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Non -Banking Finance in India- Regulatory Challenges and Concerns

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ABSTRACT: Non-Banking finance has been instrumental in expanding the reach of credit in India. They have historically leveraged the relatively looser regulatory oversight to extend credit in sectors and to consumers who are typically underserved by India's formal banking structure. However, the IL&FS crisis of 2018 exposed major systemic issues with regards to credit practices followed by NBFCs. This makes it imperative that necessary regulation is put in place to prevent future crisis. The regulations put in place must not curb the idiosyncrasies of the sector, which have led to its success and relevance and still prevent it from imploding. This paper investigates the regulatory scenario for NBFCs in India and suggests suitable reforms. A careful analysis of past exercises into the same has also been reviewed.

KEYWORDS:NBFCs, IL&FS crisis, Regulatory Arbitrage, Shadow Banks, Leverage Risk, Asset Quality Review, Central Banks

I. INTRODUCTION

Non-banking FinanceCompanies are vital to India's growth story and have emerged as critical financial intermediaries over the years. They have been at the forefront of meeting the credit needs of India's under-served retail and micro, small and medium enterprises (MSMEs). Non-banking Finance Companies (NBFCs) have differentiated themselves in the lending market by leveraging their keen understanding of consumer segments and developing customised solutions, innovative products, and faster loan sanctioning processes. They serve customer segments who are generally excluded by the highly regulated banking industry and play a crucial role at the bottom of pyramid financing. Innovative strategies and customer-friendly processes have made them indispensable in auto, home, and gold financing. For instance, Shriram Transport Finance, Cholamandalam Investment and Finance Company pioneered used vehicle financing. Muthoot Finance has made gold financing simpler. NBFCs like Vistaar, U GRO Capital and Five Star Business have been catering to the capital needs of Indian MSMEs. However, the sector has faced a serious liquidity crisis over the past year and a half, which might balloon into a solvency crisis.

The recent crisis in the NBFC sector has not only brought out their systemic importance but also the need for their orderly functioning to prevent future crises. In this backdrop,the present essayis structured as follows: Section-2 discussesthe current regulatory landscape for NBFCs. This Section describes their business model, which takes advantage of the regulatory arbitrage and discusses the backdrop to the current crisis. The measures suggested by the past committees to strengthen the NBFC sector has been analysed inSection-3. Section-4discusses some of the stylised facts relating to the regulation of NBFCs based on cross country experience. Drawing on thelessons from the recent NBFC crisis, Section-5 offers some suggestions which will streng then the NBFCs. Section-6provides the concluding observations.

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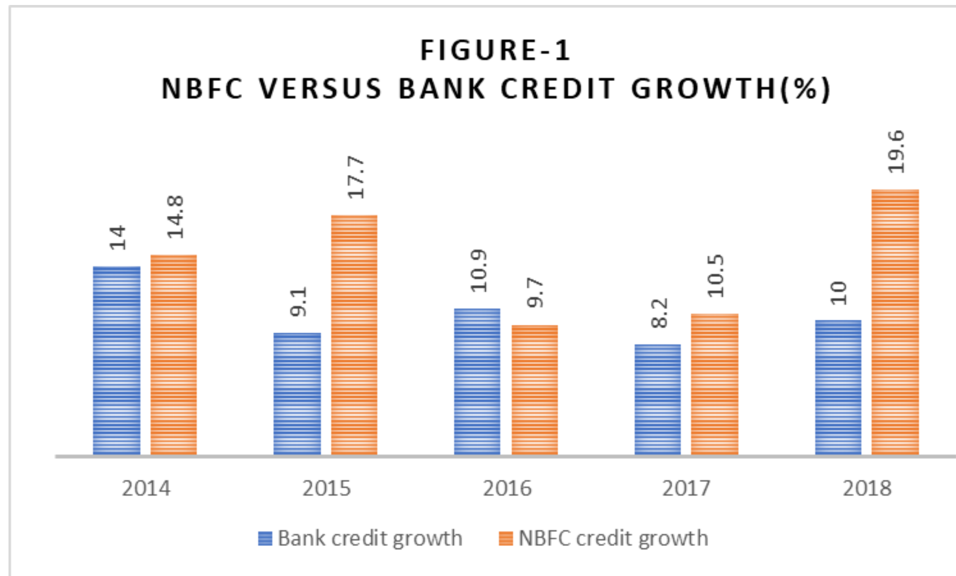
II. REGULATORY LANDSCAPE AND BACKDROP TO THE CRISIS



Historically,the regulatory oversight overNBFCs has been relatively light when compared to 'banks'.This has led NBFCs to adopt an operating style which utilizesthis regulatory freedom.This regulatory freedom was extended to NBFCs as they served segments that banks were reluctant to lend. NBFCs faced relativelyless restrictive regulations with regard to sector concentration norms, credit standards and use of third-party sales channels, etc. Consequently, NBFCs achieved high credit growth compared to banks during 2015-18 (Fig-1) following the asset quality review undertaken by RBI for the commercial banks. It is worthwhile to note that 40% of the incremental consumer financing in 2018 came from NBFCs. The high credit growth resulted in a larger share of NBFCs in the total credit (Fig-2). The business of the NBFCs was also on a sound footing as reflected in their relatively lower non-performing assets (NPAs) and higher capital adequacy (Fig-3) The relatively highercredit growth of NBFCs partly owes to the regulatory arbitrage they enjoy.

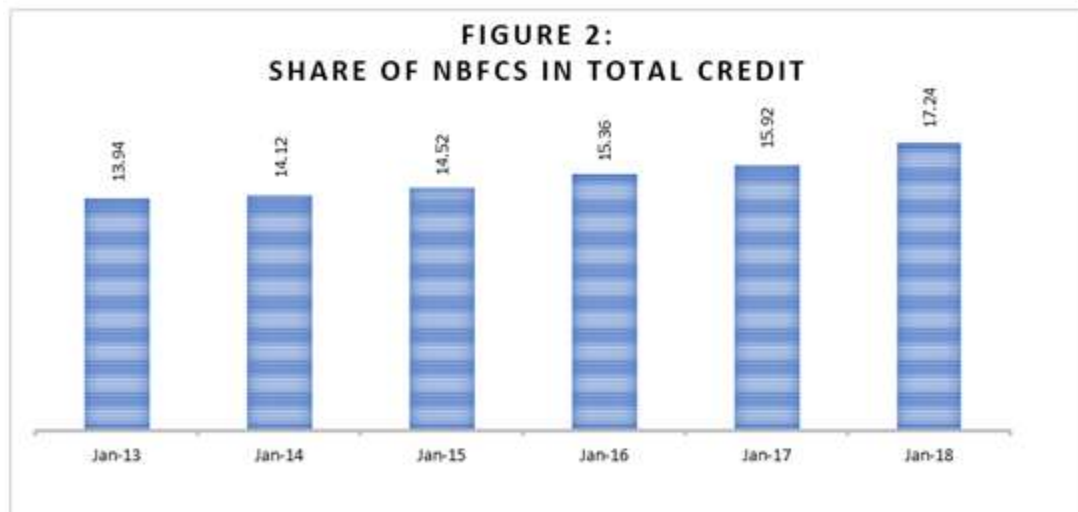
Being non-banking entities, NBFCs did not have access to public deposits. This prompted NBFCs to adopt a business model which uses commercial papers to raise short termloans of between three and six months and lend to businesses and households on a long-term basis. This business model required steady issuance of commercial papers to stay sufficiently liquid.

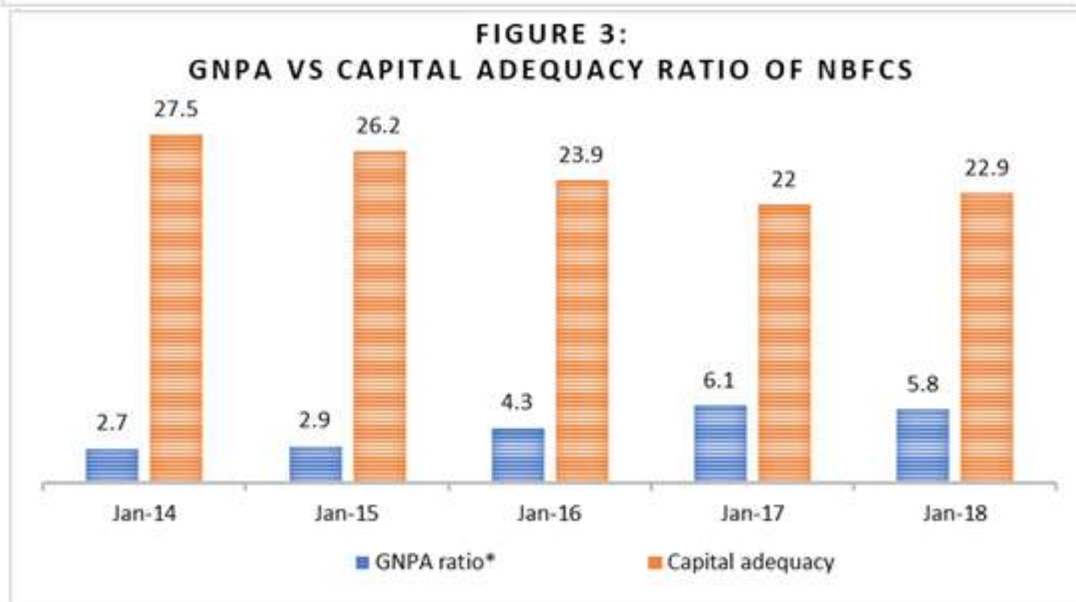
The very high credit growth in the recent past led to the dilution of credit standards while their dependence on the debt market for funds grew significantly. The tipping point was reached when Infrastructure Leasing and Financial Services (IL&FS), one of the large NBFCs failed to fulfil its debt obligations. This immediately affected the debenture holders of entities such as company pension funds, mutual funds and other NBFCs who had lent to IL&FS. Given their interconnectedness and the signalling effect of IL&FS default, most NBFCs faced a liquidity crunch as a significant portion (45-50%) of their financing came from mutual funds. Banks, another major source of funding for NBFCs, were grappling with the problem of rising NPAs at the time and hence, they too shied away from financing NBFCs. To add fuel to the fire, credit rating agencies also downgraded debt papers of significant NBFCs like Dewan Housing Finance Limited (DHFL), Reliance Commercial Finance and Reliance Home Finance, damaging investor confidence in the sector. This was reflected in a sharp rise in the cost of raising funds rose from 8.9% to 15.9% following the IL&FS crisis.

As the funding tap for NBFCs dried up, the liquidity squeeze could be felt similarly across businesses and market sectors (like construction, auto, jewellery, etc.) which primarily depended on NBFCs for funding. According to the Society for Indian Automobile Manufacturers (SIAM), the NBFC segment currently finances almost 70per cent of new two-wheelers and 60 percent of new commercial vehicles in the country[6]. SIAM believes that the liquidity crisis in the NBFC sector and the increase in interest rates have hit vehicle financing, particularly in rural areas. This is a prime example of the far-reaching impact of the NBFC crisis on the economy.

The contagion risks associated with current NBFC crisis is also veryhigh. For instance, Reserve Bank of India in its Financial Stability Reportcautioned that the failure of any of the top five NBFCs/HFCs could result in default in up to two banks.

The regulatory arbitrage enjoyed by the NBFCs and the recent crisis in this sector indicates the need to revisit the regulatory framework for NBFCs to protect them from future liquidity and solvency crises. At this juncture, it is instructive to revisit some of the measures and suggestions made by past Committees for effective NBFCs regulation for deeper insights.





III. SUGGESTED MEASURES FROM PAST COMMITTEES

RBIhadappointedUshaThorat Committee(UTC) in 2011to reduceregulatory arbitrageenjoyedby the NBFCs and the attendant systemicrisk. The major recommendations of the UTC included the following:

[1]. Bringing the statutory liquidity ratio requirements of NBFCs at par with that of banks.
[2]. Applying the same income and NPA recognition norms as compared to banks.
[3]. Higher capital requirements of 15% for NBFCs as compared to 9% for banks to reduce the transmission of risks to banks.
[4]. Maintenance of high-quality liquid assets to ensure that there is no liquidity gap in 1-30 days.

[5]. Tier I capital be raised to 12% for all captive NBFCs and NBFCs lending to sensitive sectors like capital markets, real estate, etc.

Subsequently,theNachiketMor Committee (NMC) constituted in 2013 to promote financial inclusion recommended partial convergence of regulations between banks and NBFCs. NMC had suggested that the provisions of SARFAESI Act, 2002 should extend to NBFCs and they should comply with the same minimum SLR requirements as that of banks.

Though these Committees had a lot of foresight, many of their recommendations were not implemented owing to a lack of urgency. However, with the recent crisis, some of the recommendations related to liquidity norms are being implemented in a phased manner. In this context, it will be useful to discern the regulatory approach adopted for NBFCs in different country contexts.

IV. REGULATORY PRACTICES IN SHADOW BANKS ABROAD

NBFC's in India belong to what is broadly classified as shadow banks in the cross-country context.The importance of shadows banks differs widely across countries (Figure-4). As can be seen from Figure-4, Shadow banks in USA and China account for a large portion of their financial assets. There is a considerable differencein the approaches to the regulation of shadow banks in these countries. This might provideinsights for NBFC regulation in India.

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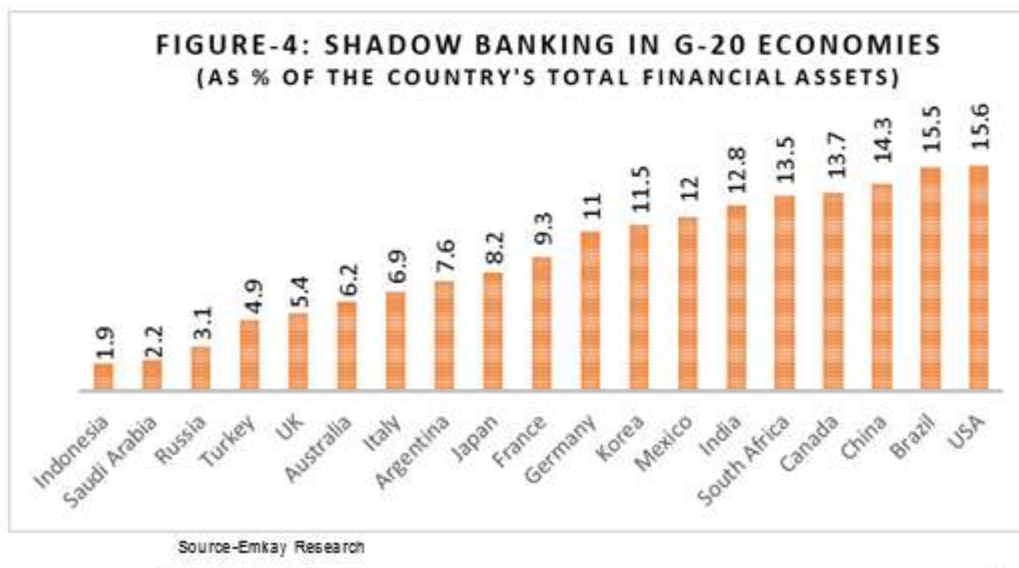
In the USA, after the financial crisis of2008, the regulatory measures implemented were not targeted towards any specific sector but to curb the regulatory freedom of shadow banks, in general.

The scenario in China has been different. The shadow banking sector in the country grew rapidly in the decade following the global financial crisis. However, authorities have attempted to address the risks stemming from the sector by directly implementing measures that curb regulatory freedom.

When compared to norms existing in the USA, the Indian NBFCs are already tightly regulated. However, the experience of China suggests that caution should be exercised before letting a systemic risk spill over and disrupt the financial system.

In this context, it is worthwhile to note that some regulatory initiatives havebeen already undertaken by RBI to address the asset-liability mismatch facing the NBFC sector.



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V. REGULATORY INITIATIVES AND SUGGESTIONS

Many NBFCs had been running large asset-liability mismatches in the short-term in the run-up to September 2018 (Figure-5).

As a response to the recent crisis, RBI on 24 May 2019 published draft guidelines on "Liquidity Risk Management Framework for Non-Banking Financial Companies (NBFCs) and Core Investment Companies (CICs)"[8]. According to the guidelines, all NBFCs with an asset size of more than Rs 5000 crores must maintain a minimum 50% of Liquidity Coverage Ratio as highly liquid assets by December 2020, which will be increased in a calibrated manner to 100% by December 2024[8]. Further, NBFCs will be required to maintain "high-quality liquid assets" (HQLA) worth of a minimum of 100% of the net cash outflow in the next 30 days. The purpose of these measures isto ensure that NBFCs are liquid enough to meet short term obligations and hence, will curb excessive risk-taking tendencies. Some other progressive measures foraresilient NBFC sectorhavebeenalreadyimplementedlikecreditrating hasbeen mandatory for NBFCs to accept deposits.

Keeping in view the need to contain the systemic risks posed by NBFCs without compromising their ability to meet the diverse credit needs of the Indian economy there is a need to address the multifarious challenges (Figure-6) associated with their functioning.

FIGURE 5: Asset- Liability Mismatch in select NBFCs

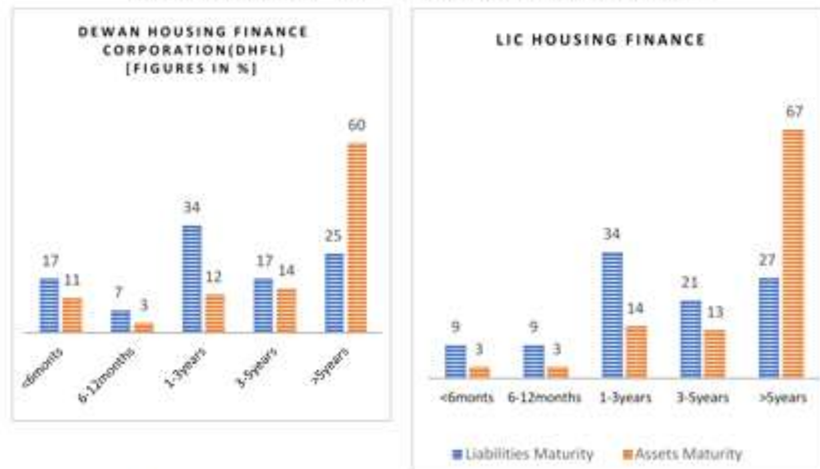

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FIGURE 6:
Multifarious Challenges

We discuss the suggestions to tackle thechallenges listed in Figure-6 for a resilientNBFC sector.

[1]. Regulatory Maze: Indiannon-banksare governed by a regulatory maze of RBI, Securities and Exchange Board of India, IRDA, NHB, ministry of corporate affairs (for Nidhi companies) and state governments (for chit funds). Ensuring coordination among the diverse set of regulators is a challenge. As such, there is a need for a Unified Financial Authority (UFA) comprising SEBI, IRDA, Pension Fund Regulatory and DevelopmentAuthority. It is also desirable that the Financial Stability and Development Council (FSDC) which is an informal forum of regulators be given legal sanctity. FSDC consisting of RBI, UFA and Government of India can be mandated to supervise regulatory functioning of banks, deposit taking and other systemically important NBFCs (NBFC-D, NBFC-ND-SI) and ensure systemic stability.

[2]. Diversion of Funds to Related Entities: Some of the NBFCs have found new ways to divert funds to related entities. For example, DHFL uses a new structure called 'box companies', toescape from reporting the funds given to related entities. To avoid disclosure of related party transactions, owners of NBFC floats three entities with each holding 50% in another entity to camouflage the ownership identity.It is instructive to note that the Thorat Committee had proposed to treat multiple

[3]. are floated by a common set of promoters, as a single entity. It is desirable to introduce the single entity concept for NBFCs to address fund diversion and better risk management.

[4]. Asset Quality Review: In the present stress situation, many NBFCs may not be a position to withstand a compulsory asset quality review (AQR) along the lines undertaken for commercial banks in 2015. However, NBFCs should be encouraged to subject themselves to a voluntary AQR in return for a lower regulatory capital requirement. A voluntary AQR will help separate the wheat from the chaff, increasing confidence in the sector.

[5]. Regulatory Arbitrage: We have already discussed how NBFCs leverage regulatory concessions. However, excessive exploitation of the regulatory arbitrage by some NBFCs has led to a crisis that has major ramifications for the industry and the economy. Hence, there is a need for policy intervention which prevents excesses.

[6]. We suggest that NBFC-D, NBFC-ND-SI should be considered at par with Banks for financial disclosures and the extent of a regulatory framework. They should be required to follow the CAMEL framework and meet benchmarks on capital requirements and asset quality. They should also come under the purview of the Prompt Corrective Action (PCA) framework; if CRAR, NPA and Return on Assets are not maintained at a stipulated level.

[7]. Leverage risk: NBFCs tend to be over-reliant on debt funding to manage their capital requirements. They are susceptible to over-leveraging as some of them have a debt to equity ratio as high as 10:1. As such, there is a need to cap the debt-equity ratio to 5:1. Also, short term borrowing as a percentage of total borrowing should be brought down from the present high level of 50-60% to 40%.

VI. CONCLUDING OBSERVATION

NBFCs are critical in meeting India's growth ambition and financial inclusion goals. The regulatory bodies need to ensure that the NBFCs are robust without diluting their'raison d'être'. A delicate balance is needed so that the regulatory arbitrage is not misused by NBFCs, and regulation is sensitive to the special needs of the NBFCs. We hope that the implementation of the suggestions made in this essay will strengthen NBFCs and help them to play a more meaningful role in India's development.

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