# Significance of the NBFC Sector

## What is the issue?

\n\n

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

\n\n

## How did NBFCs evolve?

\n\n

\n
- There were days when moneylenders were charging exorbitant interest rates and dictating terms to the borrower.
\n
- Unlicensed moneylenders used to inhabit the rural neighbourhood without any regulation, leading to pricing inefficiencies.
\n
- Eventually, chit fund companies (regulated by states) and Nidhi companies (regulated by Ministry of Commerce) came up.
\n
- For the past decade or so, this space had been occupied by the RBI-regulated non-banking financial companies (NBFCs).
\n
- **NBFC** - An NBFC is a company registered under the Companies Act, 1956.
\n
- It engages in the business of
\n

\n\n

\n
i. loans and advances
\n
ii. acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature

\n

iii. leasing, hire-purchase, insurance business, chit business, etc

\n

\n\n

\n

- It, however, does not include any institution whose principal business is that of -

\n

\n\n

\n

i. agriculture activity

\n

ii. industrial activity

\n

iii. purchase or sale of any goods (other than securities)

\n

iv. providing any services and sale/purchase/construction of immovable property

\n

\n\n

\n

- NBFCs largely depend on market based funds.

\n

- They aim at bridging the gap in pricing inefficiency based on perceived risk.

\n

\n\n

\n

- **Now** - As of March 2018, there were 11,402 NBFCs registered with the RBI, of which 156 were deposit accepting (NBFCs-D).

\n

- There were 249 systemically important non-deposit accepting NBFCs (NBFCs ND-SI).

\n

- 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).

\n

- The financial performance of NBFCs-D has been quite impressive.

\n

- Their assets size has increased by 21.8% (CAGR - compound annual growth rate) in five years.

\n

- Their loans and advances have increased by 27.7% (five-year CAGR).

\n

\n\n

## What is the recent crisis?

\n\n

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

\n\n

## Why is the NBFC sector significant?

\n\n

\n
- Certainly, the contribution of NBFCs is key to India's growth.
\n
- These companies played a critical role in the core development of infrastructure, transport, and employment generation.
\n
- It also contributed to wealth creation opportunities and financial support for economically weaker sections.
\n
- NBFCs also make a huge contribution to the state exchequer.

\n

- Significantly, NBFCs provide an alternative source of funding and liquidity.
\n
- Non-bank entities with specialised expertise provide an alternative source of credit and certain functions in the credit intermediation chain more cost-efficiently.
\n
- As such, NBFCs represent a unique success story in financial innovation and last mile connectivity.
\n
- **Crisis** - Following the crisis, the NBFC sector was compared with shadow banking in India.
\n
- However, it might be immature to draw such a comparison.
\n
- 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.
\n
- In contrast, in China it has expanded to at least a $7 trillion business involving financial institutions.
\n
- Even in small jurisdictions such as Cayman Islands and Luxembourg the size of shadow banks is much larger than that in India.
\n
- NBFCs in India are also RBI-/SEBI-regulated.
\n
- The RBI has been quite farsighted in slowly migrating NBFCs to a Basel-like prudential regime structure.
\n

\n\n

## What lies ahead?

\n\n

\n

- NBFCs still are a valuable alternative and can hardly be ignored.
\n
- So it is imperative that NBFCs are supported and the financial system is kept with adequate liquidity.
\n
- A combination of mid-course corrections by NBFCs themselves and regulatory changes could be effective.
\n
- Some of the investment and small finance companies have a large fixed asset

base (including capital work in progress).
\n

- But finance companies need to be asset light so that they can improve their return on equity (RoE).
\n
- So asset heavy companies that have low yielding assets may now pursue an asset light model.
\n
- In fact, emphasis on consolidated numbers (*below*) remain key factors from a stakeholder's perspective:
\n

\n\n

\n
i. financials
\n
ii. quality of receivables
\n
iii. return on equity (RoE)
\n
iv. cash flow from operations
\n
v. portfolio mix
\n
vi. asset and liability management (ALM)
\n

\n\n

\n
- ALM needs to be straightened and a holistic touch in sub-sectors such as housing finance could be an ideal regulatory intervention.
\n

\n\n

\n\n

**Source: Economic Times, Business Standard**

\n

IAS PARLIAMENT
Information is Empowering
A Shankar IAS Academy Initiative