A Nuanced Understanding of the NBFC Sector

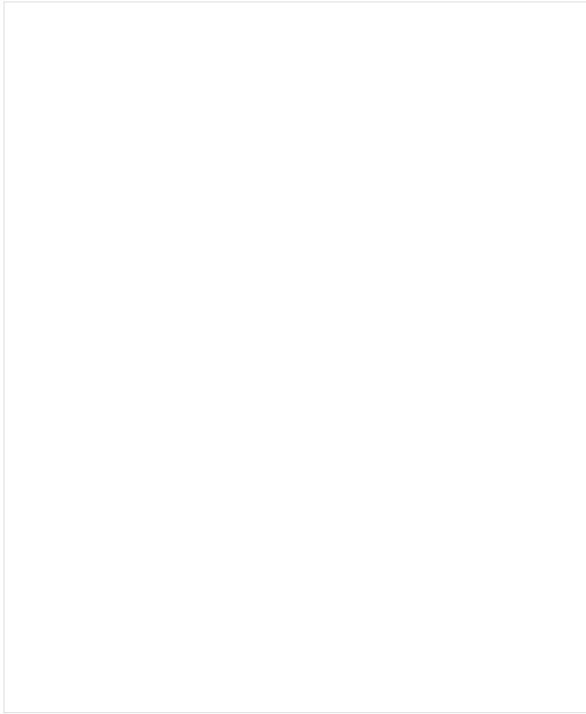
(This editorial is based on the article “A nuanced understanding of the NBFC sector” which appears in The Livemint.)

Non-Banking Financial Companies (NBFCs) have played an irreplaceable role in fueling the growth of the Indian economy and have made a noteworthy contribution towards supporting the government’s agenda of extending financial inclusion. They have emerged as key financiers to businesses, especially the high-potential, credit-hungry MSME sector.

The recent multi-level downgrade of Infrastructure Leasing and Financial Services (IL&FS) have represented a liquidity squeeze for the entire non-banking financial company (NBFC) sector. Debt default by a single NBFC has almost turned into a funding crisis for all. India’s flourishing shadow finance sector* will face a shake-up after defaults at one major lender battered the nation’s financial markets in the past week and reinforced worries about credit risk.

*A shadow finance sector contains the group of financial intermediaries facilitating the creation of credit across the global financial system but whose members are not subject to regulatory oversight.

- Risk aversion in debt markets has heightened to an extent that the market has lost its ability to make a distinction across NBFCs, bracketing all of them in the same risk category, irrespective of the underlying nature of their assets and liabilities.
- The liquidity squeeze faced by NBFCs has led to a conflict between the government and the Reserve Bank of India, with the Finance Ministry pushing for easier fund flows while the RBI insisting there’s already enough money available in the system.



What is a Non-Banking Financial Company (NBFC)?

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

Features of NBFCs

- NBFC cannot accept demand deposits.
- NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself.
- Deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs.

NBFCs can broadly be divided into three segments—

- Asset financing
- Personal loans

- Business loans
- Housing finance companies (HFCs)

The predominant asset financing NBFCs are commercial vehicle financiers. The remaining NBFCs provide a range of personal and business loans with widely varying business models.

HFCs, provide housing loans, can be considered as specialized NBFCs that have a separate regulator National Housing Bank (NHB).

National Housing Bank (NHB)

- It was set up by an Act of Parliament in 1987.
- NHB is an apex financial institution for housing.
- NHB has been established with an objective to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support incidental to such institutions and for matters connected therewith.

NHB registers, regulates and supervises Housing Finance Company (HFCs), keeps surveillance through On-site & Off-site Mechanisms and coordinates with other Regulators.

Importance of NBFCs

- NBFCs help attain the objective of macroeconomic policies of creating more jobs in the country by promoting Small and Medium scale Enterprises and private industries through lending them loans.
- The financial market relies heavily on non-banking financial institutions for raising capital. The start-ups and small-sized businesses are dependent on funds offered by NBFCs.
- NBFCs extend long-term credits to infrastructure, commerce and trade companies. The traditional banks expect timely, schedules and short-term repayment of loans that may not always suit the requirements of these industries.
- Non-banking financial companies help in rotation of resources, asset distribution and regulation of income to shape the economic development. They enable converting savings into investments and thus, helps in the mobilisation of funds/resources in the economy.
- NBFCs play an important role in promoting inclusive growth in the country, by catering to the diverse financial needs of bank-excluded customers. And very importantly, they also reach out to areas inaccessible to regular banking.
- As NBFCs aim to build capital for several industries – private and otherwise – they aid in accumulating a capital stock for the country. This directly adds on to the National Income and results in the progression of Gross Domestic Product (GDP).
- With quicker decision-making ability and prompt provision of services, NBFCs act as

not just complements but also substitutes to banks.

Problems Plaguing NBFCs

- The decline in asset quality for select NBFCs has stemmed from cases where underwriters (a person or company that underwrites an insurance risk) are inexperienced, or with limited understanding of the local situation and dynamics that drive the demand for credit.
- Misalignment in product offerings with customer needs: Small NBFCs, in an effort to capture markets, have expanded into new geographic locations and diversified their product portfolio but are misaligned with consumer needs. When products can't get associated with consumer needs, they become outmoded.
- Asset-liability mismatch: Several NBFCs are faced with a liquidity crunch (a time when cash resources are in short supply and demand is high), liabilities maturing and coming up for payment faster than loans in the same tenure.
- Lack of a strong regulator, except for housing finance companies, is also one of the challenges faced by NBFCs.

There are three primary drivers of the current risk aversion for NBFCs:

- The first driver relates to short-term funding being used to finance long-term assets—an asset liability mismatch (ALM).
    - For micro-finance, the average loan tenure ranges from eight to nine months, for commercial vehicle finance it is 16 to 18 months, while for small business finance it is 12 to 16 months. Thus, the asset side duration for these businesses is very short.
    - On the liabilities side, the duration either mirrors the asset side, or is longer, and generally ranges from one to two years. Thus, these small to mid-sized NBFCs run a positive ALM mismatch.
    - Even in the case of affordable housing finance, where one would expect a wide ALM mismatch, low asset duration for affordable housing financiers reduces the ALM gap to negligible. This is further aided by low leverage (debt to equity ratio) and high capital adequacy.
- The second cause of current risk aversion towards NBFCs has to do with refinancing or rollover* of short-term capital market borrowings.

    This concern is linked to the ALM issue, as a smooth rollover of shorter duration liabilities when assets are of longer duration is key for business continuity.
- The third cause for concern has to do with asset quality.

    This primarily pertains to exposure of NBFCs to the real estate sector—either as builder funding or loan against property (LAP).

*The term “Rollover” refers to the practice of “rolling over” a loan, wherein the borrower pays the lender an additional fee in order to extend the loan due date. This additional fee increases the cost of borrowing, and can lead some borrowers to become trapped in a cycle of debt, also known as a “debt trap.”

Way Forward

- Efficient engagement of customers: NBFCs must distinguish between active and inactive customers to develop a focused engagement methodology and allocate resources efficiently.
- Building effective reward and loyalty programmes to minimise bad debts: NBFCs must increase customer retention by building a strong loyalty programme, with discount, cashback benefits. The program must be customised according to the customer type and factor in right data variables to provide meaningful incentives and value for the customer loyalty.
- Over the years, NBFCs have played an important role in providing growth capital to various sectors of the economy. Concerted effort across stakeholders is required to prevent a market contagion that can cut off the critical supply of capital to the grassroots of the nation.

Market Contagion is the spread of market changes from one regional market to others. It can refer to the spread of either economic booms or economic crises throughout a geographic region. Contagions occur both globally and domestically, but they have become more prominent phenomena as the global economy has grown and economies within certain geographic regions have become more correlated with one another.