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A Study of the Non-Banking Finance Companies in India

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Abstract

In late 2018, the default by a major non-banking financial company (NBFC) in India led to a credit crunch in the Indian economy. The crisis raises questions about the business model of the NBFCs, and the role they play alongside banks in the economy. In this paper we analyse the evolution of the NBFC sector in India over time and its importance in extending credit and discusses the factors that may have contributed to the 2018 crisis. We attempt to understand the advantages and disadvantages of the business model of NBFCs, and the drivers of their rapid rise and subsequent challenges in recent years. We also briefly discuss the potential impact of the Covid-19 pandemic on the NBFC sector. Drawing lessons from the past, NBFCs need to be strengthened to play an important role in India's financial landscape.

Keywords: Non-banking financial company, financial intermediation, financial regulation, systemic risk, liquidity crunch,

JEL Code: G01, G23, G28

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I. Introduction

One of the major drivers of growth in an emerging economy such as India is sustained investment by the private sector. For triggering as well as sustaining investments, a critical factor is stable availability of credit. Historically in the Indian economy, credit has grown faster than gross domestic product (GDP). The ratio between the growth of bank credit and the growth of nominal GDP was between 1 and 2 percentage points and averaged at 1.42 for roughly a 60-year period from 1962 to 2019. For most of this period banks constituted the predominant source of credit in the formal economy whereas bond markets and non-bank lenders accounted for a relatively smaller share of credit.

Over the last few years, particularly since 2014, credit growth in the banking sector has been lackluster largely due to burgeoning non-performing assets (NPAs) on the balance sheets of banks, especially public-sector banks (PSBs). Some part of the shortfall in credit from the banking sector was compensated by flows of credit from non-banking finance companies (NBFCs) until 2018. In September 2018, the Infrastructure Leasing & Finance Co (IL&FS), a prominent NBFC, defaulted on its debt obligations. This event precipitated a crisis that engulfed the entire NBFC sector. Consequently, in the first half of fiscal year 2019-2020 (2019-20, ended on 31 March 2020),[1] there was a sharp decline in incremental credit from both commercial banks as well as NBFCs.

Even as the NBFC sector was struggling to recover from the 2018 crisis, the country was hit by another massive shock in the form of the Coronavirus (Covid-19) pandemic, which began spreading rapidly in India from March 2020. In response to the outbreak of the highly contagious disease, the Indian government announced a nationwide lockdown from 25 March which continued for more than two months. During this period, most economic activity came to an abrupt halt, non-essential businesses were suspended, and essential businesses got heavily curtailed. This latest shock is bound to have an adverse impact on the NBFC sector in terms of constrained availability of funding as well as growth in NPAs.

While much has been written about the NPA problems of the Indian banking sector in the post-2008 period (see, for example, Sengupta and Vardhan 2017 and 2019b), relatively less work has been done to study the NBFC sector and document the structural issues that this sector faces, in light of the 2018 crisis as well as the ongoing pandemic-related crisis.

The objective of this paper is to analyze the evolution of the NBFC sector in India over time particularly in the context of its role in commercial credit, throw light on the 2018 crisis episode, briefly discuss the potential impact of the Covid-19 pandemic on this sector and draw lessons from these events for the future of NBFCs. The paper attempts to understand the advantages and disadvantages of the business model of NBFCs, and the drivers of their rapid rise and subsequent challenges in recent years.

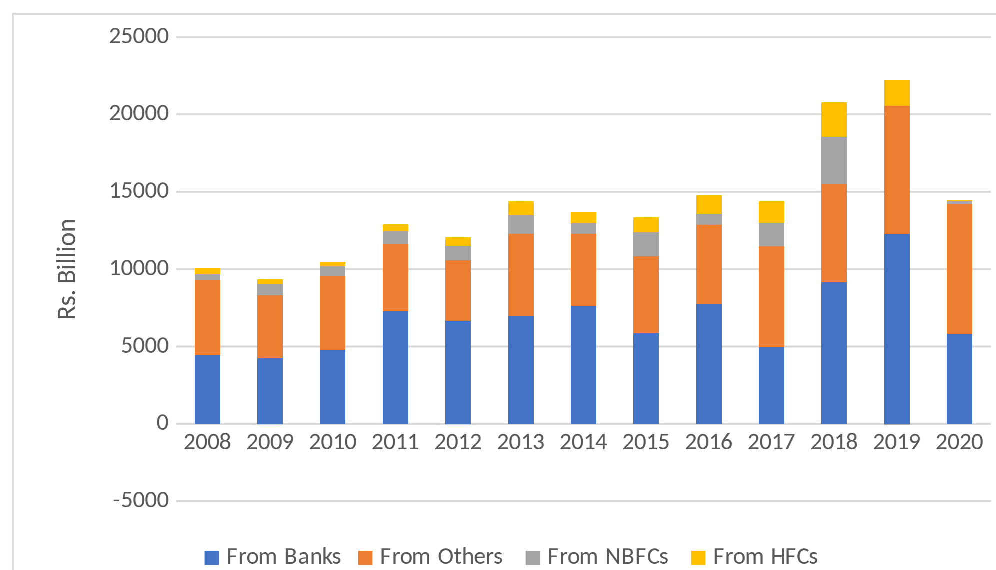
There are typically two models of providing credit: (i) intermediated credit that flows through the balance sheet of financial institutions such as banks and NBFCs; and (ii) market credit that flows through the bond market (sometimes through risk pass-through vehicles such as mutual funds). Historically, commercial credit in India has primarily relied on financial institutions because bond markets have not had the necessary liquidity and depth.

[1] The years in all figures are fiscal years starting on 1 April the previous year and ending on 31 March that year.

Within financial institutions, commercial banks have been the predominant providers of credit to the corporate sector as well as to consumers. Commercial banks by virtue of their ability to accept deposits have always been the largest and the most developed platform for converting household savings into investments, the quintessential role of financial intermediaries. In recent years, however, growth in bank credit has been slowing down and the non-bank sources of credit, especially NBFCs and housing finance companies (HFCs), have gathered momentum as alternative institutions for providing credit (Figure 1).

Figure 1: Flow of incremental commercial credit in India from various sources

Banks dominate but NBFCs and others expanded rapidly



Source: Reserve Bank of India (2020b).

Notes: Years are fiscal years ending March of that year. Others include bond issuance to insurance companies, mutual funds, commercial paper issuance, external commercial borrowings, etc.

NBFCs, as the name suggests, are companies that provide credit like banks but are not banks. A crucial difference between banks and NBFCs arises in their funding model. While all banks are permitted to accept public deposits – both demand and time, no NBFC is permitted to accept demand deposits and most of them are not permitted to accept time deposits. Only a small fraction of NBFCs is permitted to accept time deposits from the public and no new license has been issued to deposit-taking NBFCs after 1997.[2] As a result, public deposits constitute a tiny portion of the overall liabilities of NBFCs. Most NBFCs fund themselves by borrowing from commercial banks and by issuing bonds or debentures (often to banks and mutual funds), in addition to equity capital.

[2] NBFCs were set up under the Companies Act, 1956 and used to accept deposits. Given the dramatic increase in the number and volume of deposits received by the NBFCs-D, in 1997 a comprehensive legislative framework was introduced to protect the interest of the depositors. Since then, the Reserve Bank of India (RBI) actively discouraged the acceptance of deposits by NBFCs and accordingly stopped giving new licenses to NBFCs-D.

NBFCs differ widely in the business (lending) activities they engage in, their geographic and customer focus, and size. The Reserve Bank of India (RBI), the central bank and the regulator for banks as well as NBFCs, uses three parameters to classify NBFCs as follows:

- **Nature of business activities –** Based on the business of the company, ten different types of NBFCs have been defined. Of these, three are important from the point of view of providing credit –investment and credit companies, HFCs, and micro finance institutions (MFIs). MFIs primarily provide micro loans to borrowers (mostly women) from economically weaker segments under joint liability group lending programs. Hence, they are not relevant for understanding commercial credit, whereas credit and investment companies (referred to most commonly by the generic name NBFCs) and HFCs are important in the domain of commercial credit.

  Until July 2019, HFCs were regulated and supervised by the National Housing Bank (NHB). Since August 2019, the regulation of HFCs has been moved to RBI while their supervision remains with NHB.

  In October 2020, RBI introduced a circular to define HFCs as those NBFCs with at least 60% of their total assets in the housing sector and no less than 50% of total assets directed towards housing financing for individuals.[3] The total HFC loan book is roughly Rs 20 trillion (as on 19 March 2020), a significant part of the overall commercial credit.

- **Access to public deposits –** All NBFCs are classified into a small group of deposit taking (D) and a larger group of non-deposit taking (ND) companies. Of the total 9,462 NBFCs registered with RBI as of 30 September 2019, only 74 were NBFC-D.
- **Size –** NBFCs vary greatly in size. The minimum capital requirement to start an NBFC is relatively modest at Rs 20 million (about $270,000), unlike banks which need a license to operate and larger initial capital (currently Rs 5 billion for a universal bank). Many NBFCs are very small with a total balance sheet less than Rs 1 billion. In 2006, NBFCs were divided by RBI into two categories based on their asset size (Neelima and Kumar 2017) and those with assets greater than Rs 1 billion were classified as systemically important non-deposit taking NBFCs (NBFCs-ND-SI). This threshold was raised to Rs 5 billion in 2014. All other non-deposit taking NBFCs were considered a separate group (NBFCs-ND). Given their larger size, the NBFCs-ND-SI were expected to pose greater risks to the financial system and hence were subject to more strict prudential regulations compared to NBFCs-ND. As of 30 September 2019, there were 272 NBFC-ND-SI, which are the primary focus of this paper. At the end of September 2019, NBFCs-ND-SI had total assets of Rs 28 trillion, NBFCs-D Rs 4.5 trillion and HFCs Rs 13.5 trillion (RBI 2019). The government owns the two largest NBFCs-ND-SI and about 40% of their total assets, and about 10% of NBFCs-D, but only 5% of HFCs.

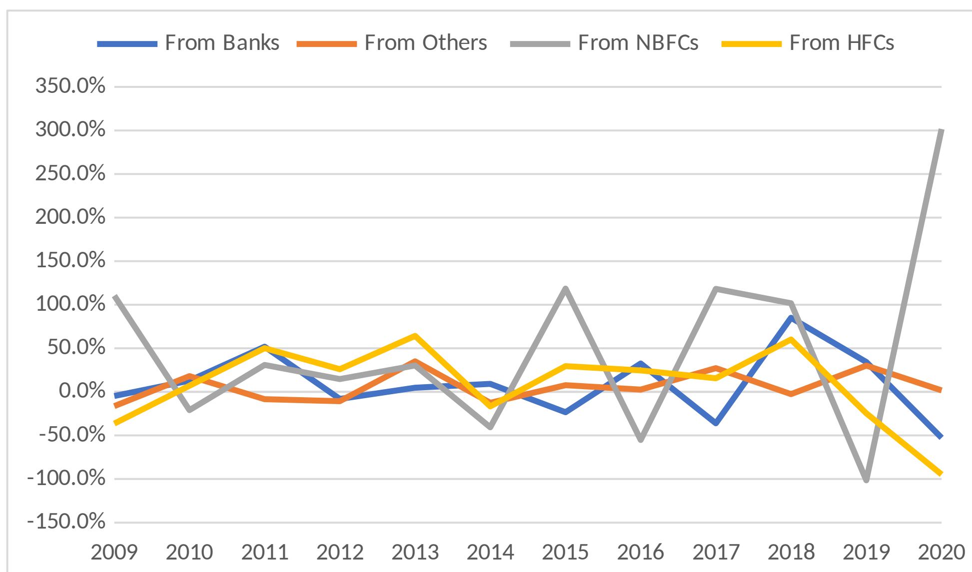
The relevance of these NBFCs as providers of commercial credit increased significantly in the last decade, especially since the banking sector began experiencing acute asset quality stress after 2015. As of March 2020, the share of NBFCs and HFCs in the institutional credit (i.e. credit from banks and non-bank financial institutions) is around 20%, net of banks' credit to NBFCs and HFCs. The average growth rate of incremental credit flows disbursed by NBFCs was 13.5%

[3] On 17 June 2020, RBI proposed new guidelines revising the definition and regulation of HFCs which will be applicable going forward and hence this is not applicable to our analysis. The guidelines are available at: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=49961

between 2014-15 and 2016-17 whereas during the same period bank credit grew by a mere 8.5% (Figure 2). This highlights the crucial role that NBFCs have been playing in the Indian financial landscape.

The IL&FS default and subsequent turbulence in the Indian credit markets in the autumn of 2018 have raised some important and fundamental questions about the role of the NBFCs, their business model, and the optimal regulatory regime for them.

Figure 2: Growth of incremental commercial credit flows from various sources
Credit by NBFCs grew fast in recent years



Source: RBI (2020b)
Notes: Years are fiscal years ending March of that year. Others include bond issuance to insurance companies, mutual funds, commercial paper issuance, external commercial borrowings, etc.

The rest of the paper is organized as follows. Section II presents a comparative study of NBFCs and commercial banks both from the perspective of their financial structures and business models as well as how they are regulated. Section III discusses the remarkable growth witnessed by the NBFC sector since 2014 and the circumstances which may have led to this phenomenon. Section IV looks at the genesis and the anatomy of the 2018 crisis episode that rocked the NBFC sector and eventually created ripple effects throughout the financial system and the larger economy. Section V also touches upon a specific class of NBFCs, namely HFC, that were particularly vulnerable in the aftermath of the crisis. Section VI introduces regulatory responses after the 2018 crisis. Section VII briefly describes the potential impact of the ongoing Covid-19 pandemic on this sector. Section VIII concludes with implications of the recent developments for the sustainability of NBFCs.

II. Comparison of NBFCs with commercial banks

In the model of credit where savings are intermediated through the balance sheets of financial institutions, the two most important players in India are commercial banks and NBFCs. To analyze the growth and subsequent crisis of the NBFC sector in recent years, it is important to understand the differences and similarities between NBFCs and commercial banks, both with regard to their business models as well as the regulatory frameworks that they are subject to.

The most crucial difference in the business model of banks and NBFCs is that while the former accept public deposits, most of the latter (NBFCs-ND) cannot. Household savings are the largest and cheapest source of funding in India. Since NBFCs cannot access household savings through deposits, their cost of funding is structurally higher than banks. Even when adjusted for the cost of maintaining reserves (the cash reserve ratio and statutory liquidity ratio), banks enjoy an advantage of 50 to 150 basis points vis a vis NBFCs in pricing credit, largely due to their access to low-cost deposits. Given the relative disadvantages on the funding side, NBFCs provide credit primarily to those segments where they can compete with banks. These segments are inaccessible or unattractive for commercial banks and where NBFCs can build specific capabilities that enable them to overcome their inherent funding cost disadvantage.

Banks may be constrained from serving a particular segment owing to regulatory restrictions imposed by RBI. One of such restrictions is on how much banks can lend against shares as collateral and consequently, NBFCs dominate the ‘loan against share’ business. Some segments that operate in the informal ‘cash’ economy are inaccessible to commercial banks and hence are not served by banks. A good example is small truck fleet operators who need financing for new and used trucks, but their business is primarily conducted in cash and the operators often lack the documentation needed to obtain credit from banks. In these cases, banks’ inability to underwrite loans based on informal information acts to the advantage of NBFCs. Sectors with limited access to banks also include commercial vehicles (especially used commercial vehicles), construction equipment used by small contractors, agricultural implements, etc. NBFCs have developed deep sectoral skills and customer segment specialization over years, specifically in these sectors.

Other segments have been unattractive to banks for reasons of high operating costs, lower credit risk appetite or inability to assess credit risk in the absence of documented financial information of customer as in the case of self-employed customers. The competitive dynamic segments that have a strong presence of NBFCs include:

- Commercial vehicle financing including used commercial vehicles
- Credit against gold collateral
- Affordable housing loans
- Consumer durable loans
- Loan against shares and margin financing for stock market traders
- Loan against property (LAP) for micro and small business owners as well as construction and real estate development firms

NBFCs thus primarily operate in the niche segments where they can overcome their funding cost disadvantage and serve a useful purpose through other capabilities such as more efficient sourcing of customers, prompt provision of services, specialized sectoral expertise, better underwriting etc. They tend not to compete head-on with banks for similar customers. In that

sense NBFCs not only complement but also act as substitutes for banks by widening the ambit of and access to financial services.

However, given their exposure to the niche segments, NBFCs are also characterized by concentration of risks. The dominant presence of NBFCs in these segments implies that any disruption to the NBFC model can create credit shortage in these segments which in turn impacts the commercial viability of these enterprises. Any disruption in the businesses of the target customer segments would imply a spike in defaults for NBFCs that lend to these segments.

Furthermore, in absence of direct access to household savings and any kind of retail or consumer funding, NBFCs have relied on funding from banks and bond and commercial paper markets. This has been inherently problematic because the Indian wholesale credit market itself is not deep or liquid. This means that any liquidity shock for the wholesale market would translate into a liquidity shock for the entire NBFC sector. Even if the wholesale market experiences liquidity challenges completely unrelated to the NBFC sector, funding for NBFCs would still suffer.

In addition to the restrictions on offering deposit products, unlike banks, NBFCs do not get access to the payments system. As a result, they cannot offer credit products that are linked to deposit accounts and payment products such as cash credit or overdraft. NBFCs primarily offer term loans which are fixed maturity loans. Even if they provide working capital, they do so through term loans.

From a regulatory standpoint, NBFCs are not as tightly supervised and monitored by RBI as banks. Partly, this is related to the feasibility of effectively supervising about 10,000 NBFCs as opposed to 90 scheduled commercial banks. Partly, this is also due to the role played by NBFCs in context of the broader credit ecosystem. The sectors they extend credit to are largely underserved by banks and hence there is a recognition of the need to give some flexibility to NBFCs through lighter regulation. However, differences in regulations for banks and NBFCs also create the possibility of "regulatory arbitrage" between these two models. Many privately-owned banks own NBFC as subsidiaries with sizable credit books. These entities essentially provide credit to segments that their parent banks do not and hence raise questions about possible regulatory arbitrage.

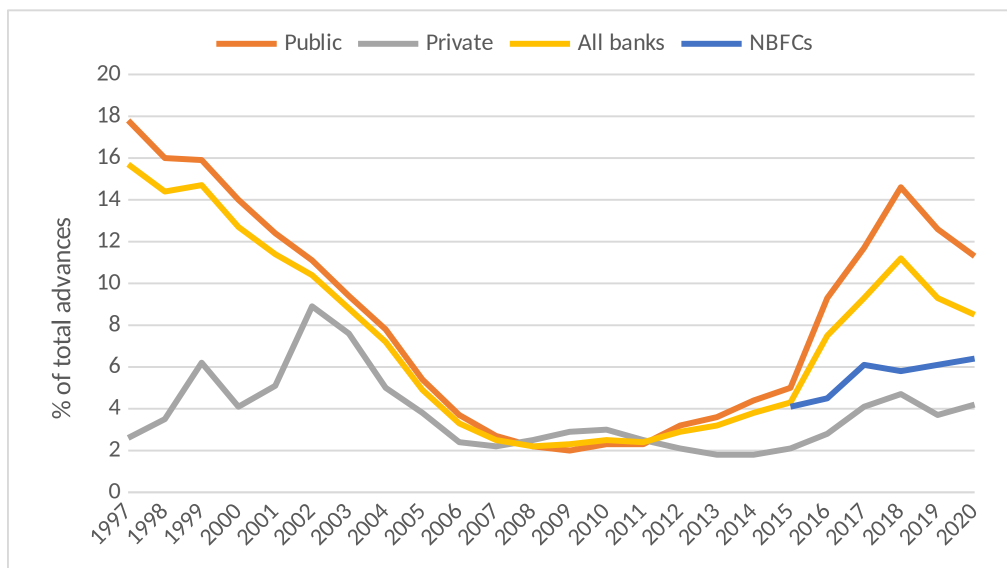
Hence it becomes important for the regulator to strike a careful balance between giving NBFCs sufficient freedom and flexibility to serve sectors where banks do not do business and at the same time monitor them such that systemic risk is contained and the potential "arbitrage" between the two models is minimized if not eliminated. The contradiction here is that a significant amount of funding for NBFCs comes from banks, and to the extent that NBFCs are not well regulated, the banking system faces a potential risk, too.

Over the last few years, there has been a focused attempt to better align the regulatory regime for NBFCs and banks to avoid any "arbitrage" that may exist between the two types of financial intermediaries. This has resulted in alignment of the norms on income recognition and more recently imposition of liquidity and asset liability management related regulations on NBFCs. The regulatory and supervisory focus is sharper than before on systemically important NBFCs given their critical role in the overall financial architecture of the economy.

III. Rise of NBFCs in recent years

The banking sector in India has gone through a cycle of credit acceleration and deceleration since the early 2000s. While the period from 2003 to 2008 was characterized by a staggering increase in the growth rate of bank credit to the commercial sector, this changed in the aftermath of the global financial crisis of 2008. After 2014, balance sheet problems in both the banking sector and the private corporate sector became apparent. This triggered the introduction of the asset quality review (AQR) by RBI, which forced the banks to recognize stressed assets on their books. The AQR was applicable to both private banks and PSBs. NPAs in the entire banking system went up (Figure 3). Between March 2015 and March 2018, gross NPAs more than doubled to reach 11.5% of total advances of the banking sector.

Figure 3: Gross NPAs in the Indian banking sector and NBFCs
NPAs rose sharply after 2015



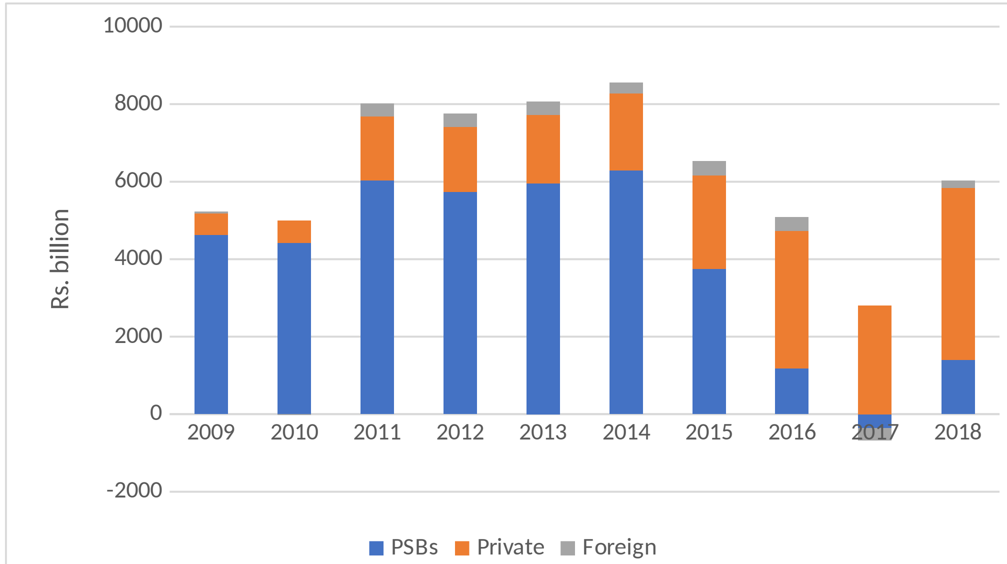
Source: RBI (2020a).

The rise in NPAs as a share of gross advances was particularly acute for PSBs which account for 70% of the total assets of the banking system. By March 2018, nine out of 10 stressed banks were government owned. Gross NPAs of PSBs were as high as 14.6% and net NPAs had reached around 8.5%. Alongside the bank NPA problem, corporate balance sheets also showed signs of trouble. Credit Suisse reported that by early 2017, around 40% of the corporate debt it monitored was owed by companies that had an interest coverage ratio less than 1, meaning they did not earn enough to pay the interest obligations on their loans. The Economic Survey 2016-17 (Government of India 2017) published by the Indian government termed this as the Twin Balance Sheet (TBS) crisis.

As a result of the worsening TBS crisis, incremental flows of bank credit to the commercial sector started to fall dramatically (Figure 4), with the most drastic decline witnessed in 2016-17. Given the concentration of NPAs, PSBs pulled back credit the most. In terms of sectoral

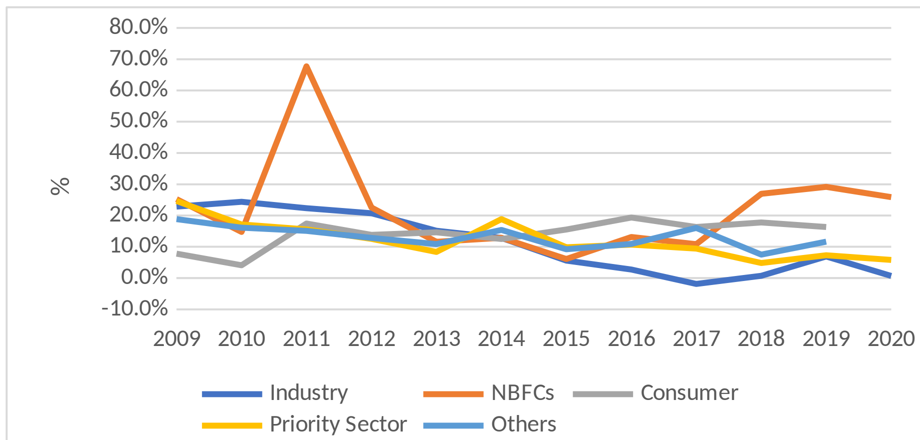
allocation, the stock of bank credit to industry was the worst affected (Figure 5). While growth of bank credit to industry fell, the banking sector increased its lending to the NBFCs, particularly after 2014-15. During this period banks were lending primarily to the consumer sector and NBFCs. Between 2015 and 2019 bank credit to NBFCs and consumers grew at an average rate of around 17% while credit to industry grew at an average rate of less than 3%.

Figure 4: Share of different types of banks in incremental credit flows
Credit flows from PSBs contracted in recent years



Source: RBI (2020b).

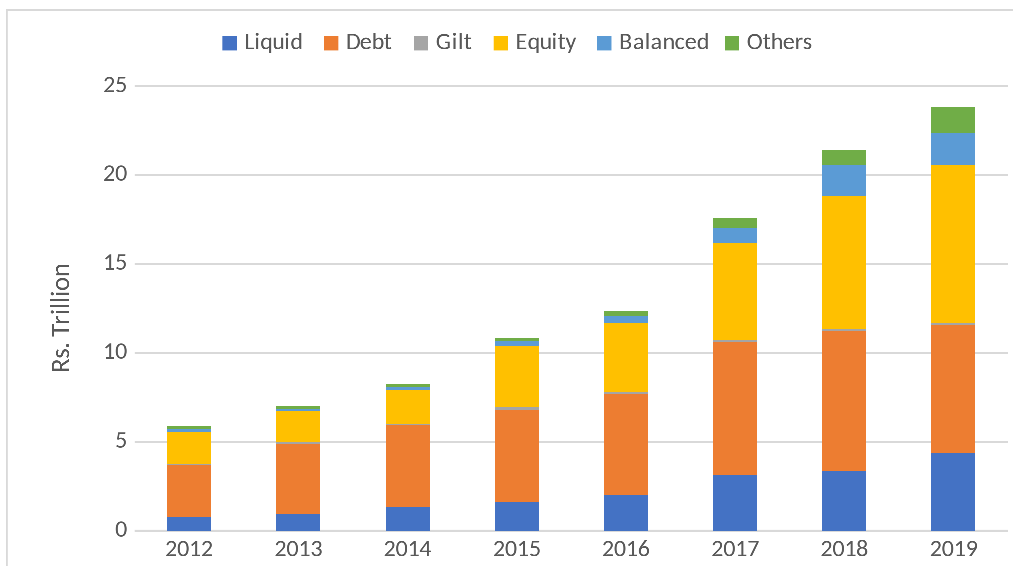
Figure 5: Growth of bank credit across key sectors
Credit to industry was sluggish



Source: RBI (2020b).
Notes: Years are fiscal years ending March of that year.

Around 2010, the Indian financial sector was undergoing a structural change. Mutual funds emerged as important players in the credit landscape. Between 2012 and 2017 their assets under management (AUM) expanded substantially, growing at a compound annual growth rate (CAGR) of 22.1% (Figure 6). This secular growth trend received a boost during the demonetization episode in November 2016. When close to 86% of the cash in the economy was declared illegal overnight by the government, households and businesses rushed to deposit their cash holdings in banks thereby resulting in a steep increase in bank deposits for the financial year ending in March 2017. Some of these deposits were invested in mutual funds, especially debt funds which showed a significant increase in AUM in 2017.

Figure 6: Assets under management by mutual funds
Mutual funds expanded fast



Source: Sebi
Notes: Years are fiscal years ending March of that year.

In addition to liquidity moving to the banking system and mutual funds, policy interest rates in India were being steadily reduced by RBI after 2014. Interest rates had peaked in 2013 when RBI raised its policy rate to defend the Indian Rupee in response to the steep currency depreciation triggered by the Taper Tantrum in May 2013. By November 2017, the yield on 10-year government securities had fallen to 6.25% from 8.85% in March 2014. The combined effect of low interest rates and ample liquidity brought down the funding cost of NBFCs sharply.

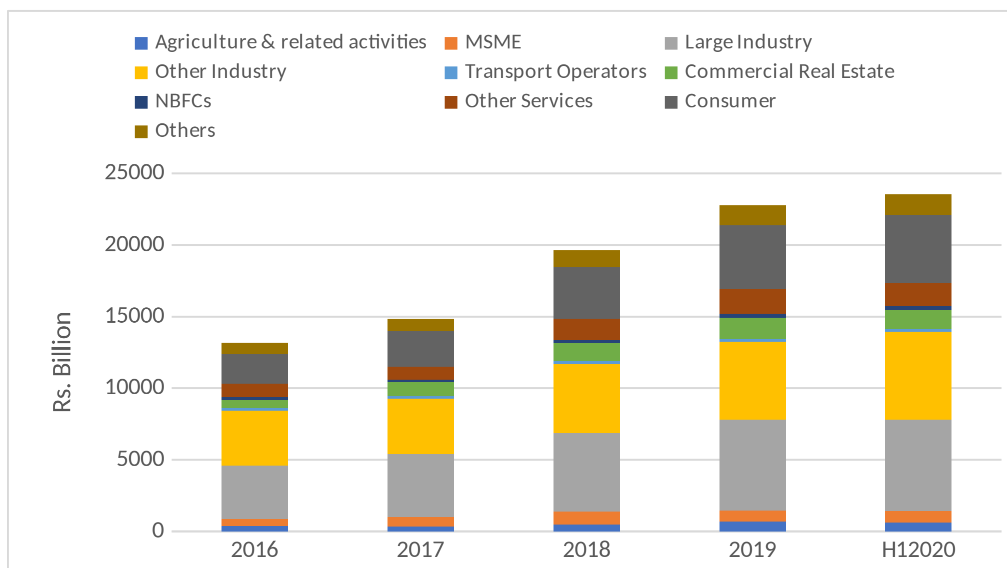
The confluence of all these indicated that on the credit supply side there was a vacuum created by the balance sheet crisis of the banks, especially the PSBs, and on the demand side falling interest rates encouraged borrowing. The situation was ripe for a dramatic growth of NBFCs, especially the systematically important ones (NBFCs-ND-SI).

The total consolidated balance sheet of these NBFCs grew at a CAGR of 11.4% from 2012-13 to 2016-17 and at a staggering 22% from 2016-17 to 2018-19.[4] Loans and advances grew at a

[4] The impact of the IL&FS crisis was felt only in the first half of 2019-20 as discussed earlier.

CAGR of 13.1% during 2013-2017 and 23.4% from 2016-2017 to 2018-19. Several new NBFCs were also set up during this period backed by private equity.

Figure 7: Sectoral deployment of NBFC credit
NBFCs increased lending to consumers



Source: RBI (2019).
Notes: Years are fiscal years ending March of that year.

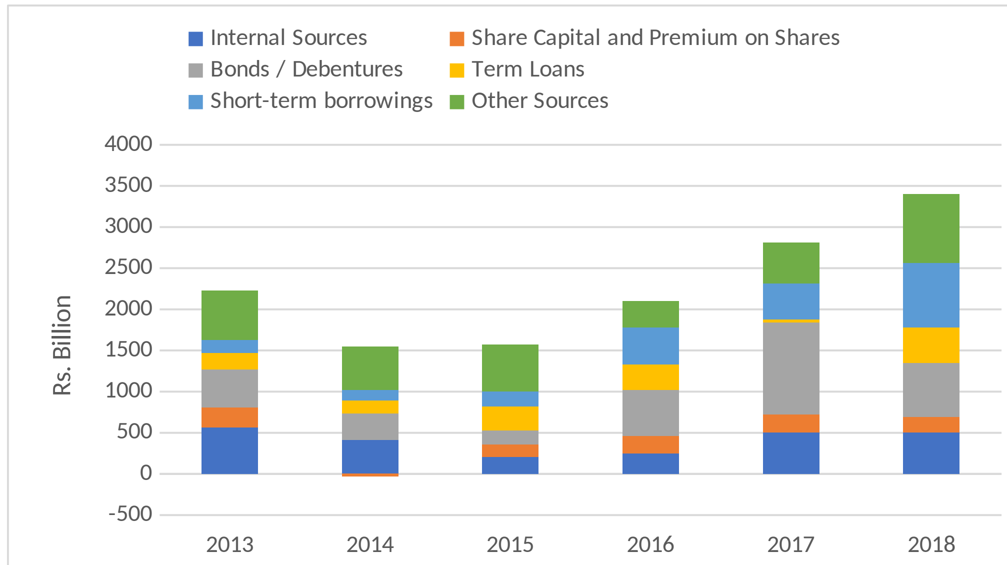
There have also been changes in sectors to which NBFCs provided credit (Figure 7). Between 2016 and 2019, industrial customers accounted for the lion's share, around 55% to 60% of the total NBFC lending. There was a substantial increase of credit to commercial real estate and consumers (such as the loans for buying white goods, cars, etc.). It is worth noting that growth in infrastructure credit by NBFCs between 2014-15 and 2016-17 was higher than that by the banking sector which in fact reported a contraction in lending to infrastructure.[5] Over 15% of the NBFC lending was to other NBFCs. This represents larger, more established NBFCs with better credit rating lending to newer and smaller NBFCs.

The funding sources of NBFCs have evolved in recent years (Figure 8). The primary source of capital for NBFCs since 2013 has been the wholesale credit market, with its share rising from 51.45% in 2013 to 58.5% in 2018. Over time market-based borrowing i.e. issuing bonds, debentures and short-term commercial papers has become more important. Ghosh et al. (2012) points out that NBFCs are inherently vulnerable to shocks given their over-reliance on wholesale funding. Indeed, this specific component of NBFCs' borrowing was hit the hardest when the 2018 crisis unfolded, which is discussed in detail in the next section. The second most important funding source are commercial banks (Acharya et al. 2013). The share of borrowing from banks has risen marginally from 9% in 2013 to 12.6% in 2018.

[5] RBI's Annual Report, 2016-17.

Figure 8: Incremental funding of NBFCs

NBFCs rely on wholesale credit markets



Source: RBI (2019).

The explosive growth along with rising competition in the sector during the 2014-2018 period masked the risks taken by NBFCs. There is evidence that NBFCs began under-pricing credit. The credit premium charged by NBFCs over the risk-free yield declined during this period (Sengupta and Vardhan 2019a). Competition among NBFCs intensified with the availability of ample liquidity and significant capital infusion by private equity players, and loan pricing became competitive, especially in relatively undifferentiated business segments such as loans against property (LAP) to micro, small and medium-sized enterprises (MSMEs) and loans to real estate developers.

To maintain margins during this growth phase, NBFCs reduced their costs of borrowing by shortening the maturity of their liabilities. They began borrowing short-term but lending long-term, which led to an asset-liability mismatch on their balance sheets. This implied that in the event of a liquidity shock when their creditors were no longer willing to roll over debt or extend new credit, they could default. Increased competition among NBFCs also resulted in some dilution of underwriting and collateral standards as asset quality of NBFCs deteriorated steadily in recent years. Gross NPAs as a percentage of gross advances increased to 6.1% in 2016-17 from 2.9% in 2011-12 (see Figure 3).

IV. Genesis and anatomy of the NBFC crisis of 2018

In September 2018, IL&FS, a major infrastructure financing NBFC, defaulted on its debt. This sent shockwaves throughout the sector, resulted in a massive credit crunch, and affected the real economy as well. This section describes the events as they unfolded and the repercussions on the entire NBFC sector.

IL&FS is a conglomerate focused on developing and financing infrastructure projects. IL&FS acts as the main holding company of the IL&FS Group with most business operations domiciled in separate companies. It had 169 separate legal entities or subsidiaries in India, with complex ownership patterns, at the time of the default.[6] It is also registered as a 'Core Investment Company' with RBI, as a result of which its operations are restricted to investing in other group companies. Many of the entities were special purpose vehicles (SPVs) set up to own specific infrastructure assets such as roads and power generators. The group also included a large NBFC called IL&FS Financial Services Limited (IFIN) which in turn lent to many of the SPVs of the group.

The overall debt of the IL&FS entities in September 2018 was estimated to be Rs 910 billion (roughly $13 billion) comprising bonds as well as loans from banks. IL&FS had borrowed from the debt capital market through long-term instruments as well as short-term commercial papers. Its debt instruments were rated at the highest grade by most rating agencies. Given the large amounts involved and the high ratings, these bonds were widely held by mutual funds, pension funds, corporate treasuries, charitable trusts, etc.

The first signs of trouble emerged in June 2018 when IL&FS defaulted on inter-corporate deposits and commercial papers worth roughly Rs 4.5 billion. Over the next two to three months, at least two rating agencies downgraded its long-term ratings. On 4 September 2018, IL&FS defaulted on a short-term loan of Rs 10 billion from the Small Industries Development Bank of India (SIDBI), while a subsidiary defaulted on Rs 5 billion due to the same development financial institution.[7]

The IL&FS defaults sent a panic wave through the debt capital market. In the aftermath of the defaults there was a sharp rise in credit risk premium on all bonds. All debt mutual funds became wary of taking credit risk and stopped rolling over commercial papers issued by various NBFCs. The roll over rates declined sharply from over 95% to less than 10%. The commercial paper market froze and created a severe shortage of liquidity in the debt market. New bond issuances came down. There was even a mini-run on the mutual funds that were heavily exposed to NBFCs. Suddenly, in a span of three months (September to November 2018), the entire supply of funds for thousands of NBFCs dried up.

As the bond markets turned risk averse, NBFCs (barring a few highly rated and government sponsored ones) found it increasingly difficult to raise fresh debt. Credit spreads on NBFC bonds shot up and even for the best rated NBFCs who could raise debt capital from the market, borrowing costs went up sharply. As shown in Figure 9, the borrowing costs went up substantially even for the highly (AAA and AA) rated NBFCs, in the immediate aftermath of the

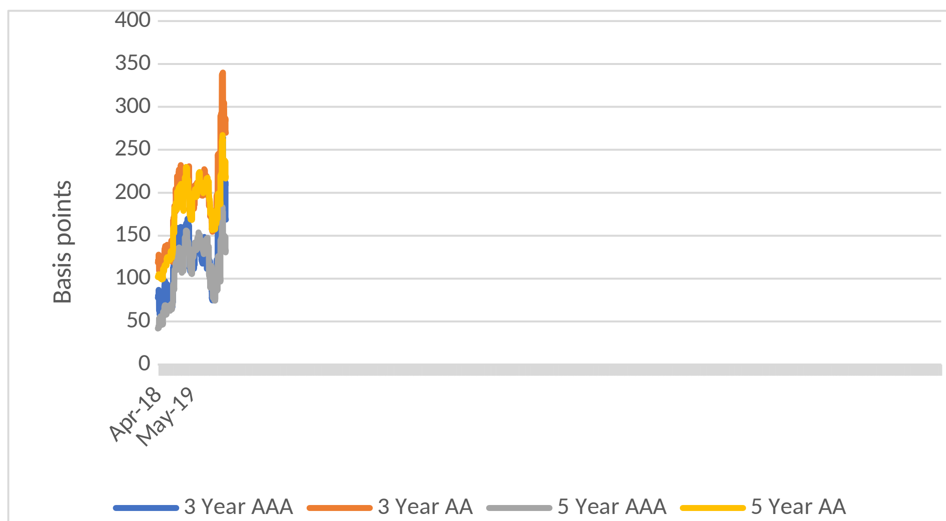
[6] Only three of the company's subsidiaries are listed – ILFS Engineering and Construction Company, ILFS Transportation Networks and ILFS Investment Managers. This makes it difficult to obtain detailed information on the financials of the companies.

[7] After the first default, a note issued in July by ICRA ratings agency said four of its subsidiary IL&FS Transportation Networks' (ILTN) project special-purpose vehicles reported irregularities in debt servicing. A fifth project had to dip into its debt service reserve to pay good on dues. In August, ICRA downgraded the long-term rating on Rs 44.75 billion worth of debt securities from AAA to AA+ considering the "company's elevated debt levels due to the funding commitments towards Group ventures". Another statement by India Ratings said that IL&FS' ability to support ITNL's operations has reduced significantly, given the increase in overall debt levels of the IL&FS group. Hence, the agency has removed the notching support for ILTN from IL&FS". (https://www.moneycontrol.com/news/business/companies/debt-and-defaults-what-happened-to-ilfs-2952381.html)

IL&FS defaults (after October 2018) and remained high for most of 2019-20. The liquidity shock soon translated into worries about a potential solvency crisis.

Figure 9: NBFC & HFC credit spreads

NBFCs and HFCs' borrowing costs went up significantly after IL&FS crisis



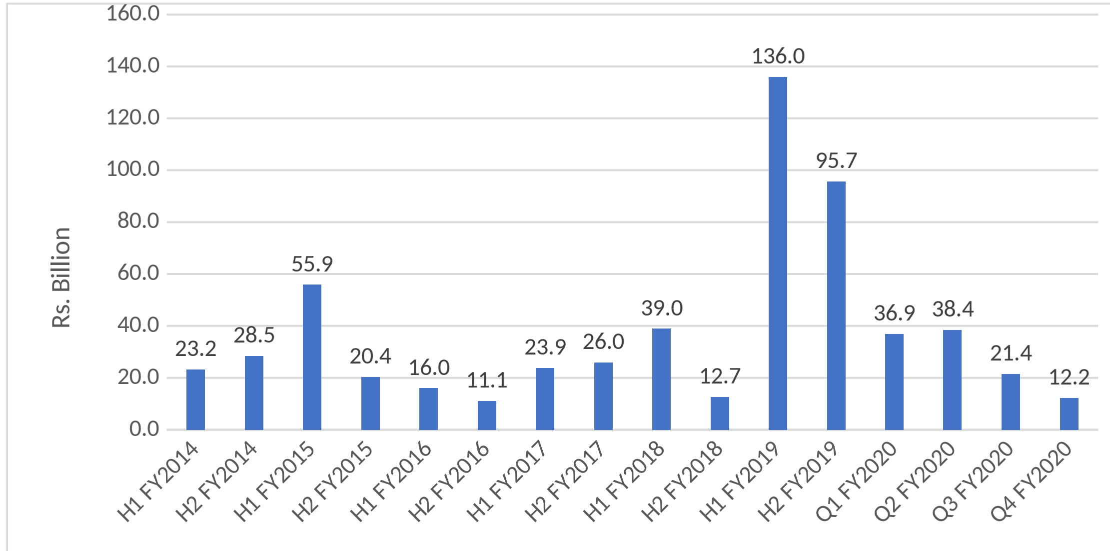
Source: Bloomberg, Clearing Corporation of India, and Sebi.
Note: the credit spread is the yield of the specific security net of the yield of government security of the same maturity for AAA- and AA-rated bonds issued by NBFCs for 3 year and 5 year maturities.

To relieve the liquidity crunch, various RBI dispensations such as reducing the risk weights for NBFCs and encouraging banks to lend to NBFCs helped increase bank lending to NBFCs for a few months. Figure 10 shows the public issuance of non-convertible debentures (NCDs) by NBFCs and HFCs declining in the second half of 2018-19 and first half of 2019-20. Figure 11 shows the rise in bank lending to NBFCs during the same period.

To tide over the liquidity challenge, some NBFCs and HFCs resorted to selling their loan portfolios to banks. The buyers, while buying portfolios from liquidity stressed NBFCs / HFCs cherry picked and as a result the residual loan books of NBFCs were perceived to be of lower credit quality. This led to a further funding squeeze and in turn adversely affected the ability of NBFCs to lend to the real economy. As shown in Figure 1, the impact of the IL&FS episode was witnessed acutely in the first half of financial year 2019-2020, that is April-September 2019. Overall flow of credit to the commercial sector from all sources declined sharply and credit from banks and NBFCs contracted.

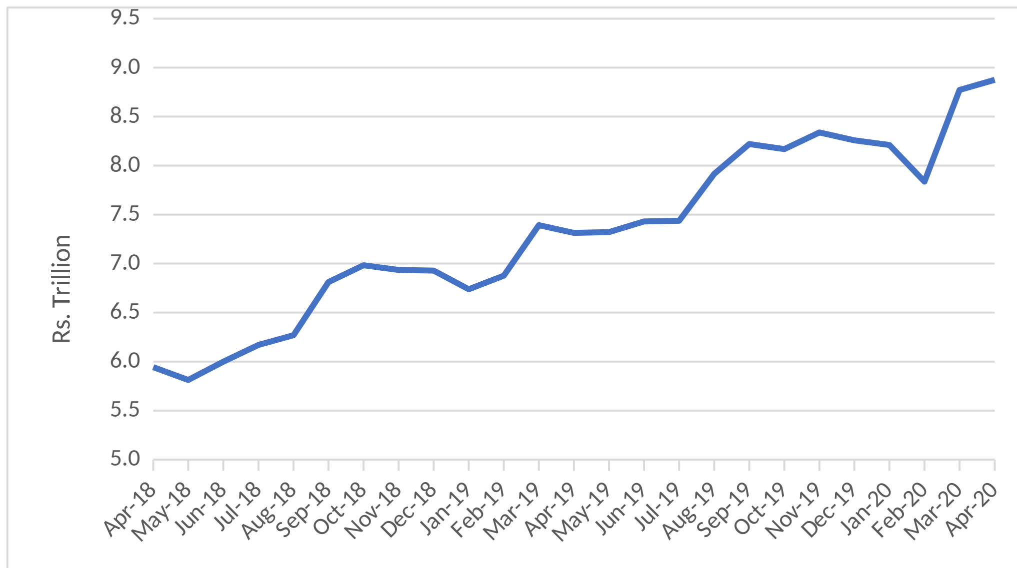
Thus, in an economy that was already experiencing a slowdown in bank credit, the NBFC crisis of 2018 aggravated the credit crunch. Sectors relying on credit flows from NBFCs suffered tremendously. Passenger car sales plummeted by a third in a year, from a high of 244,279 in September 2018 to 162,435 in August 2019. Given the wider reach of NBFCs, this had a sharp, adverse impact on the real economy with economic growth falling to 4.2% in 2019-2020 from 6.1% in 2018-2019.

Figure 10: Public issuances of non-convertible debentures by NBFCs
Demand for NBFCs debentures fell after IL&FS crisis



Source: Kotak Institutional Equities; Prime Database.

Figure 11: Bank lending to NBFCs
NBFCs borrowed from banks after October 2018



Source: Kotak Institutional Equities.

V. Housing finance companies

Housing Finance Companies (HFCs) are a specific type of NBFCs and are a significant component of the Indian financial system. These companies started in the late 1970s with the primary purpose of extending loans to individuals for buying homes (i.e. mortgages). In the late

1980s, an apex institution, the National Housing Bank (NHB), was established and tasked with regulating and supervising HFCs. NHB permitted setting up of new HFCs, regulated and supervised their operations, and provided refinancing. Between 2013 and 2018, the number of HFCs registered with NHB nearly doubled from around 50 to close to 100. However, the HFC business is highly concentrated with the top six HFCs accounting for over 85% of all the loans from HFCs.

Given the close relationship of the mortgage business with real estate development, most HFCs also tend to extend loans to real estate developers, in addition to mortgages.

Like other NBFCs, the source of funding for HFCs is primarily bank borrowing and bonds. Prior to the IL&FS default and the ensuing credit freeze in the markets, larger and the more established HFCs (the top six or so) had the ability to raise significant resources from the debt capital markets (see Figure 8), while the remaining HFCs depended on the banking system.

Given the long maturity of their lending—most residential mortgages have contractual maturity between 15 and 25 years—HFCs have a structural asset liability mismatch (ALM) problem. Their funding sources, either banks or bond markets, do not provide funding with maturity beyond five years. Given their acute ALM problem, throughout the IL&FS episode the HFCs were particularly adversely affected. Almost all HFCs, especially the smaller ones, faced severe liquidity challenges. These HFCs resorted to portfolio sales to banks, more aggressively. In early 2019 the responsibility to regulate and supervise the HFCs was moved from NHB to RBI.

VI. Regulatory response to the NBFC crisis

Recognizing the gravity of the challenge faced by NBFCs and HFCs following the IL&FS crisis and the broader economic impact of this episode, the government and RBI undertook several measures to address the situation. The government's measures included:

- Launch of Rs 1 trillion ‘first default loss guarantee’ program to provide first loss protection to all NBFC lending that met the criteria of the program; and
- Launch of a Rs 250 billion alternative investment fund (AIF) with government contribution of Rs 100 billion to provide `last mile funding’ to stalled housing development projects. It was expected to help cash strapped developers to complete their projects which in turn would help the HFCs that had given home loans to individuals buy houses in these projects.

RBI took several steps to increase the flow of bank lending to NBFCs. These steps included:

- Reduction of banks' risk weights on lending to NBFCs; risk weights were made similar to those for other companies;
- Increase in single borrower exposure limits for NBFCs from 15% to 20% of the bank’s Tier I capital; and
- Banks were allowed, subject to certain conditions, to lend to registered NBFCs (other than MFIs) for on-lending to agriculture (term loans only) up to Rs1 million, micro and small enterprises up to Rs 2 million and housing up to Rs 2 million per borrower (up from Rs 1 million before) and this was to be classified as priority sector lending.

In addition to these direct measures, several indirect measures were taken to improve liquidity for NBFCs. These indirect measures included:

- Open market operations (OMOs) conducted to impart liquidity of roughly Rs 3.5 trillion to the banking system between October 2018 and March 2019;
- Increase in the permissible level of Facility to Avail Liquidity for Liquidity Coverage Ratio (FALLCR), i.e. securities that are qualify for both statutory liquidity ratio (SLR) and liquidity coverage ratio (LCR) thus permitting banks to reduce securities held as reserves and increase their loanable funds;
- Changes in the securitization norms such as reduction of minimum holding period requirement to encourage NBFCs to securitize their loan books; and
- To harmonize regulatory oversight between banks, NBFCs and HFCs, regulations of HFCs was moved from NHB to RBI.

Most of these measures were focused on improving short-term liquidity conditions for NBFCs. More structural, long-term measures included imposition of liquidity related regulations (e.g. those related to asset liability management i.e. ALM) on NBFCs and moving the regulation of HFCs to RBI from NHB. Other long-term measures such as stricter supervisory regime for NBFCs and HFCs may unfold over time.

As a result of these measures, bank lending to NBFCs improved in the January to March quarter of 2019. Consequently, NBFC lending also picked up. However, the bank lending remained skewed in favor of large and highly-rated NBFCs whereas smaller, less established, and lower-rated NBFCs continued to struggle for funding. Also, bond market liquidity for NBFCs and HFCs remained squeezed. Only highly-rated (AAA) and government sponsored NBFCs could raise capital from the bond market.

VII. Impact of the Covid-19 pandemic

Even as the NBFCs and HFCs were struggling to recover from the impact of the IL&FS crisis, the Covid-19 pandemic hit India in late January 2020. On 25 March 2020, India went into a nationwide, comprehensive lockdown and economic activities came to an abrupt halt (Sengupta and Dev 2020). Due to the measures adopted to prevent the spread of the disease, such as social distancing, widespread mobility restrictions, temporary closures of all kinds of businesses etc., there were large scale disruptions in supply chains and a massive reduction in both aggregate supply and demand. The continuation of the lockdown for more than two months imposed enormous hardship on all economic agents (Sengupta 2020 and Sengupta and Vardhan 2020).

Most NBFCs had to shut down their branch networks and as a result their operations stalled. For consumer lending focused NBFCs (such as those in the business of lending for housing, cars, and consumer durables) the underlying businesses were temporarily shut and hence there was no opportunity to lend. Almost no passenger cars were sold in India in the months of April and May and hence there was no growth in the car loans segment.

MSMEs are likely to have been disproportionately affected in the ongoing crisis owing to their inadequate access to formal financing and lack of demand. They will struggle to stay afloat and this in turn would affect the NBFCs who have been lending to these enterprises. Asset quality stress would build up.

In late March 2020, RBI announced a six-month moratorium on the repayment obligations for the customers of banks and NBFCs, but asset quality pressures are likely to rise despite the moratorium given the complete absence of revenue generation for several months. There would be a large drop in loan repayments which in turn would affect the profitability of NBFCs. The unsecured borrowers from the informal segment are most at risk and this would especially hurt MFIs among NBFCs. In general, the level of delinquencies is expected to rise significantly across all asset classes, which may force some NBFCs to deal with solvency challenges.

NBFCs are already facing liquidity shortages amidst dwindling cash flows. This is despite policy announcements by RBI to inject liquidity in the banking system even with the explicit objective of lending to NBFCs. Ordinarily, banks can borrow on a short-term basis from RBI using the repo window. To supplement this facility, RBI announced a new 'targeted long-term repo operations' (T-LTRO) mechanism in March as well as in April 2020 (Sengupta and Felman 2020). It had announced a Rs 500 billion T-LTRO for primary and secondary market buying of NBFC bonds. This was targeted mostly to larger NBFCs.

However, given the heightened risk aversion in the banking system, this scheme has not so far been very effective in providing the much needed liquidity to NBFCs. The risk aversion in the bond market is reflected in the high credit spreads faced even by the most highly rated NBFCs during the April-May 2020 period. In fact, the spreads during the pandemic have been higher than the borrowing costs faced by NBFCs in the post IL&FS default period. Mutual funds have also been reducing their exposure to NBFCs.

So far no data has come out in the public domain that can provide a sense of the extent of damage caused by the pandemic and the lockdown specifically on the NBFC and HFC business other than rising borrowing costs, but anecdotal evidence suggests that there has been a deep and widespread impact.[8] We may see some amount of consolidation in the sector whereby large, established, and better rated NBFCs acquire the smaller ones. There might also be a rise in securitization activities and portfolio sale transactions.

The fiscal relief (Atmanirbhar Bharat, or Self-Reliant India) package announced by the Finance Minister in May 2020, to alleviate the adverse impact of the Covid-19 crisis, included liquidity schemes worth Rs 750 billion for NBFCs. This includes a Rs 300 billion liquidity scheme backed by government security and the remaining Rs 450 billion is through a partial credit guarantee scheme. This policy initiative is likely to ease the liquidity position of NBFCs to some extent.

VIII. Future of NBFCs

The recent crisis in the NBFC sector and resultant credit crunch in the economy raises several questions about their business model and in fact their very existence and importance. What are the merits of letting these specialized financial institutions function despite their obvious funding disadvantages, as opposed to encouraging banks to serve the same segments? Banks have a funding cost advantage given that they can directly access household savings. So maybe going

[8] See for example: https://cfo.economictimes.indiatimes.com/news/covid-19-impact-on-nbfcs-delayed-emi-payments-may-increase-npa-levels/74820764; https://economictimes.indiatimes.com/industry/banking/finance/nbfcs-face-twin-challenges-of-debt-repayment-cash-shortage/articleshow/75035991.cms?from=mdr, https://www.thehindubusinessline.com/money-and-banking/covid-19-to-impact-collections-fresh-loan-disbursement-of-nbfcs-in-near-term-crisil/article31215158.ece.

forward some banks will start extending their businesses to the sectors that were hitherto exclusively served by NBFCs.

If banks are not able to cover all the customer segments, then what is the correct non-bank funding model? In an economy where the bond market is illiquid and under-developed, if access to household savings is the most sustainable form of funding, then how can non-banks develop? The majority of NBFC funding comes from banks, which implies they still access deposits. In that case should they still be subject to light-tough regulation or perhaps regulation can be light on the asset side but not on the liability side. RBI as the regulator needs to recalibrate its approach towards NBFCs based on lessons from the recent crisis.

For systemically important NBFCs, the regulatory oversight, exercised through supervision, must be made more comprehensive and stringent. These NBFCs should be subject to extensive annual inspections as well as occasional regulatory actions such as the "asset quality review" (AQR) that was done for commercial banks in response to the NPA crisis in 2015-16. Among these systematically important NBFCs, it is necessary to identify those with significant linkages and possibly too-big-to-fail ones and regulate them separately and differently. It has been argued that converting these highly-connected NBFCs into commercial banks or scaling down their network externalities would make the financial system sound.[9] Yet, these highly-connected NBFCs may be more efficient than other NBFCs in channeling funds to sectors that banks do not provide credit to. It is necessary to strike a balance between regulation and economic efficiency.

Related to the regulatory oversight point, there is also a need to develop a mechanism to help NBFCs deal with episodic liquidity shocks. Unlike banks that have access to the repo operations conducted by RBI, NBFCs have no institutionalized mechanism that allows them short-term access to liquidity. As a result, in the event of a liquidity shock to the system as was witnessed in the aftermath of the IL&FS crisis in 2018 NBFCs faced a severe credit crunch. NBFCs, as described earlier, are essentially wholesale funded and hence are vulnerable to liquidity shocks when the wholesale markets freeze. Persistent liquidity squeeze could result in solvency problems for otherwise solvent NBFCs. In addition, most NBFCs do not own high quality debt securities (such as government bonds) that can be offered as collateral and hence it is not easy to replicate the bank-type repo operation for NBFCs. There may have to be a joint effort on part of NBFCs and the regulator to create an institutionalized mechanism to provide liquidity in the event of a systemic liquidity shock.

Structural diversification of funding sources is also critical for the long-term survival of the NBFC model. Currently banks and domestic debt capital market are the only source of liabilities for them. In the domestic capital markets, mutual funds and to a lesser extent, insurance companies are the largest investors in debt securities of NBFCs. To create a sustainable and stable funding model, a wider pool of debt capital – both domestic and international, must be made accessible to them. Regulations related to external commercial borrowing for NBFCs may need a review. Also, regulatory changes to encourage mechanisms such as asset backed securitization could help NBFCs access large pools of debt capital such as pension funds. Alternative investment vehicles that have higher risk appetite can be encouraged to raise capital to be invested in debt papers issued by NBFCs.

[9] See M. Rajeshwar Rao (2020).

Other stakeholders in the financial system, namely credit rating agencies (CRAs), auditors, securities market regulator, banks, and mutual funds also must learn important lessons from this crisis. One important reason that the IL&FS default sent shockwaves through the system was the high ratings of the instruments that were defaulted upon. Therefore, improved oversight of supportive institutions such as the CRAs by the Securities and Exchange Board of India (SEBI) is also crucial going forward. For a sustainable NBFC model to be developed, all the stakeholders must develop a nuanced understanding of the risks associated with this model. Indiscriminate supply of capital, both debt and equity, to NBFCs will is likely to result in the kind of collapse that the sector recently witnessed.

In a developing economy like India, many customer segments would remain underserved or unserved by commercial banks. As explained in Section II, it may not be economically attractive for banks to serve these segments, either because they do not have the necessary expertise to serve these customers, or access to them. The raison d'être for the existence of NBFCs is to serve these customer segments that are not served well by commercial banks. Doing so requires them to have some flexibility in operations and balance sheet management compared to commercial banks. Hence fundamentally, they need different regulatory treatment compared to commercial banks.

At the same time, to the extent NBFCs borrow from banks, they pose a risk to the banking system and as they grow larger their operations present an important systemic risk. Therefore, the regulatory approach to NBFCs must balance the need for operational and financial flexibility and containment of the systemic risk. An important step to achieve this balance is to separate NBFCs into the larger, systemically important ones and others. This separation allows the regulatory and supervisory attention to be focused on the systemically important entities.

Successful NBFCs have developed skills and expertise as well as credibility over the years. It is possible that a handful of financially strong and viable NBFCs that have the capabilities and deep specialization will survive the crisis and obtain greater market share whereas majority of the weaker ones that are undifferentiated will disappear as funding for them becomes increasingly scarce and costly. In other words, the 2018 crisis may trigger a rebalancing of the system which would potentially be made even more acute by the ongoing pandemic crisis.

NBFCs serve an important role in developing countries, such as India, where access to bank finance continues to be a challenge for a large chunk of the population and businesses. Non-banking financial institutions, including NBFCs in India, serve market segments that commercial banks do not offer services due to higher risk and lower returns. Because of their inherent characteristics, non-banking financial institutions are an indispensable part of an economy’s financial sector. The evolution of NBFCs in India and the 2018 crisis have provided good lessons to other developing countries. In the end, capital (both equity and debt) has to exercise the necessary discipline and capital providers (both markets and institutions) need to become more discriminating when funding NBFCs to avoid a repeat of the 2018 crisis.

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