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A Rationale behind NBFC Crisis - 2019

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Abstract

Non-Banking Financial Company (NBFC) manages one-fifth of the credit for the Indian economy and gets recognized as a crucial sector among all other sectors. NBFCs are playing an increasingly important part in the economy. Their share of credit has increased because they were lending in sectors where banks refused to go or did not want to go. The used commercial market is a good example here. Now that NBFCs are finding it difficult to raise money, this will choke the flow of credit to the economy. This has impacted many sectors which were already suffering from the twin blows of demonetisation and the goods and services tax. A reduction in flow of credit further added to economic slowdown pressures. Besides, a slowdown in credit which lead to another pile of non-performing assets (NPA) in sectors such as commercial real estate and infrastructure, which had a economy-wide knockdown effects. The flurry of recent downgrades in NBFCs, housing finance companies and infrastructure projects lead to a crisis in the year 2019. With this backdrop, this research aims to (i) uncover the rationale behind the NBFCs crisis 2019 and (ii) highlight the steps taken by RBI to overcome the situation.

Keywords: NBFC, Non-Performing Assets, Crisis, IL&FS, Liquidity, Stressed Assets

Introduction

In a very short span of time India’s Non-Banking Financial Company (NBFC) sector has swung 180 degrees which was very popular quite a recent time ago. Barely two years ago, the NBFC sector was famous for its ability to deliver high margins and scorching growth rates, by lending to lucrative segments neglected by banks. Today, the same players are being blackballed for taking on unjustified risks in their chase of growth.

NBFCs play a key role in promoting inclusive development of the country, by fulfilling the diverse financial needs of customers excluded by bank. Further, NBFCs often take lead role in fulfilling innovative financial services to Micro, Small, and Medium Enterprises (MSMEs) most suitable to their business requirements. A NBFC are financial institutes that offers wide range of banking services but do not cater few of the banking services like; lending and accepting from the people. NBFCs is a company registered under the Companies Act, 1956 involved in a business offering of loans and advances, acquisition of shares/ bonds/ debentures/ securities/ stocks issued by Government or local authority or other marketable securities like hire-purchase, chit business, leasing insurance businesses but any of the institution does not include in agricultural, industrial activity, purchase or sale of any goods (other than securities) or providing any services connected to sale/ purchase/ construction of immovable property.

NBFCs are financial intermediaries engaged in the business of accepting deposits lending credit and play a significant role in channelizing the scarce financial resources to capital formation. The NBFCs supplement the role of the banking sector in meeting the increasing financial needs of the corporate sector, delivering credit to the unorganized sector and to small local borrowers. NBFC focuses on businesses related to loans and advances, stock, bonds, debentures, acquisition of shares, securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business and chit business.

The banking sector would always be a necessary sector in the field of business because of its credibility in supporting infrastructural development, manufacturing and even being the backbone for the ordinary persons' money. But despite this, the role of NBFCs is critical and their presence in a country would only boost the economy in the right direction.

NBFCs and Indian Economy

The following are the major contributions of NBFCs towards the growth of Indian Economy;

(a) **Mobilization of Financial Resources:** A Non-Banking Financial Company allows and provide with the mobilization of resources like; funds and capitals. NBFCs help in the mobilization of assets by converting investment into most preferable sets. NBFCs create a balance between intra-regional income and asset distribution. NBFCs convert the savings into investment practices; this makes a wide and strong contribution to the economic development as compared to the traditional bank practices.

(b) **Providing Long-Term Credits:** NBFCs play a key role in providing the corporations with funds through equity participation. NBFCs differ from the traditional banks; NBFCs offer long-term credit to trade and commerce industry. These companies help to fund large projects and mega infrastructure projects which boost economic development to a great extent. Long-term credit allows sustainable growth and development of economic sector with stable interest rates. NFBCs are also engaging in funding small-scale industries and MSMEs which will create a base for the development and growth of the economy.

(c) **Upliftment in the Employment Sector:** The operations and policies of NBFCs are raising the job scenario. More job opportunities are arising with the influence of NBFCs in the private as well as government sector. NBFC helps in achieving full employment in the economy by working with the government and investing in the private sectors. NBFCs helps to fulfil the financial needs of the corporate sector, delivering credit to the unorganized sector and to small local borrowers Also, the business activities in the private sector provide more job opportunities and occupation practices due to such non-banking financial companies.

(d) **Enhancing the Financial Market:** The NBFCs cater the urban and rural poor companies that have a complementary role in the financial inclusion. Microfinance plays an important role to attain stable financial inclusions. NBFC bring the much-needed varieties to the financial market by diversifying the risks, increasing liquidity in the markets thereby promoting financial stability and bringing efficiency to the financial sector.

(e) **Future Renovations with NBFCs:** The future will mark the financial innovations driven by the NBFC sector and will help it to grow in an exclusive manner. These companies will be the game changer in the developing economy by providing factoring and bill payment service. NBFCs will play a vital role in closing the loop as regards financial inclusion for individuals and MSMEs which will become the backbone of the economy. Further, these companies are planning to attain data and algorithm to fine-tune the marketing campaigns and lower the cost per acquisition resulting in higher margins. NBFCs will surely help the infrastructure companies grow significantly by supplying financial requirements. NBFCs will surely provide real-time solutions to a company's stability and individual progress with the growing economy.

Background of the Crisis

One fine day, the market was no longer bullish about NBFCs. Instead, their stocks were being hammered. Dewan Housing Finance Limited (DHFL) which is considered to a blue chip NBFC stock suddenly saw its stock price decline by 60% in one day! The same was the case with Infrastructure Leasing and Financial Services (IL&FS) which is supposed to be a stalwart in this field. The main reasons behind the decline of the NBFCs stocks are as follows:

(a) **Timing Mismatch:** Indian NBFCs have been playing a very risky game. They have been borrowing money short term and have been lending it out long term. This asset liability timing mismatch is obviously a reason for disaster. However, the NBFCs have been able to roll it over and pay their debts when due. This is the reason the NBFCs were able to function without too many problems.

The problem started when IL&FS, i.e. one of the NBFC's mismanaged its funds. As a result, it is now not able to pay back its creditors. The end result is that IL&FS stands exposed, and so does this faulty business model of the NBFCs. Since the IL&FS panic has scared the investors away, the NBFCs are not able to issue new debt in order to roll over the old debt.

(b) **Mutual Funds:** These NBFCs also heavily relied on funds available from debt mutual funds. The problem is that the NBFCs have caused a market crash. As a result, both retail and institutional investors have reduced the quantum of investments in mutual funds. As a result, the supply of funds from there has dried down as well. This has added to the woes of the NBFCs.

(c) **Asset Quality Issues:** A lot of these NBFCs are classified as housing finance companies. They lend money either to the developers or to the homebuyers. The end result is that the money lent out by these companies is heavily invested in the housing sector. The problem is that the Indian housing sector has gone bust. Stalwarts like Amrapali Group, Supertech, Unitech, etc. have all gone bust. This is the reason why the asset quality of these NBFCs is also in question. These companies are facing a double whammy with both their assets and liabilities under increasing scrutiny. This is putting pressure on the net worth of these companies and driving them towards insolvency.

Objectives of the study

NBFCs being a crucial sector of the economy engaged in lending to those sectors neglected by banks. Emergence of NBFCs in meeting the needs of those neglected sector has gained prominence and confidence of the economy. Since the default of infrastructure finance, a series of problems were hurting the Indian NBFC sector. Now that NBFCs are finding it difficult to elevate money or having to pay a huge cost for doing so, this choked the flow of credit to the economy. With this backdrop, this paper aims (i) to uncover the rationale behind the NBFCs crisis 2019 and (ii) to highlight the steps taken by RBI to overcome the situation.

Research Methodology

This study uses Descriptive research to gather preliminary information, observe the series of events that led to the crisis, record the actions that were taken by various stakeholders and describe the consequences of the regulations.

Source: The necessary information for the study was gathered from secondary sources. Data from several research papers, journals, websites including from the official websites of regulators, company annual reports and media sources formed the basis for this paper.

Reasons for the NBFC Crisis

A few of the identified major reasons behind the NBFC crisis:

(1) **IL&FS:** The debt crisis in IL&FS has already impacted growth of the NBFC sector in India and might lead to its consolidation. The infrastructure leader has a total consolidated debt of close to Rs. 1 Lakh crore, and it started to miss deadlines on its debt obligation beginning August 27, 2018.

It has defaulted on around Rs. 450 crore worth of inter-corporate deposits to Small Industries Development Bank of India (SIDBI), and more defaults are likely in the coming weeks.

Many corporate, mutual funds, and insurance companies have invested in CPs and NCDs of the IL&FS group and there was a fear that in the wake of the default, their funds could be locked in IL&FS debt instruments, leading to a liquidity crunch.

(2) **No domino Effect:** After the dramatic default by IL&FS in September 2018, the market was extensive with fears that its collapse would set off a chain reaction of business failures across the NBFC space. Nine months later, however, this domino effect hasn't quite played out. The funds crunch caused by IL&FS has led to isolated credit downgrades of some NBFCs/ HFCs. There have been two cases of actual default the Reliance ADAG and DHFL groups.

There are two explanations for the absence of a chain reaction Forensic investigations revealing IL&FS' dubious accounting and gold-plating practices have also led markets to recognise that there were company-specific factors at play.

Two, given that IL&FS was not a deposit-taking entity and did not raise funds through public NCDs, its spectacular collapse did not elicit a panic reaction from the public at large. The mutual fund industry, the most vulnerable among institutional players to a run, had just 5 per cent of IL&FS' aggregate borrowings on its books.

Today, the fund industry is mostly done with its IL&FS write-offs and exposures of other institutions are out in the open. It is therefore unlikely that the IL&FS episode will trigger a run on other NBFCs at this late stage.

(3) **Asset and Liability Mismatch:** While it hasn't set off a domino effect across the sector, the IL&FS debacle has served to underline the high business risks inherent in NBFC business models that rely on short-term market borrowings for long-term loans. The resulting risk aversion by lenders has landed NBFCs and HFCs with high asset-liability mismatches in hot water (Reliance ADAG firms and DHFL, for instance).

After initially recoiling from all NBFCs, lenders are now scrutinising NBFC balance sheets more closely in order to avoid firms with high leverage, ALM mismatches or shaky clients. With lenders taking note of differentiated business models, NBFCs engaged in short-term asset financing (including consumer, gold, MFI, auto and truck financing companies) have seen their funding constraints ease up in recent months. But funding has dried up for select housing finance companies with high ALM mismatches and NBFCs with exposure to real estate and property loans which are seen as turning bad. They seem to be bearing the brunt of the current liquidity crunch.

(4) **The Liquidity issue:** Data on issuances show no dramatic fall in the funds raised by the NBFC and HFC sectors from the bond markets in FY19. NBFCs raked in Rs.4.01 lakh crore from commercial papers (CPs) in FY19, while HFCs raised Rs.2.2 lakh crore. After the IL&FS shocker in August 2018, monthly CP issues for NBFCs and HFCs fell steeply until October but thereafter have staged a tentative recovery.

But the aggregate trends do hide problem areas. One, under pressure from their investors to curtail exposure to NBFCs and lower-rated bonds, mutual funds have sharply cut back on their participation in the CP market, forcing NBFCs/ HFCs relying on rollovers to scrounge for funds.

Two, redemption pressures on credit funds and general risk aversion from institutional investors has led to a skew in funding towards big-name NBFCs/HFCs while lesser names struggle. Three, funding costs have seen a sharp spike irrespective of the category of non-bank borrower.

Impact of NBFC Crisis on Indian Economy

The following are the impact of NBFC crisis on Indian economy:

(1) **Decline in production of 4-wheelers:** In order to buy a car and seek finance for it, the NBFC official grants a loan immediately. Where the customers can axis to loan instantly by an NBFC, getting loan approval from a bank takes around minimum of 20 days. Hence, most of the financing was done by the NBFCs which they stopped. Due to this, consumer car loans came down and purchasing of cars also fell subsequently. As a result there was a decline in production of 4-wheelers.

(2) **Sales of two-wheelers were affected:** Same thing took place in case of two-wheeler's manufacturing. The two-wheeler manufacturing companies in several parts of India are well-financed but their sales were affected as the NBFCs did not finance in adequate. According to a report published by Kotak Mahindra, sales figure of auto and car in the country is about Rs.5 lakh crores, the monthly sales was around Rs 40,000 crore. Now a 20% decline in the Rs.5 lakh crore sales figure would sum up to Rs.1 lakh crore which was being financed.

(3) **Dependency on NBFCs:** Since the real estate companies were not being funded by banks a large chunk of the funds were being financed by NBFCs. The NBFCs were lending to these companies to start new projects, construction and financing etc. However, after Real Estate Regulatory Authority (RERA), they could not divert the money given by house owners hence; they depended on NBFCs even for their working capital requirements.

(4) **Unsustainable employment opportunities:** The operations and policies of NBFCs are uplifting the job scenario. The Iron & Steel industry, the auto and real estate sectors are the biggest consumers of building material like cement which is used by many a companies and creates abundant jobs. Hence, the rate of employment also decreased gradually in other sectors of the economy.

(5) **Plunge in the growth of GDP:** Slow down in GDP for the fourth quarter was due to temporary factors like stress in NBFC sector affecting consumption finance. NBFCs were under liquidity pressure after the shocker default by Infrastructure Leasing and Financial Services (IL&FS) in September last year.

(6) **Implementation of GST:** Implementation of GST has also partially contributed to NBFC crisis. GST is paid in advance every month on billing and collection of debtors is slow, resulting in over utilization of bank limits of business and increased debt cost.

(7) **Demonetization:** Demonetization tapped the parallel economy which was major contributor to consumption or demand in our country. Cash was squeezed which majorly hit the demand for luxury products and brands.

(8) **Higher volatility in Stock Market:** Investors were worried that liquidity conditions might tighten. The market is already dealing with the default at IL&FS. The liquidity crunch at NBFCs had compounded worries for the market, which is already struggling with the depreciating rupee and higher oil prices. This started the wave of panic in investors as they started selling their shares of NBFCs which had lent money to the IL&FS group.

RBI Actions to Overcome the Crisis

According to RBI data, outstanding bank credit to all industry stood at Rs.27.01 trillion in the fortnight ended 28 September, up 2.6% from the year-ago period. Loans to NBFCs stood at Rs.5.46 trillion on the same fortnight, up 41.5% from the same period last year. This is the latest disaggregated sectoral data available from RBI. Currently RBI has inducted Rs 40,000 crores through the government securities to meet the liquidity demand ahead of the festive season. In October, the central bank infused Rs 36,000 crores through open market operations in order to improve sustainability in crisis. Currently RBI has allowed banks to lend up to 15% of their capital funds to a single non-infrastructure funding NBFC from the earlier 10%.

Conclusion

The banking sector would always be the imperative sector in the field of business due to its reliability in supporting manufacturing, infrastructural development and even being the backbone for the layman's money. It is no secret that in the year 2019 Indian economy uncovered itself amidst a liquidity crisis which arises out of the lowering confidence of investors and the banks in the NBFCs ever since the IL&FS bubble burst leaving the NBFCs with a huge chunk of NPAs and little to no re-financing options. The problem in our economy, however does not limit itself solely to the financial sector of the economy. It is time, now, for our financial sector to move from a socialist approach to a more professional and mixed economic approach in order to stimulate private investment.

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