the default.

What are NBFCs?

- The non-banking financial companies are registered under the Companies Act, 1956 and deals in the business of loans and advances, investments in bonds/shares/debentures/stock and other marketable securities viz. lease, hire-purchase, insurance business, but do not include any institution which is principally engaged in the business of agricultural activity, purchase of any goods and services (other than securities), industrial activity and sale/purchase/construction of immovable property.
- There are two kinds of NBFCs—
 - Deposit-taking NBFCs: The non-banking companies, registered with the Reserve Bank of India can accept the public deposits and must comply with the following regulations issued by RBI.
 - Non-deposit taking NBFCs

Major difference between Banks and NBFCs

Basic	NBFCs	Banks
Meaning	They provide certain banking services without holding Bank License.	It is government authorized financial intermediary which provides banking services to the public.
Regulated under	Companies Act 2013	Banking Regulation Act 1949
Demand Deposit	Cannot be Accepted	Can be Accepted
FDI	Allowed up to 100%	Allowed up to 74% for Private Sector Bank

Payment and Settlement system	Not a part of the System	An Integral part of the System
Maintenance of Reserve Ratios	Not Required	Mandatory
Deposit Insurance Facility	Not Available	Available
Transaction Services	Cannot be provided by NBFC	Provided by Bank

What are the major fund sources for the NBFCs?

- Long Term
 - These are through loans obtained from banks and insurance companies in a single quantum. A good credit rating is mandatory for raising large sums at a competitive interest rate.
 - Bonds are also used as a common route to reduce the interest rate on the sources of funds. In some cases, tax-free bonds are also issued for priority sectors such as infrastructure and roads.
- Short Term

Short term loans offered by an NBFC can be issued by raising funds through Commercial Paper (CPs), debentures and inter-corporate deposits. CPs are short-term unsecured promissory notes issued by companies, with a tenure of 3 months to 12 months.

Potential of NBFCs

- NBFCs is a form of shadow banking. The total loans from NBFCs of 5.46 trillion Rupees are 20% of banking credit itself.
- The year on year rise of total banking credit is 2.6%, whereas, loan to NBFCs has risen by 41%.

- As of March 2018, there were 11,402 NBFCs registered with the RBI, of which 156 were deposit accepting NBFCs (NBFCs-D), and 249 systemically important non-deposit accepting NBFCs (NBFCs-ND-SI).
- The aggregate balance sheet size of the NBFC sector as of March 2018 was Rs 22.1 lakh crore.

What ails NBFCs and particularly IL&FS?

- Several corporates, mutual funds and insurance companies had invested in short-term instruments such as commercial papers (CPs) and non-convertible debentures (NCDs) of the IL&FS group that has been defaulting on payments since August 2018. This has stoked fears that funds of many could have been stuck in IL&FS debt instruments which, in turn could lead to a liquidity crunch for them. This has become a cause of concern that the funding cost for NBFCs will zoom and result in a sharp decline in their margins.
- Banks have slowed down lending to NBFCs, virtually closing a major resource avenue for NBFCs.
- The fundamental issue, is an asset-liability mismatch in the operations of NBFCs like IL&FS. These firms borrow funds from the market — for 3 or 5 years — and lend for longer tenures — 10 to 15 years. Now, because interest rate are rising, the margin of NBFCs have suffered and consequently, funding to NBFCs has decreased. Hence, lack of funds has triggered such a scenario.
- Further, because of erosion of credibility of debt payment, their stocks have suffered majorly.
- There were more than 200 subsidiaries in case of IL&FS which brought considerable management problem, further worsening the status of NBFCs.

Way Forward

- NBFCs should be under greater supervision of the RBI with better regulatory mechanism. Since, they deal with a substantial portion of credit of the market, they cannot be left unregulated. This would ensure that they are not lending beyond their means.
- Instead of bringing all the NBFCs under supervision, effort must be made to focus on the systemically Important NBFCs, which are around 250.
- Adequate funding is necessary to make NBFCs a viable platform for investment in various developmental projects. Consequently, the first step would be to strengthen the banking sector.