The Road Ahead for NBFCs

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Over the past 8-9 months, NBFCs have been the buzzword and a topic of intense conversations (NBFCs have received a lot of flak, most of which is undeserving). But before I elucidate the reasons for the current crisis, I believe it is important to step back a bit to gain a better understanding of the NBFC sector. What is vital and often not articulated enough, is that NBFCs cater to segments that banks are unwilling and unable to cater to. NBFCs in effect, play the role of intermediaries - particularly in the small scale and retail sectors. Notably, total assets of NBFCs stand at over US$ 370 billion and contribute almost 20% of the total credit in India. NBFCs and housing finance companies (HFCs) play a complementary and supplementary role to the Indian banking system.

Globally, any financial institution that is outside the purview of the banking system is considered to be part of the 'shadow banking system'. Now shadow banking is often construed as dodgy or toxic assets, which is out of the purview of regulators. It is important to appreciate that while NBFCs and HFCs in India are not part of the banking system, these are regulated entities. It is erroneous to believe that NBFCs and HFCs are unregulated and are therefore significantly riskier than banks.

The financial needs of the Indian economy are diverse and cannot be fulfilled by the banking sector alone. For instance, in India consumer credit to GDP ratio stands at ~13%, this is amongst the lowest in the world for a large economy. In comparison, consumer credit to GDP is 80% in the US and 40% in China. Similarly, the mortgage to GDP ratio in India is just 10% compared to 26% in China, over 50% in US and 86% in Denmark. Out of an estimated 267 million households in India, only 74 million households have access to formal credit. So the scope to grow and the needs are immense. Moreover, NBFCs specialise in lending in a particular sector, develop skill sets that are unique to that customer base and hence are able to better manage risks while simultaneously driving growth in that sector.

It needs to be pointed out that IL&FS was not a systemic issue as its default did not create any contagion effect. Since September 2018, there has been an unfounded belief that other NBFCs would default as well. However, there was recognition that the pain seen in the broader NBFC sector was liquidity and not a solvency crisis. Nonetheless the IL&FS default has created a 'risk aversion' in the system. The current crisis signalled the end of easy money – which is using cheaper, short-term market instruments to fund longer term assets. Yet, this situation was in sharp contrast to the 2008-09 crisis where the trust deficit resulted in a complete liquidity freeze and the government had to step in.

Admittedly, perception and liquidity issues have affected NBFCs with notable fall in credit to automobiles, agriculture and small & medium enterprises. Whilst many well-managed NBFCs continue to do well, other NBFCs are struggling. Interestingly, investors (especially foreign institutional investors) appear to be showing interest in the NBFC sector due to attractive valuations and the long-term growth potential. The Reserve Bank of India (RBI) is taking a hands-on approach and closely monitoring the performance of the sector. To tide over the liquidity crisis, RBI has relaxed the minimum holding period (from 1 year to 6 months) for NBFCs to raise funds via the securitisation route.

RBI has strengthened the regulatory framework of NBFCs by introducing a robust liquidity framework and proposed a liquidity coverage ratio for large NBFCs, which is currently applicable only to banks. The proposed guidelines require NBFCs to maintain asset liability management and liquidity discipline. It is also apparent that RBI is bringing NBFCs on par with banks as far as asset quality norms are concerned. Given these steps, RBI could consider the following:

a) Initiate conversations with senior bankers and provide assurances so that banks can start funding to NBFCs.
b) Examine a roadmap for the merger of NBFCs into banks with appropriate guidelines to grandfather the balance sheet and relaxation in the maintenance of the cash reserve ratio, statutory liquidity ratio and priority sector lending requirements.

In the medium term, NBFCs will have to focus on liability management, which could curtail growth. Most large NBFCs are well capitalised, but have got exposed due to excessive short-term borrowing (e.g. over dependence on 2-3 months commercial papers). The stronger NBFCs and HFCs have a more diversified lender base. Very few non-bank financial entities have the benefit of retail deposits which is a source of stable funding, especially in these times.

The lessons learnt are that there is no substitute for prudent lending. When you are in the business of lending, growth is never a challenge - by sacrificing margins or appraisal norms you can capture all the growth you want (particularly in a country like India where so many growth opportunities exist). However, this kind of growth will not lend to sustained long term success. Further, there is a need for NBFCs to sacrifice short-term margins to ensure asset liability management. Another issue I would like to point out that managing over 10,000 NBFCs is too unwieldy. Regulators need to increase the threshold entry level of NBFCs and HFCs by raising the minimum capital requirements. Checks and balances are needed to ensure that risks do not build up in NBFCs due to structures which are too complex to manage and become too big to fail.

To conclude, NBFCs are an integral part of the financial services ecosystem and will continue to create meaningful financial inclusion and employment opportunities. One must not forget that NBFCs have shown tremendous product innovation and evolved into specialised funding entities. By covering a wide spectrum of customised services such as equipment financing, transport / commercial vehicles, infrastructure and agriculture, NBFCs have actively participated in strengthening of the Indian economy.