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Regulating NBFCs

What is the issue?

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The Reserve Bank of India (RBI) is currently reviewing the reporting and financing requirements of NBFCs post IL&FS crisis.

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What are the possible regulatory measures?

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- There are more than 10,000 NBFCs in the country and they play a vital role in the economy as the third and most engaged layer of the financial system.
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- Infrastructure and project finance, as well as micro, small and medium enterprises, has come to depend upon the healthy working of the sector.
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- NBFCs defined as “large”, with assets of more than Rs 5 billion are being considered as systemically important ones and have been subject to differing requirements.
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- As lending from NBFC’s are increasing, it is likely that the RBI will bring their regulatory status close to that of banks.
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- Unlike banks, Non-Banking Financial Companies (NBFC) do not have access to low-cost public deposits and have to heavily rely upon commercial paper and commercial debt markets.
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- Commercial Papers(CP) are issued by companies, especially NBFCs, with high-quality debt ratings for raising money to meet their short-term liabilities.
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- Recently, IL&FS have raised a huge amount through CPs and since the

interest rates have soared to multi-year highs for short-term borrowings, they faced default on their borrowings.
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- Hence, a ceiling may be placed on the financing of NBFC sector by commercial papers.
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- In addition, the structural liquidity statements of large systemically important NBFCs could be made more rigorous.
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What is the need for this change?

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- Over the past few years, banks have exited some forms of lending and the NBFCs have taken its role to some extent.
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- This means that NBFCs are now a significant source of macroeconomic risk and thus the macro-prudential environment must be altered to reflect this new reality.
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- The recent crisis in Infrastructure Leasing & Financial Services, or IL&FS also underlined the importance of such a change.
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- Thus, the direction of this regulatory tightening is not to be argued with.
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- However, the timing must be carefully calibrated, keeping in mind the needs of the broader economy.
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- Some have argued that a full-fledged asset quality review of large NBFCs is needed as was conducted over the past years for commercial banks.
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- This would be a mistake at the present juncture, as it would likely increase irrational concerns rather than setting them at rest.
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What should be done?

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- It is to be noted that a gradual and careful examination, transformation and unwinding of assets and liabilities is ongoing post IL&FS crisis in the NBFC

sector.
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- This process should not be interfered by too rapid changes to the existing regulatory environment.
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- The market must be allowed to make reasonable decisions about rolling over NBFC debt.
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- Thus, while a transformation of NBFC balance sheets may well be essential, it is important for systemic stability that this takes place in a gradual rather than a rushed fashion.
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Source: Business Standard

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