



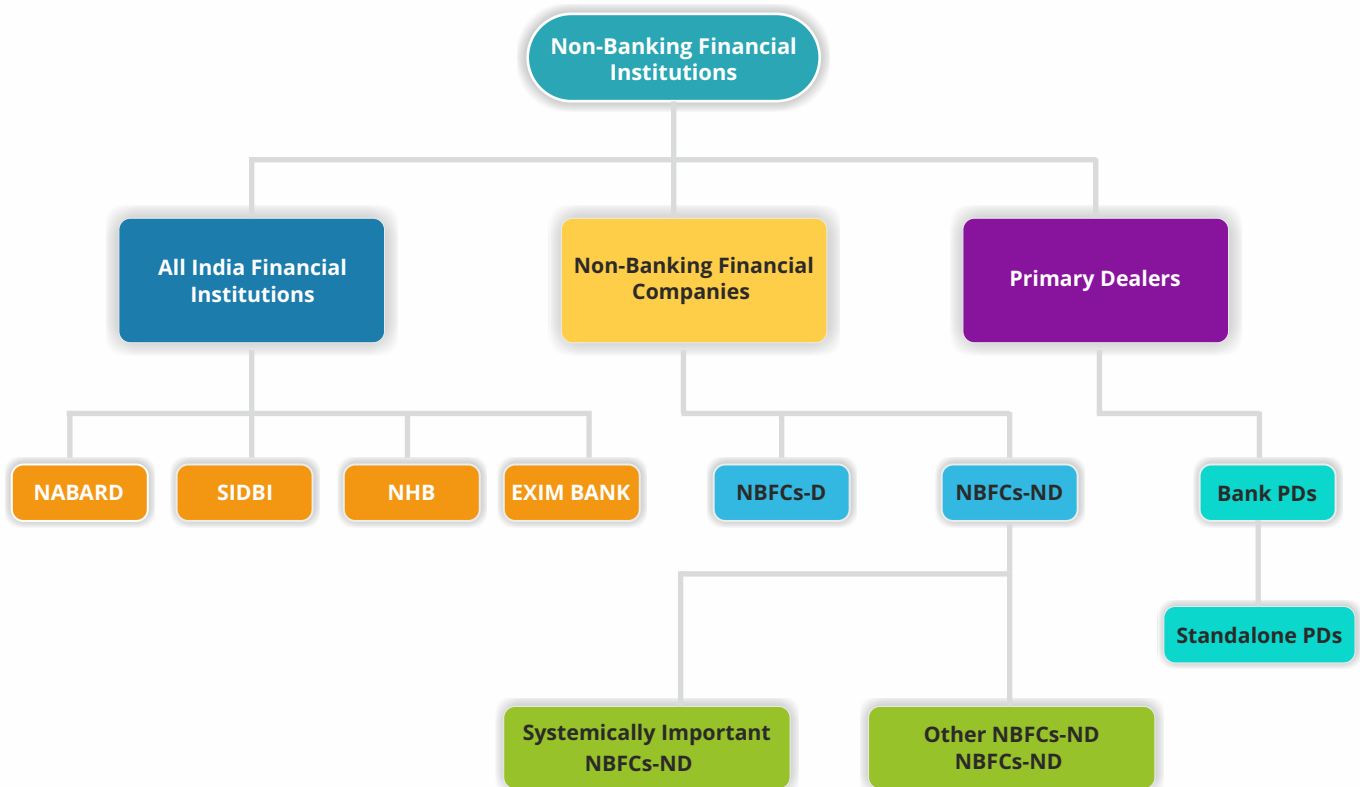
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All India Association of Industries

# Report on **Strengthening NBFC Sector**





**MVIRDC**

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## **Bharat Ratna Sir M. Visvesvaraya**

(15 September, 1860 - 14 April, 1962)

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## Preface



**Mr. Vijay Kalantri**  
Vice Chairman  
MVIRDC World Trade  
Center Mumbai &  
President  
All India Association of  
Industries (AIAI)

NBFCs have been a game changer in financing the small business enterprises and thus facilitating the Ease of Doing Business for a long time now. The line of credit from the NBFCs reaches to at least 60% of the creditors.

The small and unorganized sector is in fact one of the major sectors which the NBFCs have been catering through micro lending, loan against gold, equipment finance, personal loans and other forms of credit. The NBFCs thus are playing an important role not only in navigating instant capital to fulfill the working capital needs but also help reduction in time for operational finance.

It is a known fact that the unorganized sector and MSMEs are the worst sufferers as far as the access to institutional credit is concerned and it is the Non Banking Finance Companies (NBFCs) who are the principal vehicles that bring this unbanked section into the formal financial system.

Thus, in event of the ongoing stress in the NBFC sector there is an all time possibility of the stress spreading to the associated sectors not only to that of MSMEs but also to that of housing and logistics finance as well. The effect of stress on MSME may take a longer time to show but the effect will be immediate for housing and logistics sector thus impeding the capability of the small man to buy shelter and food.

Today, NBFCs account for hardly 10% of the total credit flow from banking channels to the MSME sector in contrast to the Rs. 20-25 trillion unmet credit need of the MSME sector, as estimated by the report of the Expert Committee on MSMEs under the Chairmanship of Mr. UK Sinha. Strengthening this sector is the need of the day to avoid large scale distress among the masses supplemented by the ongoing global depression.

Prudential regulation, adoption of cutting edge technologies and addressing gaps in current policy framework are prescribed to curb the ongoing stress in the NBFC scenario. It is also apprehended that the current crisis is one of liquidity squeeze faced by a few financially weak NBFCs and not by the entire sector. The industry thus has suggested policymakers to open new sources of funding such as RBI liquidity window, refinancing under MUDRA and allowing on-tap issuance of non convertible debentures.

Default by a few high profile NBFCs has dented investor confidence in this sector, thereby choking flow of short term and long term funding for some players with weak balance sheets. We appreciate the timely initiatives taken by the government and Reserve Bank of India to prevent this funding constraint from transforming into a full blown crisis. A full fledged Board for NBFCs regulating the financial flows is the need of the hour before the intervention of the RBI in various issues pertaining to this industry.

We hope the NBFC sector will stand strong through the perils of time and continue to support the smaller sectors of the economy.

## Panel Discussion on 'Strengthening NBFC Sector'

MVIRDC World Trade Center Mumbai organised a panel session to deliberate on the magnitude of the NBFC crisis and policy measures to address the stress in the sector at WTC Mumbai on August 21, 2019. The event was organised jointly with All India Association of Industries (AIAI). The session was addressed by representatives from NBFC industry, banks, rating agencies and mutual funds. During the event, speakers from the NBFC industry put forth the suggestion that Reserve Bank of India must open liquidity window to ease short term funding constraints in the sector.



(L-R) Ms. Rupa Naik, Senior Director, MVIRDC World Trade Center Mumbai, Mr. Firoze B. Andhyarujina, Senior Counsel, Supreme Court of India, Mr. K.V. Srinivasan, Director and Chief Executive Officer, Profectus Capital, Mr. Mahesh Thakkar, Director General, Finance Industry Development Council (FIDC), Mr. Umesh Revankar, MD & CEO, Shriram Transport Finance, Ms. Sunaina Dacunha, Senior Fund Manager, Aditya Birla Sun Life AMC, Mr. Vijay Deshwal, Head – Services Sector Group, Wholesale Banking, ICICI Bank and Mr. Krishnan Sitaraman, Senior Director, Financial Sector & Structured Finance Ratings, CRISIL at the Panel Discussion on 'Strengthening the NBFC Sector' organized by MVIRDC World Trade Center Mumbai and All India Association of Industries (AIAI)



### Mr. K.V. Srinivasan

Director and Chief Executive Officer, Profectus Capital

Mr. Srinivasan moderated the panel session by making initial remarks on the prevailing misconception in the sector. He said, "The current NBFC crisis has been largely misunderstood and it attracted disproportionately kneejerk reaction from media. It is high time to place the truth in the right perspective. After one year of this crisis, people have come to the conclusion that the days of panic in the sector have passed.

There is no need for asset quality review in this sector. NBFCs play a major role in providing last mile connectivity and bringing small enterprises to the formal financial sector. NBFCs cater to 70% of first time borrowers and they contribute 40% of the total credit to MSME sector."

Speaking further about the misconceptions about this crisis, Mr. Srinivasan said, "NBFCs are well regulated by the RBI. Time has come to adopt a forward looking approach based on the learnings from this crisis."



**Mr. Umesh Revankar**  
MD & CEO, Shriram Transport Finance

Mr. Revankar opined that the recent decline in the sale of automobiles in the country should not be attributed entirely on the crisis in the NBFC sector.

He said, "The current NBFC crisis is not the only reason for slowdown in the automobile sector. Sales of auto companies have been declining because of a slew of regulatory changes, weak monsoon and slackness during election season. Vehicle buyers are delaying their purchase decisions awaiting clarity on government's emission standards and introduction of electric vehicles in the market."

In order to address the funding crisis in the NBFC sector, Mr. Revankar suggested small NBFCs to tap capital market through public and private issuance of debentures for raising capital, instead of just depending on banks for funds. He also advised NBFCs to take prudent decisions on pricing and managing margins in their lending activity.



**Mr. Vijay Deshwal**  
Head - Services Sector Group, Wholesale Banking, ICICI Bank

Mr. Deshwal pointed out the current NBFC crisis must be seen as an opportunity to rethink collaboration between banks and NBFCs. He said, "I strongly feel that NBFC sector will emerge strong from the lessons of this crisis as they will re-align their capital structure and leverage, improve governance and transparency. The lessons from this crisis will help banks and NBFCs partner with a risk calibrated approach. The collaboration of banks and NBFCs will grow stronger through co-origination, liability franchise and securitization."

Mr. Deshwal denied the perception that banks withdrew all credit lines to NBFCs at the height of the crisis. He clarified that banks were the major source of capital to NBFCs through securitization.



**Mr. Mahesh Thakkar**  
Director General, Finance Industry Development Council (FIDC)

Mr. Thakkar suggested policy measures to address short term liquidity stress and also to create long term funding options for the sector. He said, "Government and RBI must act proactively and send signal continuously that funding situation is improving in the sector. Government must also take a slew of steps such as allowing on tap issuance of non convertible debentures, permitting refinance of Mudra loans and opening separate refinance window for NBFCs. These steps will help strengthen the financial position of NBFCs and promote fresh lending from this sector."



**Mr. Krishnan Sitaraman**  
Senior Director, Financial Sector & Structured Finance Ratings, CRISIL

Mr. Sitaraman put forth his assessment of the current crisis in the sector. He said, "The funding problem for NBFCs is not as grave as it is made out to be. In fact, during May-July 2019, NBFCs have managed to raise 70% of total funding that they raised in the corresponding period last year. The asset quality of retail lending NBFCs is steady, while the asset quality of standalone, wholesale lending NBFCs have deteriorated. NBFCs with sound governance and asset liability management have no problem in raising finance. This crisis situation is the period of adjustment for NBFC sector."



**Ms. Sunaina Dacunha**  
Senior Fund Manager, Aditya Birla Sun Life AMC

Ms. Dacunha shared her perspectives on the funding situation being faced by strong and weak NBFCs and called for new avenues for funding in the sector. She remarked, "We should not paint the entire NBFC sector with the same brush. NBFC is a heterogeneous industry comprising housing finance companies, micro lending institutions, auto finance companies and structured finance institutions. The market is discerning and they can differentiate between weak and strong borrowers. Companies with strong balance sheet and backing from large corporate houses do not face difficulty in accessing capital."

In order to ensure alternative source of finance for NBFCs, Ms. Dacunha suggested the development of corporate debt market by introducing standardization of debt issues, documentation and governance norms, infrastructure for listing and trading securities and transparency in data sharing.

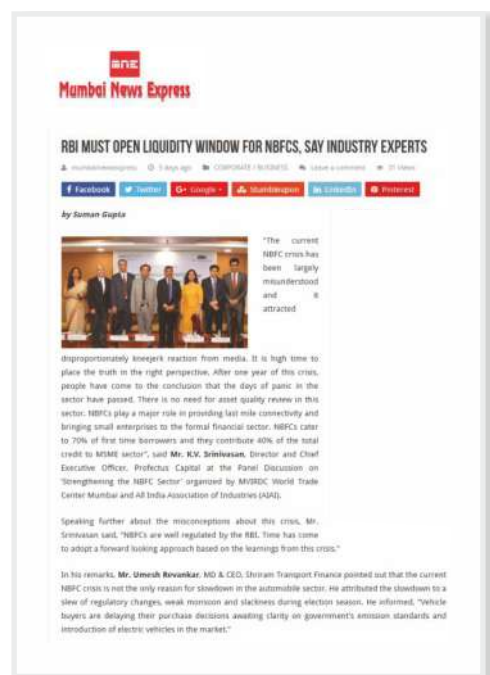


**Mr. Firoze B. Andhyarujina**  
Senior Counsel, Supreme Court of India and Legal Advisor  
MVRDC World Trade Center Mumbai

Mr. Andhyarujina delivered welcome remarks for the session by presenting an overview of the stress being faced by NBFCs. He said, "The current NBFC crisis brings to the fore the role of credit rating agencies, identification of sound NBFCs, role of auditors and role of independent directors. Slowdown in NBFC financing has affected automobile and real estate sectors, thereby claiming at least 2.5 lakh jobs. The impact of this crisis is not only on a few sectors, but on the entire economy. Therefore, we need to come up with a mechanism to segregate financially sound NBFCs from weak ones."

The event was attended by representatives from micro, small and medium enterprises, banks, NBFCs and other financial institutions.

## Media Coverage



## NBFC Crisis – An Overview

### NBFC Sector at a Glance

Non Banking Finance Companies (NBFCs) have been a major driver of funding to the MSME sector and consumers in the last several decades. Considering their systemic importance, Reserve Bank of India felt the need to regulate them way back in 1964 by inserting Chapter III B in its Act. Today, India is home to more than 9,659 RBI-registered NBFCs, of which 88 are deposit taking NBFCs, while the remaining are non deposit taking NBFCs (as of March 2019).

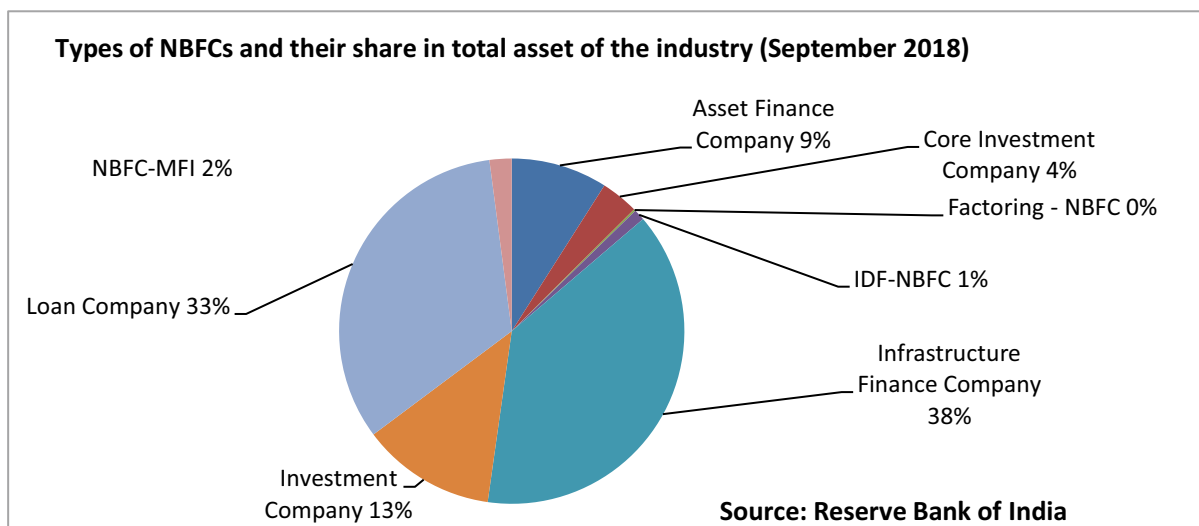
Among the 9571 non deposit taking NBFCs, 276 are systemically important NBFCs (with asset size more than Rs. 500 crore) which account for 85% of the asset size of the sector<sup>ii</sup>. These systemically important NBFCs, along with the deposit taking NBFCs are subject to prudential regulations such as capital adequacy requirements and provisioning norms of the RBI.

Based on ownership criteria, systemically important (SI) non deposit (ND) taking NBFCs are classified as government owned and private owned. Government-owned NBFC-ND-SIs account for 30% of assets of the sector and government-owned deposit taking NBFCs contribute 1.4% to the total asset of the sector. According to RBI norms, all registered NBFCs must have minimum net owned funds of Rs. 20 million. In 2018-19, RBI cancelled registration of 1604 NBFCs for not meeting this minimum net owned fund requirement.

RBI classified NBFCs into 12 categories based on their activities. Accordingly, NBFCs are categorized as infrastructure finance companies, loan companies, investment companies, asset finance companies, microfinance institutions, among others. Out of these companies, infrastructure finance companies account for 38% of the asset of the industry. Infrastructure finance companies include Power Finance Corporation, India Infrastructure Finance Company, Srei Infrastructure Finance, Indian Railway Finance Corporation Ltd, L & T Infrastructure Finance Company Limited, among others.

Loan Company and Investment Company, which are together called general NBFCs, contribute 46% to the total asset of the industry. These companies are generally engaged in consumer loans, credit to MSMEs, real estate and other services. Asset finance companies such as Shriram Transport Finance Co, Srei Equipment Finance Limited, M&M Financial Services Ltd and others account for 9% of the total asset. The following chart provides the relative share of various types of NBFCs in the total asset of the industry.

Infrastructure Leasing & Financial Services Limited (IL&FS), the group companies of which defaulted on repayment of commercial papers, non convertible debentures and bank loans in 2018, is classified as a systemically important non-deposit accepting core investment company (CIC-ND-SI).



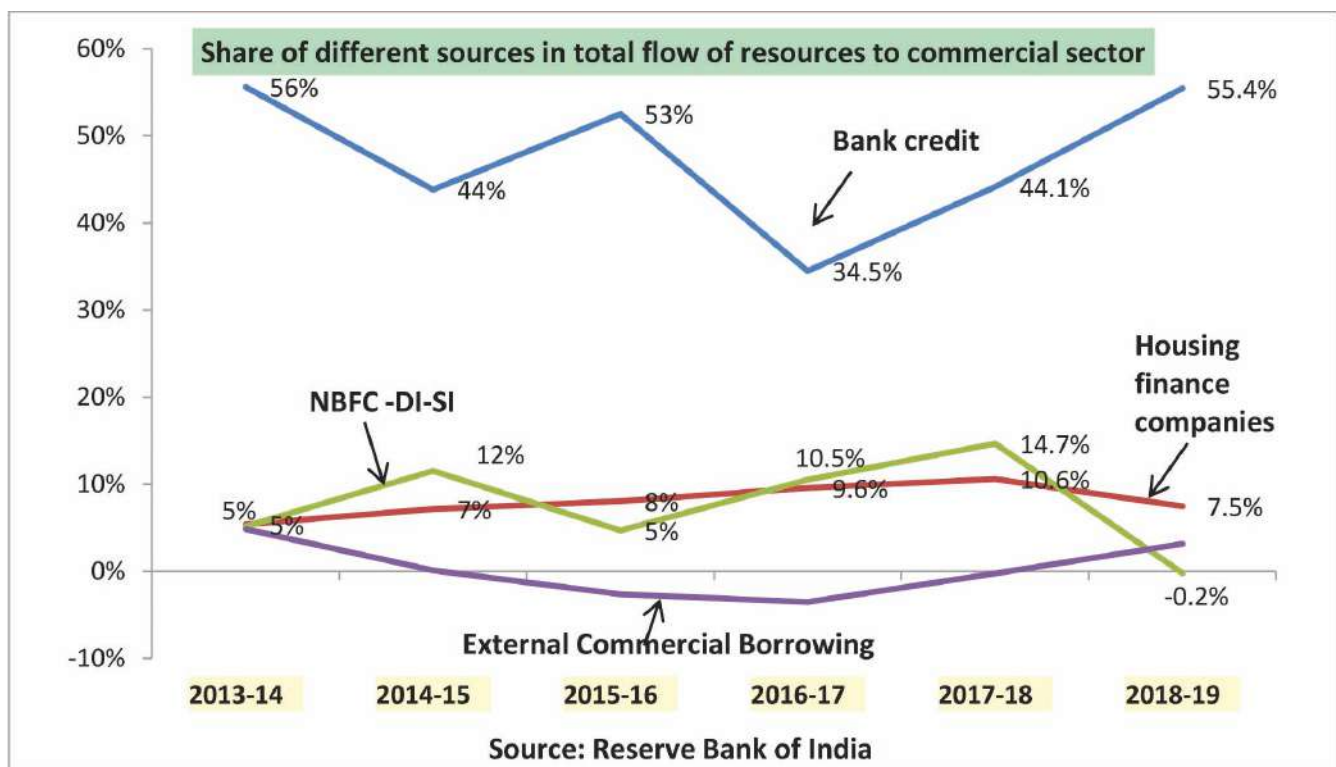


### NBFCs and Credit Flow

Banks and non banking finance companies are the major source of funding as they together meet more than 50% of the credit needs of the commercial sector.

As can be seen from the data since 2013-14 (see chart below), the share of NBFCs in total lending increases whenever the share of banking sector declines and vice versa.

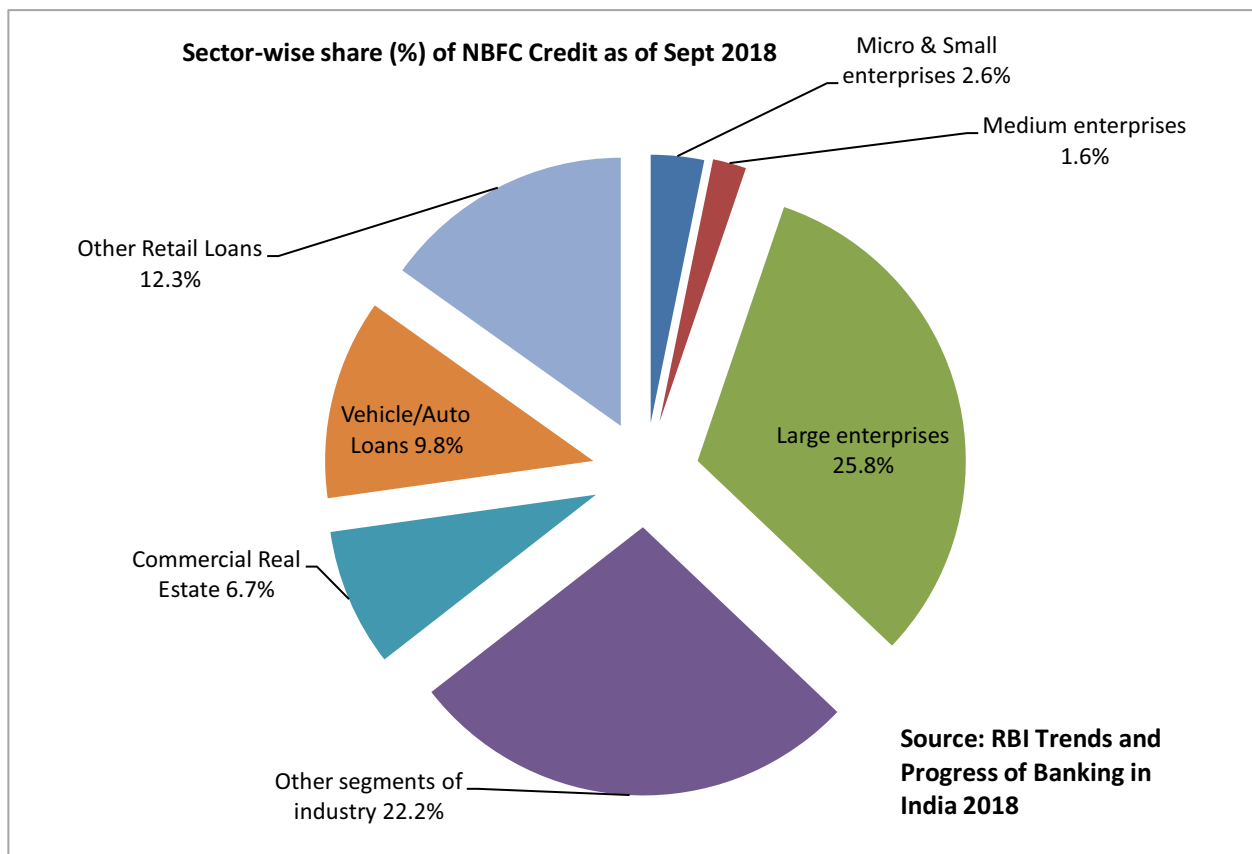
In the year 2015-16, banks met 52% of the total credit needs of the commercial sector, while the share of NBFCs stood around 4.7%. In the following year, the share of banking sector declined sharply to 34% because of the considerable rise in non-performing assets and the consequent increase in provisioning requirement. The space left by banks was filled by the NBFC sector with its relative share more than doubling to 10.5% in 2016-17 and rising further to 14.7% in the following year. This inverse relationship between share of NBFCs in total credit flow and share of banks in total credit flow was broken as an exceptional case after demonetization when the general public parked their excess cash in banks and mutual funds. Mutual funds, in turn, invested this excess cash in the commercial papers and non convertible debentures of NBFCs. This improved



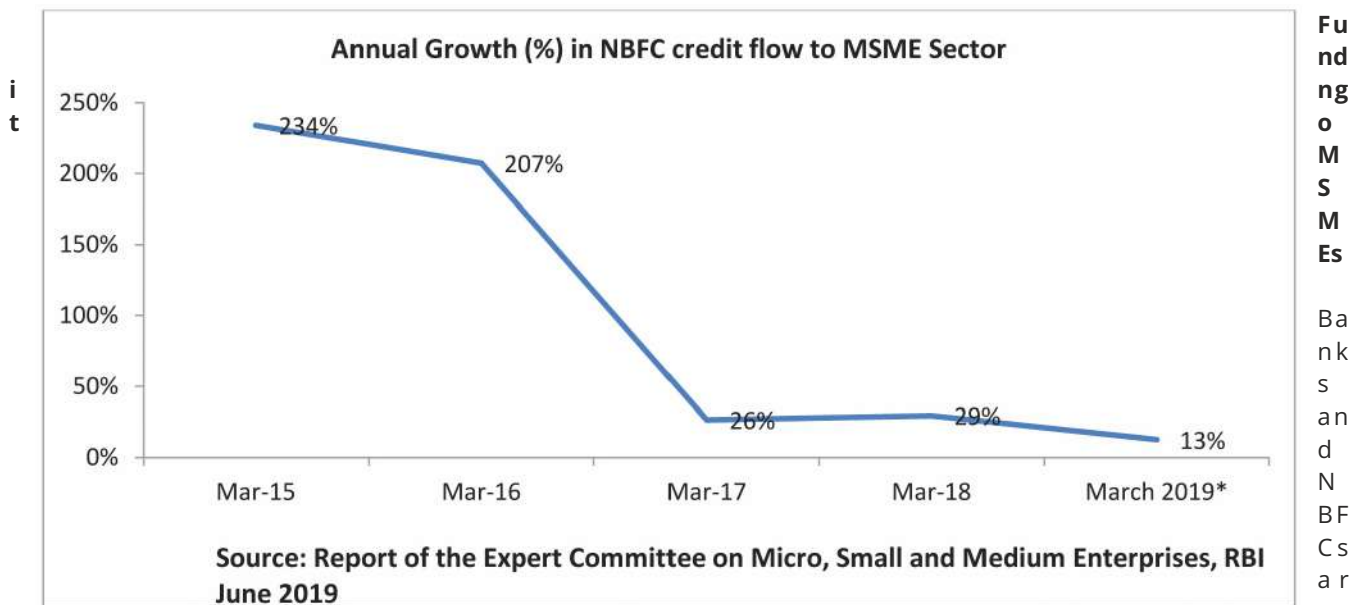
the ease of accessing funds for NBFC sector and thereby increased flow of credit from NBFCs. Banks also stepped up their credit disbursements because of excess cash deposits after demonetization. Therefore, the period between 2016 and the ILFS default in 2018 saw high growth of credit disbursements, both by banks and mutual funds.

The ILFS crisis, which started with its default on bond in September 2018, created heightened risk perception among investors towards the NBFC sector. Risk perception worsened as the ratings of some NBFCs were downgraded after the ILFS crisis. As a result, mutual funds, banks and insurance companies were wary of renewing their existing investment in the NBFC sector. As a result, many NBFCs faced difficulty in raising funds from the market and this severely affected their ability to disburse credit. Consequently, the share of NBFCs in overall credit flow to the commercial sector fell sharply to -0.2%. Also, slowdown in the real estate sector and stress in some of the housing finance companies (HFCs) led to their share declining from 10.6% in 2017-18 to 7.5% in the following year.

Financial stress in the NBFC and HFC sectors led to the share of bank credit growing sharply as banks supported bought some of the securitized loan portfolio of NBFCs and HFCs. The share of bank credit in overall resource flow grew to 55% in 2018-19 from 44% in the previous year.



NBFC crisis affected consumption in the country as a sizeable share of NBFC credit was in the form of consumer loans such as vehicle finance, consumer durable loans, housing finance etc. Retail loan accounted for 22% of total NBFC credit, of which auto or vehicle loans had a share of 10% in 2018.



major source of funding to the micro, small and medium enterprise sector. As of March 2019, the outstanding loan given by banks and NBFCs to MSMEs stood at Rs. 17.4 trillion, of this NBFCs had a share of almost 10%. It is the medium size enterprises that rely largely on the NBFC sector for financing. Of the total (banks and NBFCs) outstanding credit to the

Funding to MSMEs  
Banks and NBFCs are the

medium size industries, the share of NBFCs stood at 17%, as of March 2018.

As can be seen from the chart below, credit flow from the NBFC sector to MSMEs grew at more than 200% during 2015 and 2016. NBFCs are the preferred source of funding for MSMEs because it takes relatively less time and paperwork by NBFCs to process loans compared to banks. While NBFCs take 18 days to process loan application of MSMEs, the time taken by public sector banks and private sectors banks are respectively 31 days and 29 days. Also, the low cost business model of NBFCs made it easier for them to reach out to the first time borrowers from the MSME sector.

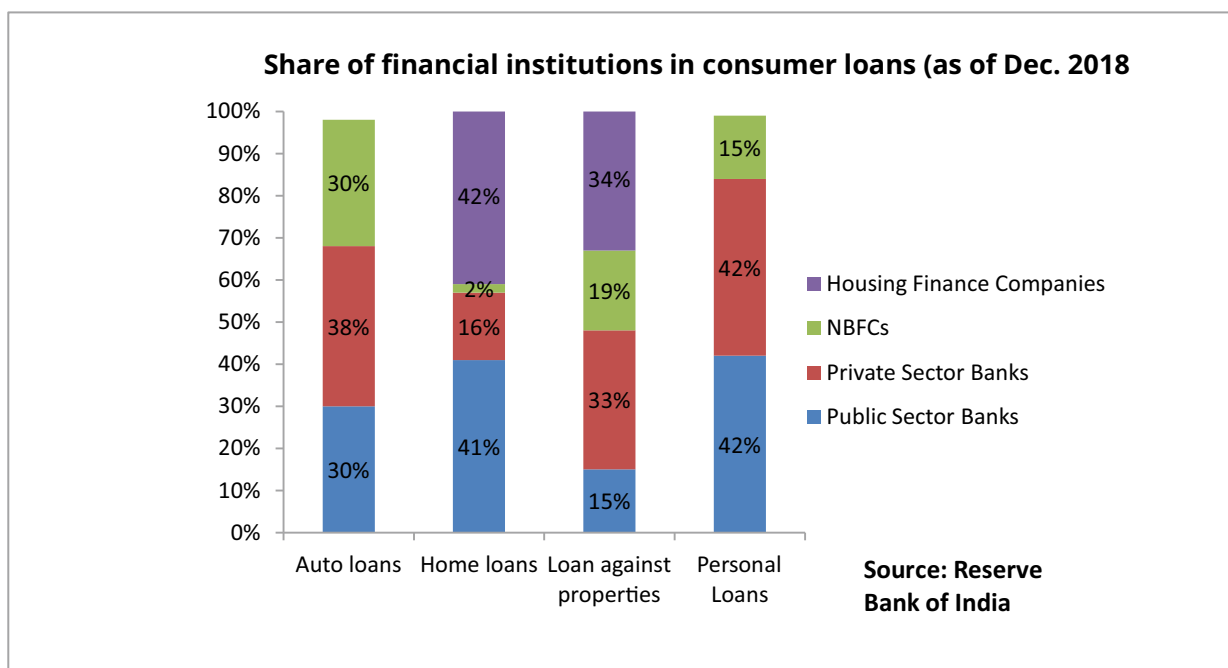
Another factor driving NBFC credit to the MSME sector is that banks that are unable to meet priority sector lending targets will be willing to buy MSME loan portfolio from NBFCs. According to RBI guidelines, domestic scheduled commercial banks have to allocate 7.5% of their total annual credit to micro enterprises. However, banks that are unable to meet this target of their own can fulfill this obligation by buying MSME loan portfolio of NBFCs.

Credit growth to MSME sector from NBFCs declined sharply during March 2017 because of demonetization and introduction of GST. Most of the NBFC credit to the MSME sector was in the form of working capital, factoring of bills receivables or inventory financing etc. The slowdown in NBFC credit growth to MSME sector worsened after the liquidity crisis that ensued the ILFS fiasco in September 2018 (as can be seen from the chart above).

**NBFC funding to other sectors**

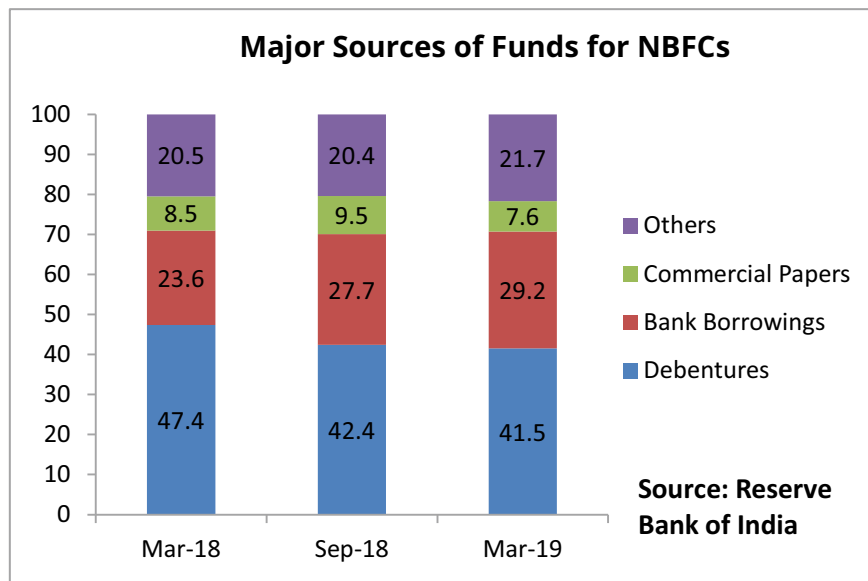
As can be seen from the following chart, NBFCs accounted for 30% of total credit for the automobile sector. Buyers of two wheelers and three wheelers, who do not have prior credit history, prefer to approach NBFCs for finance, rather than seeking loan from banks. According to industry body SIAM, 70% of two wheeler purchase and 60% of commercial vehicle sales are financed by NBFCs. NBFCs also support automobile dealers by funding them for maintaining inventory. The tight liquidity condition being faced by the NBFC sector affected flow of credit to the automobile industry, thereby affecting vehicle sales. In the first five months of 2019-20 (April-August), domestic sale of passenger vehicle declined 23%, while sale of two wheelers and three wheelers contracted 14% and 7% respectively<sup>iii</sup>.

Construction and real estate is another major sector that depends on NBFC sector for financing. From the following chart, it can be seen that besides auto loans, NBFCs have substantial market share in loan against property, with a share of 19%. HFCs are the major lenders in this segment, with a market share of 34%, followed by private sector banks. On account of the liquidity crisis being faced by NBFCs and HFCs, real estate developers will have to look for alternative sources such as banks for funding.



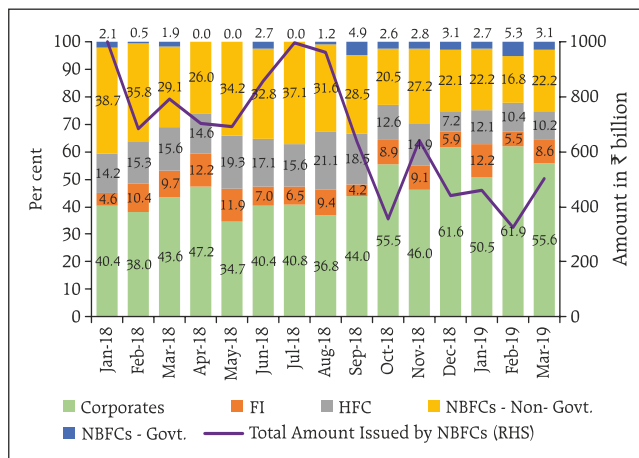
**Funding crisis for NBFCs**

Non Banking Finance Companies (NBFCs) depended on debentures to meet 47% of their funding requirement before the ILFS crisis. Banks, mutual funds and insurance companies were the major investors in these debentures. When ILFS group defaulted interest payment on its debentures and commercial papers in September 2018, these investors turned risk averse and started reducing their exposure to debentures and commercial papers. As a result, NBFCs with weak balance sheet, or those with high exposure to sectors such as real estate, had difficulty in accessing funds through debentures and commercial papers. Consequently, the share of debentures in NBFCs' overall funding declined to 41% in March 2019 from 47% a year ago (as seen from the following chart). While the share of commercial papers in overall borrowing declined marginally to 7.6% from 8.5% during this period. Therefore, NBFCs had to rely more on bank financing to meet their short term and long term capital needs. Bank funding to NBFC sector got a boost after the ILFS crisis as Government of India and RBI took a series of measures to encourage flow of bank finance to this industry (key policy measures to boost bank funding have been mentioned in the following section). Consequently, the share of long-term bank borrowing in the total NBFC funding mix increased to 29% by March 2019 from 23% in the previous year.



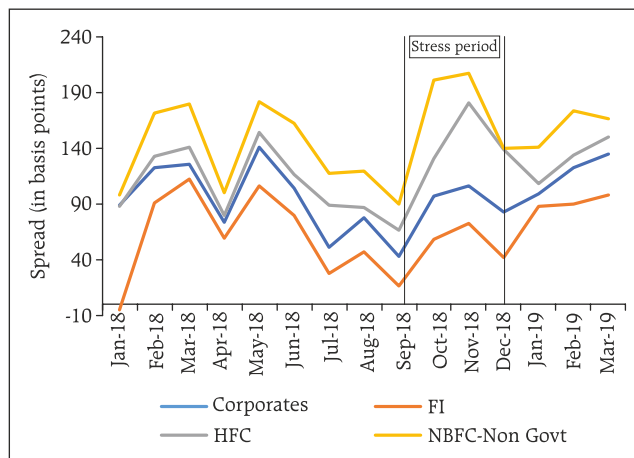
The monthly total issuance of commercial papers by NBFCs declined to less than Rs. 600 billion by October 2018 from Rs. 1000 billion in July 2018. As a result of heightened risk perception, interest premium on short term commercial papers spiked. The interest rate spread between 3-month commercial paper issued by private sector NBFCs and 91-day treasury bill rose to 190 basis points by October 2018 from around 90 basis points in the previous month (see images below).

**Commercial paper issuance by categories**



Source: The Reserve Bank of India.

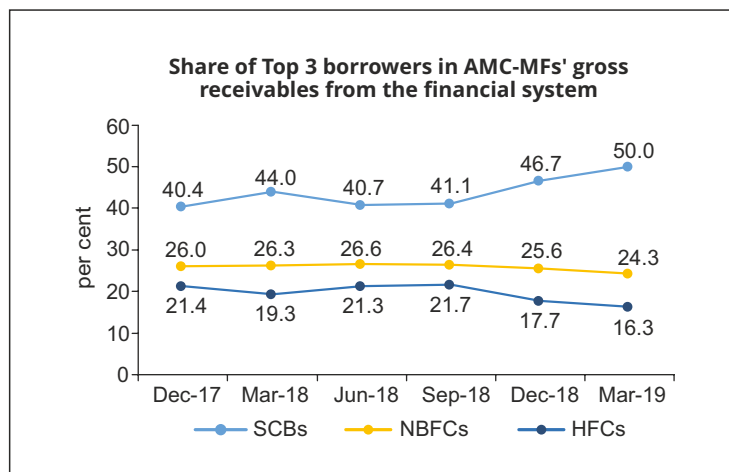
**Category wise 3-month CP spreads over 91-day T-bill**



Source: The Reserve Bank of India.

It is worth noting that mutual funds reduced their exposure to NBFCs and particularly housing finance companies because of their weak balance sheet. As can be seen from the following graph, the share of NBFCs in total funding by mutual funds declined to 24% by March 19 from 26% in the year ago. During the same period, the share of housing finance companies declined to 16% from 19%.

Gross receivables of asset management companies

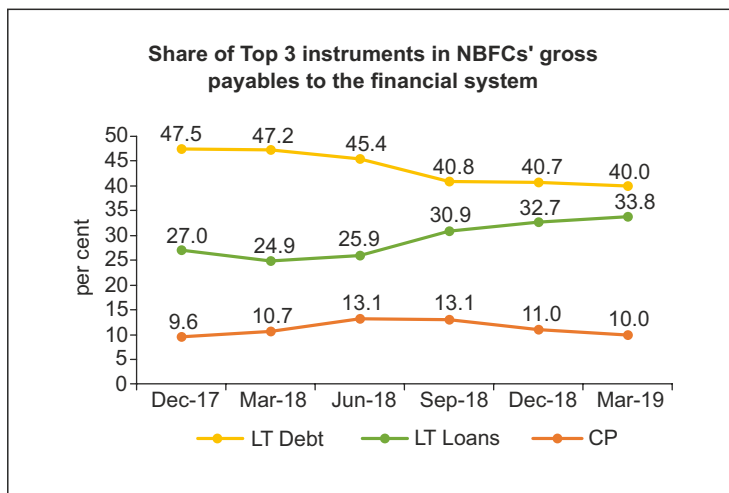


Source: Reserve Bank of India

As mutual funds and to some extent insurance companies became wary of funding to NBFCs, the latter had to rely more on borrowings from banks and All India Financial Institutions (AIFIs). As a result, the share of long term borrowing from banks and AIFIs in total liabilities of NBFCs rose to 33% by March 2019 from a peak of 30% in September 2018. The share of commercial papers financed by mutual funds and insurance companies declined to 10% from 13% during this period (see the chart below).

However, despite the heightened risk perception, NBFCs with strong balance sheet or those associated with big corporate houses faced relatively less difficulty in raising funds from the market.

Gross payables of NBFCs



It is worth noting that the NBFC sector comprises diverse mix of players from micro finance companies to asset finance companies to large infrastructure finance companies. The modes of funding of these players differ based on their business model. Infrastructure finance NBFCs are more dependent on market borrowings (through issue of long term debt instruments) rather than borrowing from banks and other financial institutions. For infrastructure finance NBFCs, long term debts (corporate bonds) account for 57% of total liabilities, while long term borrowing account for 27%. On the other hand, for general NBFCs (loans and investment companies) and asset finance NBFCs, long term borrowing account for around 40% of their liabilities, while long term debt forms around 24% of their liabilities.

### **Steps Taken So Far**

NBFCs are the major source of funds to MSMEs and consumers. As funding from mutual funds and insurance companies to NBFCs declined after September 2018, RBI and Government of India took a series of regulatory and policy measures to restore funding to the NBFC sector. Specifically, policy makers took several measures to promote bank funding to the NBFC sector. Some of the policy measures taken to reduce funding constraints for NBFCs and to restore investor confidence in the sector are mentioned below:

**Partial credit enhancement (PCE) to bonds:** In order to improve ease of accessing funds from the market for NBFCs, Reserve Bank of India allowed banks to provide PCE to bonds issued by registered systemically important non deposit taking NBFCs and Housing Finance Companies (HFCs).

**Co-origination of loans:** In September 2018, Reserve Bank of India introduced guidelines for banks and non-deposit taking systemically important NBFCs (NBFCs-ND-SI) for co-origination of loans to the priority sector. Under this arrangement, banks and (NBFCs-ND-SI) will jointly contribute funds for lending to the priority sector and share the resultant risks and rewards proportionately.

**Relaxation of liquidity norms:** In October 2018, Reserve Bank of India relaxed norms to provide flexibility for banks to use government securities for meeting liquidity coverage ratio. Banks can use government securities equal to their fresh lending to NBFC sector for meeting this ratio.

**Relaxation of single borrower limit:** In another significant move to encourage bank lending to the NBFC sector, Reserve Bank of India increased the single borrower limit for lending to NBFC sector from 10% to 15% in October 2018.

**Restoration of Priority Lending Status:** On August 13, 2019, Reserve Bank of India allowed banks to classify loans to NBFCs under priority sector category as long as the loans are used for onlending to agriculture, micro and small enterprises and housing sectors. These loans can be classified under priority sector category under certain conditions prescribed by the RBI in its notification. With this notification, RBI has restored the priority sector treatment given to bank lending to NBFC sector. In 1999, the central bank allowed commercial banks to classify loans to NBFCs for onlending to the above mentioned sectors as priority sector lending. However, this benefit was abruptly withdrawn in 2011.

**Relaxation of norms on External Commercial Borrowings (ECB):** In July 2019, Reserve Bank of India relaxed ECB norms to allow NBFCs to raise ECB with a minimum average maturity period of 10 years for on-lending for working capital purposes and general corporate purposes. NBFCs were also allowed to raise ECB with a minimum average maturity period of seven years for on-lending for the repayment of rupee loans.

**Mandatory appointment of risk officer:** In order to strengthen risk management practices of the NBFC sector, Reserve Bank of India mandated large NBFCs (with asset size of more than Rs. 50 billion) to appoint a Chief Risk Officer (CRO). CRO has to function independently to uphold highest standards of risk management.

### **Performance of NBFCs**<sup>iv</sup>

Decline in investor confidence in the NBFC sector increased cost of funding and liquidity stress for some players with weak balance sheet or high non performing assets. However, there is no threat to the systemic stability as the financial performance of the sector as a whole remains strong, with moderate increase in non performing assets and decline in

capital ratio. In fact, net profit to total income of the NBFC sector grew marginally to 15.3% as of March 2019 from 14.1% in the previous year. The return on asset of the sector remained constant at 1.7% as of March 2019 from the previous year. On the other hand, return on asset of all scheduled commercial banks stood at -0.1% as of March 2019.

Gross non performing assets ratio of the NBFC sector rose to 6.6% as of March 2019 from 5.8% in the previous year, but lower than the corresponding figure for scheduled commercial banks (9.3%). The Capital to Risk Weighted Asset Ratio (CRAR) of the NBFC sector declined to 19.3% as of March 2019 from 22.8% the previous year, but higher than the mandatory level of 15%. CRAR of all scheduled commercial banks stood at 14% as of March 2019.

This shows that the financial health of the sector as a whole remains sound and the liquidity crisis is limited to only a few weak NBFCs.

<sup>i</sup> Reserve Bank of India Financial Stability Report, June 2019

<sup>ii</sup> RBI Annual Report August 2019

<sup>iii</sup> Press Release dated September 9, 2019 of SIAM

<sup>iv</sup> All Data in this section have been sourced from RBI's Financial Stability Report June 2019

### Box 1 : Credit flow to MSME sector from banks and NBFCs (Amount in Rs Billion)

Year ended	Public Sector Banks	Private Sector Banks	Foreign Banks	Schedual Commercial Banks	Non-Banking Finance Company
	Amt. O/s	Amt. O/s	Amt. O/s	Amt. O/s	Amt. O/s
March 2014	7583.78	2471.22	344.30	10399.30	85.76
March 2015	8526.89 (12.44%)	2815.48 (13.93%)	367.87 (6.85%)	11710.26 (12.61%)	286.48 (234.05%)
March 2016	8205.18 (-3.77%)	3590.85 (27.54%)	363.73 (-1.13%)	12160.07 (3.84%)	880.13 (207.22%)
March 2017	8289.33 (1.02%)	4309.62 (20.2%)	365.02 (0.35%)	12963.98 (6.61%)	1113.10 (26.47%)
March 2018	8615.98 (4.30%)	4107.60 (-4.69%)	488.81 (33.91%)	13212.39 (2.15%)	1111.10 (29.49%)
March 2019	9367.24 (8.34%)	5717.04 (39.18%)	691.37 (41.44%)	1577.66 (19.13%)	1622.17 (12.54%)

Source: As reported by Scheduled Commercial Banks to RBI

# **Recommendations from Industry and Experts**



## Short Term and Long Term Measures to Strengthen NBFC Sector

By Finance Industry Development Council (FIDC)

When the financial market is gripped with the crisis of confidence in the aftermath of a high profile default by a major player, even solvent financial companies find it difficult to raise funds from the market. The heightened risk perception following the default will prevent lenders from rolling over their existing exposure or issue fresh funds to creditworthy companies. This funding risk is all the more severe for non deposit taking NBFCs who are not allowed to raise low cost deposits or borrow from the interbank call money market. Currently, the funding avenues available for non deposit taking NBFCs are limited to short term instruments such as commercial papers, non-convertible debentures, inter-corporate deposits and funding from banks.

Therefore, there is a need to open long term funding sources for this crucial sector, which plays an important role in bringing unorganized sector into the formal financial system. Also, with NBFCs brought on par with banks in terms of regulation of asset side of their balance sheet, there is a need to call immediate attention to the liability side. With this background, Finance Industry Development Council (FIDC) proposes the following policy suggestions to address the immediate concerns and long term stability of the NBFC sector.

### FUNDING SUPPORT TO NBFCs TO ENSURE LIQUIDITY

#### Important Clarification on the Current Situation

The IL&FS default in September 2018 resulted in a sudden change in the perception of the strength of the entire NBFC sector. As is typical in such situations, it is the negativity in the sentiments which plays the key role rather than the actual performance. As the representative body of the NBFC sector, we would like to clarify the following:

- The core issue today relates to the sudden and great impact on the growth of NBFC sector and is not a solvency issue.
- This has heavily impacted the flow of credit to the key sectors of the economy such as automobiles, MSMEs and consumer goods, which have suffered heavily
- Defaults by one Infrastructure Financing NBFC and a Housing Finance Company do not represent the actual picture of the NBFC sector
- The typical NBFC model is a heavily retail and small business focused lending model with an average asset tenure of 2-5 years
- Therefore, asset liability mismatch is practically a non-issue for NBFCs and is more relevant for long term infrastructure project financing and housing finance companies
- While the flow of bank funds to NBFCs has dropped since October 2018, the recent data released by RBI on sectoral deployment of bank credit presents a different picture. This is because the figure for bank credit to NBFCs includes Government owned NBFCs.

### Banks are the Major Contributors to Funding NBFCs

Banks continue to be the major source of funding for NBFCs. When it comes to Small and Medium NBFCs, (which comprise 95% of the total number of NBFCs) banks are the only option. The major concern arising as a fall out of this negativity has been a sudden change in attitude and the perception that majority of the public-sector banks have shown towards NBFCs. The most disturbing aspect has been the apprehension and reluctance on the part of the banks to continue with the existing lending arrangements to NBFCs. Instances of banks withdrawing the unutilized lines of credit or showing apprehension / reluctance in renewal/rolling over the existing credit lines have been reported by some of our members. While they are willing to buyout NBFC portfolios but that is merely a band aid solution which does not ensure growth of NBFCs. RBI has taken measures to address overall liquidity in the system by way of open market operations and other means. However, the liquidity thus created naturally ends up with the banks. It is the hesitation and reluctance on the part of banks to ensure percolation of this liquidity down to NBFCs which needs to be addressed immediately. The same may be done by

- incentivizing banks to fund NBFCs
- Creating a window for flow of bank credit dedicated to NBFCs
- Excluding PSU NBFCs while calculating sectoral bank exposure to NBFCs.

### Funding Avenues Are Restricted

NBFCs raise most of their fund requirements through bank loans, non-convertible debentures and commercial paper. Banks are the most important source of funding for the sector, accounting for well over 50% of the resources raised by NBFCs.

In the aftermath of higher reporting of NPAs and the subsequent entry of several banks into the PCA mechanism and especially post the events of September 2018, NBFCs have found it difficult to raise growth capital from the banking system and have therefore been forced to either shrink business or resort to securitisation of their high quality assets. This has contributed to a sharp slowdown in the automobile, MSME and similar sectors which have had direct implications on capital formation, GDP growth and employment generation.

### Funding avenues for NBFCs outside the banking system are heavily restricted, as

- Public Deposits are not allowed/ encouraged by RBI
- Bond Market is not developed in India
- Securitization guidelines by RBI are restrictive in nature
- There is no refinance window available to NBFCs

### Refinancing of Small and Medium Sized NBFCs by MUDRA

There are a large number of small and medium sized NBFCs providing last mile credit delivery in urban, semi urban and rural areas across the country. They have been complying with the RBI norms. These companies are primarily dependent on banks for fund raising, since they do not have access to capital markets and neither do they have any ECBs. They are feeling the real heat of the recent situation and there is an immediate need to provide a refinance window to these companies.

MUDRA was setup with the prime objective of refinancing banks, NBFCs and MFIs for on-lending to non corporate small businesses. For this purpose three categories of loans were prescribed – Shishu (upto Rs.1.0 lakh), Tarun (Rs.1.0-5.0 lakhs) and Kishore (Rs. 5.0-10.0 lakhs). While the “Shishu” category is primarily the forte of MFIs, it is the “Tarun” and “Kishore” categories which are a perfect fit for Non- Banking Finance Companies (NBFCs).

In spite of registering an impressive growth, a study of MUDRA loans reveals that a vast majority of this growth has been in the Shishu (upto 1 lac category) while both Tarun and Kishore categories have performed far below the expectations. Ministry of MSME, Ministry of Finance, RBI and SIDBI have all voiced their concern over this important aspect. The underlying reason for this gap is due to the fact that till date MUDRA's exposure to the NBFC sector has been negligible. Only a handful of NBFCs (out of the total number of 11,000) have been able to avail refinance from MUDRA.

### Eligibility Norms to Avail Refinance from MUDRA – A Stumbling Block for Small & Medium NBFCs

MUDRA's future expansion plans have to involve NBFCs in a big way. On the other hand small and medium sized NBFCs' future growth plans must involve MUDRA as the Refinancing body. In other words, both are answers to each other's problems.

The major stumbling block between the two are the eligibility norms prescribed for NBFCs to avail refinance from MUDRA. If this is taken care of, then it shall not only cater to the funding needs of small and medium sized NBFCs, but also incite them to shift from acceptance of public deposits and thus save on the high regulatory compliance cost and burden.

### The three key norms which are keeping NBFCs away from MUDRA are:

- Entry level Net Own Funds (NOF) prescribed by MUDRA is much above the RBI's prescribed entry level to set up an NBFC. This has resulted a large chunk of RBI registered NBFCs being ineligible.
- MUDRA has prescribed a minimum investment grade credit rating for NBFCs. All the accredited Credit Rating Agencies follow the same rating model and scale, irrespective of the company's size. Therefore, obtaining a minimum investment grade credit rating for these companies is a big challenge, simply because of their size.

- MUDRA prescribes a cap on the lending rates, by prescribing a maximum spread between borrowing and lending rates of NBFCs. This has discouraged large, small and medium sized NBFCs, since any such cap makes the business uncompetitive and in some cases unviable.

### **MUDRA may Refinance Big NBFCs for On Lending to Small & Medium NBFCs**

With funding avenues for small and medium sized NBFCs restricted, they are heavily dependent on banks, which has also been of concern to RBI. As a result, some of the big NBFCs undertake refinancing the smaller ones, especially, in case of asset financing NBFCs. Such arrangements have shown great promise and comfort and reduce the risk for any outside funding agency (including banks) whose exposure is only on the better governed and more stringently regulated NBFCs only.

### **Measures to Address the Funding / Liquidity Concerns of the NBFC Sector**

#### **Short Term Measures – Need Immediate Action**

1) The crying need of the hour is to create a dedicated liquidity window for NBFCs through the banking channels. The same may be provided for a period of one year. Precedence may be drawn from a special repo window created by RBI in 2008 for banks under the liquidity adjustment facility (LAF) for on lending to NBFCs.

2) Since 1999, RBI had allowed all bank lending to NBFCs for on-lending to the priority sector, to be treated as priority sector lending by banks. This gave a huge incentive to banks to lend to NBFCs. While it ensured sufficient bank funding to NBFCs at a reasonable cost, it also facilitated banks to meet their PSL targets. However, this was abruptly withdrawn in 2011. The same arrangement may be restored urgently.

3) For small & medium sized NBFCs, eligibility norms for NBFCs for availing refinance from MUDRA should be made favorable by:

- Allowing all RBI registered NBFCs to avail refinance
- External Credit Rating criteria may be replaced by prescribing some additional financial parameters to be met, which may be more realistic and doable
- The cap of 6% on the maximum spreads allowed should be done away with, since market forces ensure that the rates are within acceptable limits

Systemically Important NBFCs should be allowed to act as aggregators by availing refinance from MUDRA for on lending to small and medium sized NBFCs.

#### **Long Term Measures**

##### **1) Setup up a Permanent Refinance Window for NBFCs**

A dedicated “Refinance window for NBFCs”, on the lines of National Housing Bank (which provides refinance to Housing Finance Companies) has been a long-standing demand of the NBFC sector. The Parliamentary Standing Committee on Finance in their 45th Report dated June 2003 (relating to The Financial Companies Regulation Bill, 2000) had recommended setting up of a new refinance institution for NBFCs.

##### **2) Establishment of Alternate Investment Fund**

An Alternate Investment Fund (AIF) may be established to channelize institutional funds to NBFCs. Non-convertible debentures (secured by hypothecation of business receivables of NBFCs) could be subscribed to by the AIF for onward lending by NBFCs. These NCDs could be administered by investor trustees who could take care of the interests of the AIF and its constituents and would be subject to all extant guidelines in this regard. The manner of constitution of the AIF and the sources of its funds could be discussed further.

### 3) “On Tap” Issuance of Secured Bonds/NCDs

NBFCs have access to Non-Convertible Debentures (“NCDs”) having flexible tenure and rates, both through the private placement (with restrictions) and public issue. While private placements have severe restrictions on the number of investors, the frequency of issue etc., public issue of bonds tends to be very expensive, laborious and inflexible.

It is proposed that NBFCs be allowed an on-tap facility for issuance of NCDs to the retail market by making the offering of NCDs through an easy to operate and less costly procedure, but with proper governance to provide investor protection and comfort. The features proposed are:

- Bonds or NCDs to be rated minimum BBB- (minimum investment grade). Instruments must be secured and should not fall under the definition of ‘deposit’
- Company to file umbrella prospectus (valid for one year) with quarterly financial updates. In no event, can the financials be older than 4 months. This document would lay down the overall limits and the type of NCDs to be issued (deep discount/interest bearing etc.)
- Under this, NBFCs should be allowed to issue as many NCDs as they wish in whatever frequency they wish to. There should be no need to file an updated prospectus – only updated financials may need to be filed as an addendum.
- There should be no need for a specific issue closure date and issue allotment date. The allotment of bonds to be similar to acceptance of deposits – with tenure being determined from the date of the application.
- NCDs to be marketed similar to deposits. Intermediaries may be allowed
- Tenure may be long term say, 2 or 3 years and upwards
- Given that these are secured instruments, there should be no need to maintain SLR
- Governance under SEBI guidelines, with overall borrowing cap being permitted by RBI
- Lead Manager to have responsibility of reporting to SEBI & RBI on quarterly basis
- Grievance redressal mechanism similar to deposit acceptance regime; access for investors to SEBI and RBI Ombudsman
- Minimum investment amount could be low – say, Rs 10,000/- so that greater retail participation is possible
- Instruments would be listed and tradeable on a recognised stock exchange to provide liquidity to retail investors.

### 4) Need to Have a Regular Dialogue

Today, inspite of playing an important role in the economy, the NBFC sector does not have a platform to engage with the Ministry of Finance on a regular basis. In a fast changing scenario, a structured dialogue on a regular basis is an important need of the hour. This acts as a two way flow of information and areas of concern. It also enables the policy makers to get first hand market report. It is therefore requested that a mechanism for structured dialogue may be developed to ensure regular meetings (at least twice a year) between senior officials of Department of Financial Services at Ministry of Finance with FIDC as the representative body of NBFCs.

## **DIRECT TAX**

### **1. TDS on Interest (Sec 194A) – Request for Exemption**

As per section 194A of the Act, any person making payment of interest is required to deduct tax at source (‘TDS’) @ of 10%. There are certain exemptions given under this section wherein the person making payment to various institutions like Banking Company, Life Insurance Companies and UTI etc., is not required to deduct TDS. Accordingly, any person making payment of interest to banks is not required to deduct tax.

However, no such exemption has been provided to NBFCs from the applicability of section 194A. Accordingly, tax is required to be deducted at the rate of 10 percent from interest paid to NBFCs. This creates severe cash flow constraints since NBFCs operate on a thin spread/ margin on interest which at times is even lesser than the TDS on the gross interest. Further, due to enormous transactions, NBFCs have to face severe administrative hardship in terms of collection of TDS certificates from their thousands of customers.

The additional limitations of the existing system are the following:

- a) Follow up with every customer for TDS certificates every quarter (details of which are mandatory for claiming the same in the I.T. return) becomes almost impossible. NBFCs have clients who number in thousands and it is practically very difficult to collect details from everyone.
- b) Even if the TDS certificate is issued by the customer, if TDS return has not been filed or not filed properly, the credit for such TDS would not be granted to the NBFC as the details of such TDS would not appear in the NSDL system.
- c) Once the TDS credit is disallowed, the NBFCs have a hard time following up with the customers and the exchequer has a hard time clearing outstanding demands against NBFCs which, in reality, do not exist.

### Co-origination of Loans by Banks and NBFCs

RBI vide its notification dated September 21, 2018 has allowed banks and NBFCs on Co-origination of Loans to the priority sector. According to this notification, a single borrower may be co-funded by a bank and an NBFC in a pre-determined ratio. Both bank and NBFC may price the loan independently. However, the borrower shall be offered a single blended rate of interest. All the repayments made by the borrower (including the interest) by way of EMIs shall be made to an escrow account from where the amounts shall be credited to the bank and NBFC in respective proportion. In such a scenario, the borrower shall not be in a position to determine the exact interest component of the NBFC portion and hence TDS deduction shall be practically impossible. It is therefore important to bring both bank and NBFC at par on the TDS provisions.

Exemption May be Granted to Non-Deposit Taking Systemically Important NBFCs (NBFC-ND-SI) and Deposit Taking NBFCs (NBFC-D).

According to the prevailing Regulatory Framework of RBI, the following two categories of NBFCs are subject to the most stringent regulations:

1. All Deposit Taking NBFCs (NBFC – D) irrespective of their size –there are total 88 NBFCs-D as on 30th April, 2019
2. Non-Deposit Taking Systemically Important NBFCs (NBFC-ND-SI) i.e., NBFCs which do not accept public deposits and have an asset base of Rs 500 crore and above – there are total 264 NBFCs –ND-SI as on 30th April, 2019.

All major aspects of working of above said two categories of NBFCs are regulated and monitored by RBI. Considering that NBFCs are facing liquidity crunch in recent months, exemption from TDS provisions shall contribute to easing of the liquidity condition for NBFCs.

#### Request:

Based on the above said facts, it is hereby requested to exempt those NBFCs which are registered with RBI and classified by RBI as Deposit Taking NBFC (NBFCs-D) and Non-Deposit Taking Systemically Important NBFC (NBFCs-ND-SI) from the provisions of TDS on Interest Income. The same may be granted by issuance of Notification u/s 194A(3)(iii)(f) of The Income Tax Act, 1961.

### 3. Request for Allowing Higher Depreciation Rates For Construction Equipment

The I. T. Act allows depreciation at the rate of 100% in case of certain equipment meant for pollution control, solid waste control, mineral oil concerns, mines and quarries, energy saving devices and renewable energy devices. The Act also allows high rate of depreciation (30%) to motorcars, buses, lorries and taxis used in the business of running them on hire.

However, construction equipment which contribute immensely to infrastructure development are not given this benefit of

higher depreciation rate when they are financed, instead the depreciation rate for such vehicles is only 15%. For other plant and machinery too, the rate is 15%. This acts as a roadblock to infrastructure development.

Request:

In today's age of rapid technological progress, assets like construction equipment and plant and machinery become obsolete faster. Thus, keeping in mind the nature of the asset, its average life-cycle and the pace of technological development, the depreciation rate should be at least at par with commercial vehicles i.e.; 30%. This will also give an impetus to the infrastructure spend and will incentivize such investments.

### 1. Need to Promote Leasing

World over “Leasing” has been promoted as an important tool for capital formation. Today, the country is making huge investments in the Infrastructure sector and there is a special impetus being given to the MSMEs and the Farm sector. In this scenario, there is a crying need to promote “Leasing” in India, which has suffered a body blow due to imprudent taxation. Prior to the introduction of GST, Lease / Hire Purchase rentals were subject to the levy of VAT @ 4-14% at the state level and in addition, the interest component (to the extent of 10%) of the rental was subject to the levy of Service Tax @ 15%.

While GST has done away with the issue of dual taxation, the rate of GST on rentals of lease of any movable asset is equal to the rate of GST levied on normal sales/purchase of that asset, which does not give any incentive to lease.

Request

- The interest component of the lease rental may be exempt from the levy of GST on the lines of the exemption given to the interest on loans.
- The rate of GST on lease rentals should be reduced to 5% in order to promote and encourage lease as a tool of capital formation.

### RECOVERY - ENFORCEMENT OF SECURITY INTEREST UNDER THE SARFAESI ACT COMES WITH A RIDER OF MINIMUM LOAN TICKET SIZE OF Rs. 1.0 CRORE

Union Budget 2015 had announced coverage of NBFCs (with asset base of Rs. 500 crore and above) under the SARFAESI Act. This came as a welcome move since the asset classification (NPA) norms for NBFCs were brought at par with banks by RBI. However, in the gazette notification issued on 5th August 2016 to this effect, a clause was inserted whereby sections 13 to 19 of the SARFAESI Act, which cater to the “enforcement of security interest”, shall be applicable only in cases where the minimum ticket size of lending is Rs 1 crore. This has come as a big surprise to the NBFC sector.

### The Underlying Need to Bring Parity with Banks, Housing Finance Companies (HFCs) and Other Financial Institutions (FIs) Is Not Fully Addressed

The prime objective of giving NBFCs coverage under the SARFAESI Act was to bring parity with banks, HFCs and other FIs, and providing NBFCs with an all important tool of recovery. This has been done in the light of the Revised Regulatory Framework for NBFCs, issued by RBI which is aimed to “address regulatory gaps and arbitrage arising from differential regulations, both within the NBFC sector as well as vis a vis other financial institutions”. As a result, the Asset Classification (NPA classification norms) were brought at par with banks. However, the above said rider of Rs. 1 crore does not fully justify the objective of bringing parity, since no such clause exists for banks, HFCs and other FIs.

### Size of the Loan Should Not Be the Criteria

As per the Prudential Norms for Asset Classification (NPA Classification) for banks, HFCs and NBFCs, it is the duration of the overdue period of a loan, and not the ticket size, which determines whether the loan (Asset) is to be classified as “nonperforming” or not. It is therefore, imprudent and unjustified to make the ticket size of the loan as a determining factor for use of tools of recovery of that particular loan.

## The Deterrence Factor Gets Diluted

In addition to enable Financial Institutions make recoveries, such recovery tools play a very important role of being a “deterrent to default”. The above said rider of minimum ticket size of Rs. 1crore, dilutes the deterrence factor of an important recovery tool like the SARFAESI Act.

### Request

1 Based on the facts explained above we hereby request you to kindly do full justice by bringing complete parity with banks, housing finance companies and FIs in matters relating to recovery.

2 For this, kindly delete the following words from the Notification dated 5th August 2016:

“.....with the exception that the provisions of Sections 13-19 shall apply only to such security interest which is obtained for securing repayment of secured debt with principal amount of Rs 1 crore and above.”

## Box 2: Share of NBFCs and other institutions in loans

### Relative Share in Auto-Loans

	16-Dec	17-Mar	17-Sep	18-Mar	18-Jun	18-Sep	18-Dec
Public Sector Banks	30%	27%	31%	31%	30%	31%	30%
Private Sector Banks	37%	38%	38%	38%	39%	37%	38%
NBFCs	32%	34%	31%	30%	30%	30%	30%
Total (Rs. Billion)	2,737	2,816	3,296	3,682	3,766	3,787	4,089

Source: TransUnion.CIBIL

### Relative Share in Home-Loans

	16-Dec	17-Mar	17-Sep	18-Mar	18-Jun	18-Sep	18-Dec
Public Sector Banks	41%	39%	41%	41%	40%	41%	41%
Private Sector Banks	17%	17%	17%	17%	17%	16%	16%
NBFCs	1%	1%	2%	1%	2%	2%	2%
HFC	41%	42%	41%	41%	42%	41%	42%
Total (Rs. Billion)	12,104	12,433	14,049	15,656	16,204	17,020	17,431

Source: TransUnion.CIBIL

### Relative Share in Loans Against Properties

	16-Dec	17-Mar	17-Sep	18-Mar	18-Jun	18-Sep	18-Dec
Public Sector Banks	14%	14%	15%	15%	15%	15%	15%
Private Sector Banks	30%	31%	31%	33%	33%	31%	33%
NBFCs	27%	25%	23%	20%	19%	21%	19%
HFC	29%	30%	31%	32%	34%	33%	34%
Total (Rs. Billion)	2,354	2,440	2,745	3,135	3,228	3,442	3,497

Source: TransUnion.CIBIL

### Relative Share in Personal Loans

Member Class	16-Dec	17-Mar	17-Sep	18-Mar	18-Jun	18-Sep	18-Dec
Public Sector Banks	47%	47%	46%	44%	43%	42%	42%
Private Sector Banks	40%	41%	41%	42%	42%	42%	42%
NBFCs	13%	13%	14%	14%	16%	17%	15%
Total (Rs. Billion)	1,843	1,989	2,376	2,831	3,009	3,253	3,490

Source: TransUnion.CIBIL

## Does Strengthening NBFCs call for a “heavy-touch” Regulation

By Dr. KUSHANKUR DEY, Assistant Professor, Agri-Business Management Group, IIM Lucknow

NBFCs crisis is looming large following the debacle of some systemically important financial institutions in infrastructure, financial leasing, and housing space. It is a fact that NBFCs have become important financial intermediaries as they can leverage on low transaction costs, financial innovations, and regulatory arbitrage (RBI bulletin, 2014). It may be noted that there are about 9,623 NBFCs registered with the RBI, of which 156 are deposit accepting (NBFCs–D) and 249 are systemically important non-deposit accepting NBFCs (NBFCs–ND). Notwithstanding their role in financial intermediation, the on-going crisis has received considerable attention of regulator and national government. Considering policy issues on how to strengthen the NBFC sector, this article aims to shed light on overarching regulatory framework to beleaguered yet systemically important NBFCs with a sectoral thrust.

How government is willing to rescue systemically important NBFCs and would it last long? Budget 2019 has announced and incorporated in Finance Bill that only solvent NBFCs can sell their high-rated (AA) pooled assets (of Rs 1 lakh crore) to public sector banks and government is likely to extend partial credit guarantee given the first loss of up to 10%. While this measure will facilitate fund raising for cash strapped NBFCs in the short-run, liquidity problem may not be cured owing to higher transaction costs or large spread between lending and borrowing rate, and interest rate risk riding the yield curve. Further, regulatory arbitrage has already pushed many NBFCs to face headwinds of shadow banking and lack of due diligence and poor asset transformation strategies, NPAs have moved to 6.6% in 2018-19 from 5.0% of total loan outstanding in 2017-18. Therefore, any short-term stimuli will not be a panacea, rather RBI should have more bandwidth to overhaul the NBFC sector in general. It is interesting to note that RBI Governor, Shaktikanta Das said that to avert the crisis and any contagion effect of the crisis on economy due to interconnectedness, RBI should move from a ‘light-touch’ to ‘heavy-touch’ principle-based regulations. The improvisation in existing regulatory architecture can instill buoyancy in prudential norms for NBFCs.

In existing regulatory frameworks, stressed asset management and asset liability management have already caught the RBI's attention. One is prudential framework for resolution of stressed assets and the other one, liquidity risk management for systemically important NBFCs, NBFCs – ND with asset size of Rs. 100 crore and above, NBFCs – D (irrespective of asset size) and Core Investment Companies.

First, framework for resolution of stressed asset directs the formation of inter creditor agreement once NBFCs recognize the NPAs and chart a resolution plan within a month from the date of recognition of default. Asset-size will have impact on varying resolution plan as per agreement. A special purpose vehicle can be initiated to expedite the resolution plan and necessitate the recovery process through empanelled Asset Reconstruction Companies/Asset Management Companies.

Second, liquidity risk management framework as a pro-active measure must be adopted by too-big NBFCs to prevent their fall. For example, granular maturity buckets and tolerance limits can help reduce net cumulative negative mismatches in cash outflows of maturing loan portfolios. According to the proposed framework, RBI mandates that “the 1-30-day time bucket in the Statement of Structural Liquidity is bifurcated into granular buckets of 1-7 days, 8-14 days, and 15-30 days. The net cumulative negative mismatches in the maturity buckets of 1-7 days, 8-14 days, and 15-30 days should not exceed 10%, 10% and 20% of the cumulative cash outflows in the respective time buckets.

The measurement of structural and dynamic liquidity should be put in place. RBI liquidity risk management framework states that “NBFCs are mandated to monitor liquidity risk based on a “stock” approach to liquidity. The monitoring shall be by way of predefined internal limits as decided by the Board for various critical ratios pertaining to liquidity risk. Indicative liquidity ratios are short-term liability to total assets; short-term liability to long-term assets; commercial papers to total assets; non-convertible debentures (NCDs) (original maturity less than one year) to total assets; short-term liabilities to total liabilities; long-term assets to total assets”.

NBFCs–D having asset size of Rs 50 billion and above and NBFCs–ND irrespective of their asset size need to maintain a liquidity buffer in terms of a Liquidity Coverage Ratio (LCR) that should be at least 60% of high-quality liquid assets to net cash flows from April 2020 onward. This might induce resilience of NBFCs to liquidity disruptions in the financial market system.



Tolerance limit with respect to liquidity strain faced by NBFCs requires of monitoring tools “to cover a) concentration of funding by counter party/ instrument/ currency, b) availability of unencumbered assets that can be used as collateral for raising funds; and, c) certain early warning market-based indicators, such as, price-to-book ratio, coupon on debts raised, breaches and regulatory penalties for breaches in regulatory liquidity requirements” (refer to RBI Liquidity risk management framework, 2019).

Besides these two regulatory measures to protect the downfall of NBFCs or likelihood of bankruptcy, the following measures should be considered for a nuanced policy formulation for NBFCs sector.

### 1) Basel accord policy

RBI should implement the Basel-III/IV as expected in 2019 accord in true spirit. The regulatory architecture needs to incorporate various indicators attributed to three important pillars of Basel, namely capital requirement, market discipline, and supervisory review. Consideration of CAMELS in the case of systemically important NBFCs can satisfy and complement the logic of Basel-III though – in that sensitivity measures such as duration and convexity adjustment for portfolio immunization or managing interest rate risk should receive considerable attention. While duration-based hedging or price sensitive hedging is encouraged to protect the value of net worth, capital requirement can be revised a bit from source of funding point of view. We can argue that Tier-I capital comprising of common equity, reserves and surpluses, non-cumulative preferred stocks can amount to 6-8% and Tier-II capital comprising of other reserves and sub-ordinated debt can be of 50% of Tier-I capital. If CRAR can be reduced to 9-12% from 15% level. In effect, the amount of discretionary financing needed would be reduced as NBFCs can use retained earnings for their internal financing in view of current fund-raising problems both from the money markets and capital markets.

### 2) Assets/investments maturity policy

Under this approach, NBFCs need to shift their interest sensitive assets or can change the blending of investment maturities as the interest-rate outlook changes. For example, portfolio of investments or assets can shift toward long-term maturities when interest rate is expected to fall (as can be seen from a downward sloping yield curve) and on the corollary, can bucket interest sensitive assets to short-term maturities if interest rate is expected to rise (as can be evident from an upward sloping yield curve). Also, NBFCs can improve their liquidity position and avoid large capital losses in the presence of upward move of interest-rate by adopting front-end load maturity policy. When interest rate is expected to fall, NBFCs can maximize their income through back-end load maturity policy. Combining both can give earnings potential and ease out liquidity position of NBFCs.

### 3) Interest rate risk management policy

It is also worth noting that NBFCs have longer duration assets (primarily loans and investment in bond/securities markets in part) than liabilities (primarily non-deposit borrowings). Hence, they need to finance their fixed- rate assets with floating-rate liabilities. However, as NBFC's credit-rating has already been downgraded, they are likely to pay on deposits/borrowings at fixed rate and receive floating-rate interest on loans and advances. Thus, adoption of interest rate collars by systemically important NBFCs–D & NBFCs–ND (combination of cap-rate and floor-rate) akin to long call and long put options, which can help freeze lending rates or protect yields on securities within the limits specified by the accompanying contract.

### 4) Principle-based financial reporting for valuation policy

RBI in consultation with the Ministry of Corporate Affairs should encourage NBFCs follow a principle-based financial reporting system wherein off-balance sheet items should be reflected for fair valuation. Book-based valuation is important to capture the impact of market sentiment on their stock prices and price-earnings growth. This will also factor in fund raising from equity market at a higher risk premium.

### 5) Portfolio diversification, asset securitisation policy

A right mix of assets and liabilities can help NBFCs hedge their cashflows against basis risk and reduces the chance of credit default. Appropriate swap structure can transfer the risk from NBFCs to borrowers while credit rating determines the

transaction cost. NBFCs need to manoeuvre portfolio diversification to improve their economic value of equities and earnings spread. Asset securitisation through mortgage guarantee, leverage buy-out, and collateralized debt obligations should receive regulator's renewed interest.

## 6) Appointing an advisory committee

One-size-fits-all cannot be a blueprint for all NBFCs. Therefore, RBI should appoint a dedicated advisory committee to assess the health of sectoral NBFCs – both NBFCs–D & NBFCs–NDs and systemically important NBFCs. Periodic review of their operations, financial disclosure can help the regulator take corrective measures a priori. The committee should follow terms of reference and conduct bi-monthly meeting and discuss the state of NBFCs in financial landscape – lending and borrowing quantum, associated interests, product and market mix, etc. The Committee's recommendation can provide a firm ground for regulatory oversight.

### Box 3: Liquidity Risk Management Framework for NBFCs

NBFCs have developed significant inter-linkages with the rest of the financial sector in terms of access to public funds and participation in credit intermediation, with implications for systemic risks. This has warranted a review of the liquidity risk management for NBFCs.

The extant ALM guidelines are applicable to non-deposit taking NBFCs with an asset size of ₹1 billion and above, and deposit taking NBFCs having a deposit base of ₹200 million and above:

- Instructions on the three pillars of ALM framework, viz., ALM information systems, ALM organisation (including formation of Asset-Liability Committee (ALCO), its constitution, etc.) and ALM processes.
- Monitoring of structural and short-term dynamic liquidity and interest rate sensitivity.
- Maturity gap analysis across time buckets with main focus on 30/31 days time bucket in which the negative gap is not supposed to exceed 15 per cent of the cash out flow.
- CICs with asset size of ₹5 billion and above to disclose the maturity pattern of assets and liabilities.

#### Proposed Changes

##### a. Augmentation of the General Framework for Management of Liquidity Risk

- ALM Guidelines:** ALM guidelines have been recast on the lines of those applicable to banks, incorporating (a) off-balance sheet and contingent liabilities; (b) stress testing; (c) contingency funding plan; (d) intra-group fund transfers; (e) collateral position management; and (f) diversification of funding.

- LCR is defined as:

$$\frac{\text{Stock of High Quality Liquid Assets (HQLAs)}}{\text{Total Net Cash Outflows over the next 30 calendar days}}$$

- NBFCs to maintain LCR of minimum 60 per cent from April 1, 2020, progressively increasing in equal steps till it reaches the required level of 100 per cent, by April 1, 2024 and maintaining it at minimum 100 per cent on an on-going basis with effect from April 1, 2024.

- Maturity Buckets Revised:** Maturity buckets have been made granular by trifurcating the 1 to 30/31 days bucket into 1-7 days, 8-14 days and 15 to 30 days, with cumulative gap limits set at 10 per cent, 10 per cent and 20 per cent of the respective outflows. Cash flow stress will be captured at an early stage and mitigation is expected to be timely.

- Liquidity Risk Monitoring Tools:** NBFCs will be required to monitor (a) concentration of funding (by counterparty, instrument, currency); (b) available unencumbered assets (that can be used as collateral for raising funds); and (c) market related monitoring information (equity prices, coupon on debts raised, regulatory penalty and the like).

- Stock Approach to Liquidity Risk Management:** Boards of NBFCs are required to identify critical ratios and monitor them against internally prescribed ceilings [an illustrative list could include short-term liabilities to total assets; short-term liabilities to long-term assets; commercial papers to total assets, non-convertible debentures (NCDs) of original maturity less than one year to total assets; short term liabilities to total liabilities; long term assets to total assets].

##### b. Introduction of the Liquidity Coverage Ratio (LCR) for Large NBFCs

The proposed LCR framework will apply to all deposit taking NBFCs and NBFC-ND-SIs with asset size of ₹50 billion and above. It will be implemented in a phased manner.

- NBFCs to hold HQLAs to cover the net cash outflow over the next 30 day period under a situation of stress.
- Computation of HQLAs to be based on prescribed haircuts applied on the eligible assets.
- For computation of net cash outflow in the 30 day period, the stress scenario is built by overestimating outflows by 15 per cent and underestimating inflows by 25 per cent.

Source: Annual Report 2018 - 19 Reserve Bank of India

## Strengthening NBFC Sector by Leveraging Technology

By Mr. Vivek Belgavi, Partner, FinTech Leader, PwC India

The NBFC sector has been playing an important role to ensure credit flow and boost consumption. The sector which was once hailed for delivering high margins by tapping lending markets neglected by banks, is currently facing strong headwinds. The crisis that began with IL&FS fiasco has now spread across the NBFC sector leading to debt defaults and asset liability management (ALM) mismatch issues.

According to the RBI Financial Stability Report published in June 2019, the loan growth of the NBFC sector declined to 18.6% in 2018-19; mainly attributed to higher borrowing costs for smaller NBFCs because of their asset quality and ALM mismatch issues<sup>1</sup>. Additionally, the GNPA of the NBFC sector as a percentage of total advances increased to 6.6% in 2018-19<sup>1</sup>. Therefore, RBI would not only be more stringent in the upcoming regulations with respect to liquidity but would also be extra thorough in monitoring and surveillance of current regulatory submissions. There would also be a greater focus on asset quality and market exposure during the annual RBI inspection.



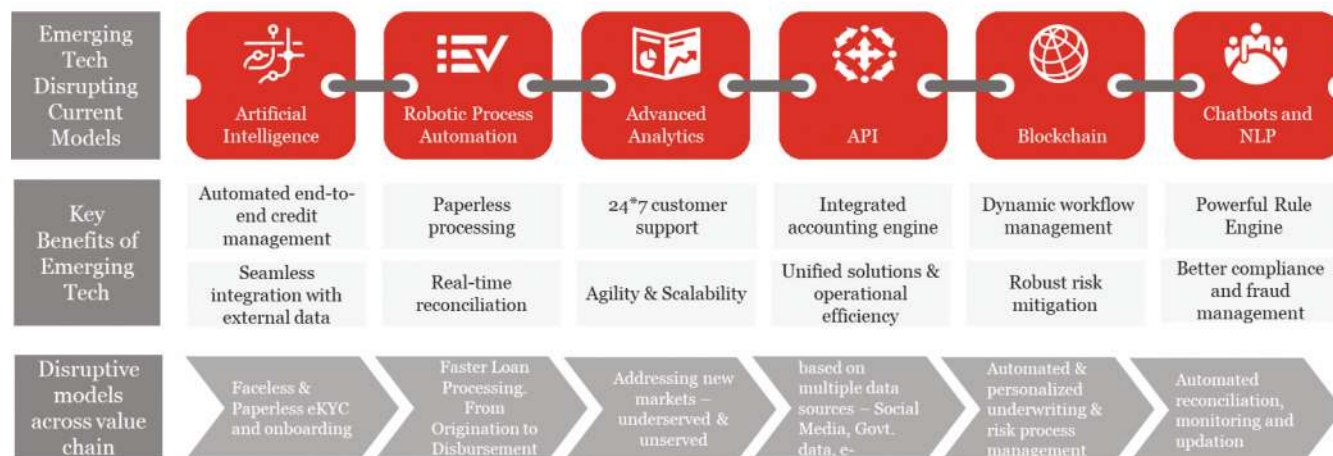
We believe that NBFCs need to gear up for a transformation journey to overcome the internal systemic issues and to ensure complete regulatory remediation and to overcome the internal systemic issues. Both traditional and emerging technology can be great enablers to alleviate the pain points that the NBFC sector is facing.

### Leveraging traditional technology for addressing systemic data quality & governance issues

The RBI currently mandates submission of regulatory returns covering ALM, capital risk adequacy ratios (CRAR), special mention account (SMA) and non-performing assets (NPA), exposures to large corporates. While this information can aid RBI in correctly accessing and monitoring the health of the NBFCs, the quality of underlying data has been a point of contention. Due to system limitations and non-existent data governance policy, most NBFCs have limited view of their end-to-end data cycle leading to poor data auditability & traceability. This leaves the organization’s management and the regulator with reduced visibility to monitor as well as foresee any risks.

### Analytics-driven data management & governance

To improve data auditability & traceability, NBFCs need to create a reconciled centralized data layer with record-to-report data lineage for their regulatory and financial reporting. This means end-to-end data lineage i.e. lineage for each loan account from source system to final reporting element. Furthermore, NBFCs need to create a compliance register comprising data definition which would act as the foundation of this layer. They should also enforce strong governance around data flow life cycle by putting strong risk controls. This robust data foundation can lead the way for an analytics-driven digital governance, risk and compliance (GRC) solution. The GRC solution would be able to apply business rules (based on empirical evidence) to flag potential anomalies with credit appraisals, underwriting and also should be able to track remediation. Benefits would include a reduced cost and time to compliance, increase of accuracy of audit reports and easy monitoring through dashboards. Additionally, Early Warning System should be commissioned by leveraging internal data and external available corporate/sectoral data from sources such as CIBIL, CFR (Central Fraud Registry), SEBI, etc. to identify potential red flags in the customer behavior. Analytics-driven dashboards need to be created for continuous monitoring of trends, Financials, ALM, Expected Credit Loss (ECL), Disbursement, Repayment and Collections.



### Leverage Emerging Technologies to transform NBFC

In addition to strengthening of systemic issues, investing in new technologies will enable NBFCs to increase their customer base, lower customer acquisition cost, deliver better services to customers and de-risk the portfolio.

#### Artificial Intelligence (AI)/Machine Learning (ML) and Robotic Process Automation (RPA)

Traditionally, NBFCs have adopted a one-size fits all approach. With advent of AI combined with ML, NBFCs can adopt a personalized approach to underwriting and origination. The approach shall help broaden the customer funnel, allowing sales teams to target a large pool of prospective customers and offer relevant products. Digital-focused NBFCs can transform the manual, time-consuming, human judgement-based underwriting process using technology advances to provide instant, real-time approvals. With next level of growth coming from accounts with little or no credit history, NBFCs shall need to leverage wider data sets from LinkedIn, Facebook, Swiggy, etc. to explore derivation of delinquent account strategy.

#### Blockchain

NBFCs should leverage the opportunity to reduce transaction costs and the amount of paper that they process and should work in tandem with technology vendors, financial institutions and FinTechs for implementing Blockchain to make their onboarding process increasingly efficient, secure, and profitable.

#### Open API (Application Programming Interface)

The ability of NBFCs to directly retrieve transactional data from the borrowers’ bank account will go a long way in eliminating fraud and improving access to credit. Since most of this data is already available, it would be easier for NBFCs to get this data through APIs directly from banks as against using intermediaries; thus providing seamless experience and saving on operational costs, which further can be passed on to consumers. Success of a credit risk system like this will depend on the number of institutions involved and how much data is shared among them. There is an opportunity to develop common industry standards around APIs to increase ease of interoperability.

#### Road Ahead

The future of NBFCs lies in digitizing customer lifecycle with a seamless integration between front-end, middleware and back-end for making the entire product and service stack technology-driven. This doesn’t simply end at automating the end-to-end process, but adopting agile & robust technology platforms and solutions that would enable the companies to quickly react to external events, market and customer demands and simultaneously address NBFCs core issues.

<sup>1</sup><https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/FSRJUNE2019E5ECDDAD7E514756AFEF1E71CB2ADA2B.PDF>

## Addressing Stress in NBFC Sector

By Mr. Ashvin Parekh, Managing Partner, Ashvin Parekh Advisory Services (APAS)

The NBFC sector in India is in the midst of a crippling liquidity crisis that threatens to balloon into an insolvency crisis if it prolongs. Though the proximate reason has been default by IL&FS, it has been exacerbated by defaults from other entities such as DHFL. Given the quickly morphing nature of the crisis, it will take a concerted effort by the RBI in conjunction with other market regulators to resolve the crisis. While some of the measures below could bring immediate relief, some would benefit the sector in the long term. However, we believe all of them are important to resolve the current crisis and prevent future crises from occurring.

- **Asset Quality Review (AQR) of Systemically Important NBFCs**

The roots of the current NBFC crisis lie in a loss of confidence of market participants in the books of the affected NBFCs. This is reflected in the differential access of these players to market borrowings - while some have been unable to raise funds at any cost, some have seen a significant rise in cost of funding whereas others have only seen modest rise in funding costs. As such, a path to resolve the current crisis lies in restoring confidence of the market in the NBFCs through RBI doing an in-depth AQR and quasi-certifying the books. Though this exercise would require significant resources from RBI, such a step would have important long-term benefits in the form of reduction in borrowing costs of NBFCs that could drive credit growth in the economy.

- **Board representation of RBI personnel in NBFCs**

A common thread across the NBFCs which have been hit hardest by the current crisis is the poor corporate governance standards as perceived by the market. Presence of a senior RBI member on the board would add strength to the quality of the board and give the regulator a much closer and real-time view in the functioning and health of the NBFCs. This would be an important step to identify and correct process irregularities which would be more efficient than spending time cleaning up after the problem arises.

- **Providing liquidity to NBFCs against safe assets**

One of the steps to provide immediate relief in the current crisis is for the RBI to provide liquidity to the NBFCs against their safe assets such as Government Securities and State Development Loans. Akin to the Statutory Liquidity Ratio (SLR) for banks, RBI should prescribe such a ratio albeit at a lower level than banks. Although this would result in lower flexibility of NBFCs to use their funds, the costs would be more than offset by the benefit of access to a lender of last resort like the RBI.

- **Deepening bond markets, securitization and bankruptcy resolution**

One of the immediate causal factors for the current crisis has been the asset-liability mismatch of NBFCs. This has been in turn driven partly due to high risk taking by NBFCs choosing to run such a mismatch by raising lower cost short term funds (CPs) and partly due to inability of these entities to raise long term debt capital which matches their asset profile. Closer RBI monitoring of ALM mismatches could reduce such instances whereas a vibrant and deep debt market would help NBFCs to raise capital suitable to their assets.

A stumbling block to deepening bond markets for NBFCs has been the lack of a bankruptcy resolution framework for financial institutions as the current Insolvency and Bankruptcy Code (IBC) applies only to corporates. Development of such a framework would increase confidence of market participants in recovering debt investments in NBFCs.

Deeper bond markets would help NBFCs to diversify their liability profile by raising funds through securitization of pools of assets across the spectrum. Currently, securitization is largely driven by demand from banks to purchase pools of assets to fulfill their Priority Sector Requirements (PSL). Depth in markets would help NBFCs with non-PSL loans to actively tap the securitization market.

- **Reform of Credit Rating Agencies (CRAs)**

A symptom of the current crisis has been the quick transition of select NBFCs from high grade AAA ratings to junk category ratings. As a result of extreme reliance on credit ratings and poor credit appraisal by multiple market participants including MFs and insurance companies, they have ended up suffering significant markdowns on these investments further denting market confidence. On this front, RBI will need to work with other market regulators to formulate stricter norms for CRAs including stipulations for rating grade wise probabilities of default that their ratings shouldn't exceed. CRAs should issue (a) "Probability of default" not to exceed certain % within a certain time frame (b) "probability of downgrade" to any lower ratings within a certain time frame, for every rating issued by them. For instance, an "AA" rating shall also mean the probability of default doesn't exceed ....% within the next 3 years and the probability of downgrade to a lower rating doesn't exceed ..% within the next 3 years. In case any of the above are not met, they should be penalized by RBI. This is expected to bring in more accountability of CRAs.

Additionally, to resolve the inherent conflict in the issuer-pays model and to curtail rating shopping by NBFCs, the regulator should assign rating mandates to rating agencies from a common pool of capital raised from the issuers. Such mandates can be assigned based on the accuracy of ratings as represented by the historical Rating Transition Matrix published by the CRAs. Further, the respective regulators should review credit appraisal function of MFs and insurance companies to identify their ability to look beyond ratings.

- **Focused implementation of IBC and RERA**

Tighter implementation of recent reforms like IBC and RERA would help improve transparency and quicken resolution of stressed assets for NBFCs with exposure to corporates and real estate developers. Though this is unlikely to bring immediate relief to the sector, it can be a game changer in the long run.

- **Aggressive recapitalization of banks to increase liquidity to SMEs**

The current economic slowdown has been marked by an increase in working capital requirement of SMEs/MSMEs due to delays in processing of GST returns by the government. Some of the NBFCs with exposure to this sector have suffered as a result. To ease liquidity to such sectors, the government needs to smoothen GST processing and recapitalize public sector banks on a war footing to enable them to lend further to these sectors. Using RBI reserves to recapitalize public sector banks is a temporary solution. In the long run, the government must resort to privatization of state-run banks as it is expected to bring in discipline and address fundamental problems of banking.

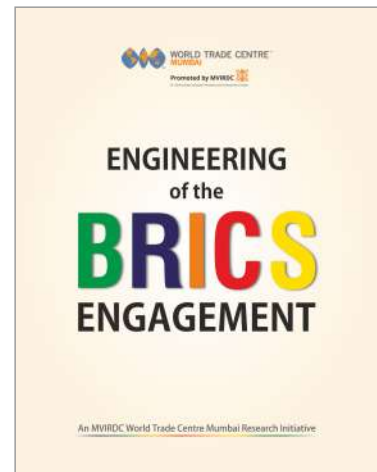
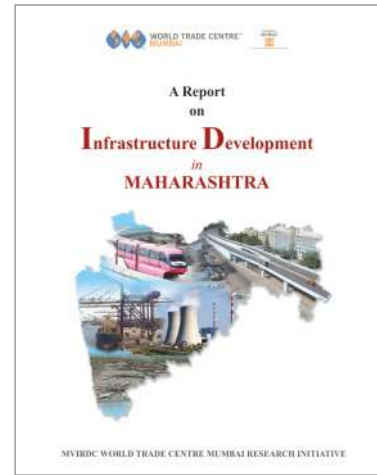
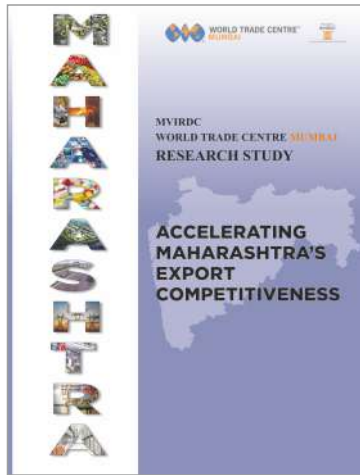
### Box 4: Growth in aggregate balance sheet and select ratios of NBFC Sector

Aggregated balance sheet of the NBFC sector: y-o-y growth		
Particulars	(per cent)	
	18-Mar	19-Mar
1. Share capital	6	6.3
2. Reserves and surplus	18.7	14.6
3. Total borrowings	19.6	19.6
Of which 3.1 Debentures	13.1	5.2
3.2 Bank borrowings	34.4	47.9
3.3 Commercial paper	13.3	4
4. Current liabilities and provisions	22.4	48.7
Total Liabilities / Assets	17.9	20.6
1. Loans and advances	21.1	18.6
2. Investments	12.9	24.4
3. Others	26.7	-2
<b>Income/Expenditure</b>		
1. Total income	11.4	17.8
2. Total expenditure	9.6	17.8
3. Net profit	27.5	15.3
Source: The Reserve Bank's Supervisory Returns		

Select ratios of the NBFC sector		
Particulars	(per cent)	
	2017-18	2018-19
1. Capital market exposure to total assets	10.5	9.5
2. Real estate exposure to total assets	6.7	6
3. Leverage ratio <sup>39</sup>	3.2	3.4
4. Net profit to total income	14.1	15.3
5. RoA	1.7	1.7
Source: The Reserve Bank's Supervisory Returns		

Select ratios of the NBFC sector			
Year	(per cent)		
	GNPA Ratio	NNPA Ratio	CRAR
2014-15	4.1	2.5	26.2
2015-16	4.5	2.5	24.3
2016-17	6.1	4.4	22.1
2017-18	5.8	3.8	22.8
2018-19	6.6	3.7	19.3
Source: The Reserve Bank's Supervisory Returns			

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