Non-Banking Financial Service Crisis and Risk Management

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1. Introduction

On 27th August, 2019 Reserve Bank of India released the Bimal Jain panel review of Economic Capital Framework. One of the important recommendation of the report was the Government and Reserve Bank of India must be mindful and aware regarding new potential sources of financial instability from systematically important financial institutions. Business line, Money and Banking dated 28th August, 2019 reported that the committee also focussed on the rapid growth of interconnectedness between banks and non-banking financial entities in Indian market thus increasing the risk of contagion. Financial Stability report, June 2019 reported the total outstanding bilateral exposures among the financial institutions increased from Rs. 31.40 lakh crore in March, 2018 to Rs. 36.30 lakh crore in March, 2019. Public sector banks are expected to come under stress in the event of stress in NBFC sector because public sector banks have a net receivable position vis-à-vis NBFC Sector. With recent systematic liquidity problem and asset liability mismatch in the NBFC sector in India have resulted in the free fall of NBFC sector stocks in capital markets leading to the contagion spread to other financial stocks creating bearishness and crashed benchmark indices. Lender of the last (LoLR) action by the RBI was necessary for the current stress being faced by NBFC and the default by non-banking financial institutions such as DHFL and IL&FS have a ripple impacts on the financial system.

This paper study the reasons and impact of NBFC`s crisis with reference to systematic risks leading to contagion risk in the various sub sectors of Indian Financial Markets. The paper also focusses on the Global issues of NBFC and steps taken by various stakeholders to resolve the liquidity, systematic and contagion risks.

2. Background of the Study – History and Evolution of NBFC`s in India

NBFCs in India made a humble beginning way back in the 1960's to serve the need of the savers and investors whose financial requirements were not sufficiently covered by the existing banking system in India. The NBFCs began to invite fixed deposit from investors and work out leasing deal for big industrial firms. Initially, they operated on a limited scale and could not make a significant impact on the financial system.

- During the first stages of their development, this business of financing was regulated by the Companies Act. At that time a need was felt that due to the unique and complex nature of operations and also financial companies acting as financial intermediaries, there should be a separate regulatory mechanism.
- Accordingly, Chapter III B was included in the Reserve Bank of India Act, 1934, assigning limited authorities to the Bank to regulate deposit taking companies. The RBI has since initiated measures to bring the NBFC sector within the realm of its regulation.
- The RBI accepted and implemented the key **recommendations of James S. Raj Study Group formed in 1975** that financial companies be allowed to gearing often times. As per the salient features of the Directions, the hire purchase and leasing companies could accept deposits to the extent of their net owned funds. The Directions also required the Companies to maintain liquid assets in the form of unencumbered approved government securities.
- **Between 1980's and 1990's**, NBFCs gained good ground and started to attract a huge number of investors owing to their customer friendly reputation. Since the days of Liberalization, Privatization and Globalization (LPG, started in 1991), there has been a mushrooming growth of NBFCs; the number of NBFCs grew from a mere 7000 in 1981 to around 30000 in 1992. This is when the RBI felt that it was becoming increasingly onerous for it to regulate the industry. In 1992, the RBI formed a Committee headed by A. C. Shah, former Chairman of the Bank of Baroda, to suggest measures for the effective regulation of the industry. The Shah Committee gave its recommendations, which ranged from compulsory registration to prudential norms.
- **January 1997** witnessed drastic changes in the RBI Act, 1934, especially the Chapters III-B, III-C, and V of the Act with the fundamental objective of putting in place a complete regulatory and supervisory structure, aimed at protecting the interests of depositors as well as ensuring the robust functioning of NBFCs.
- **In the period following the amendment of the Act in 1997,** the NBFCs have evolved substantially in terms of operations, variety of market products and instruments, technological sophistication etc.

3. Regulatory Framework

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 2013 and engaged in the business of loans and advances, or businesses of hire-purchase, insurance business and chit-fund etc. (1) NBFCs are regulated by the Reserve Bank of India (RBI) which outlines norms and standards, issues relevant notifications, and monitors overall functioning of NBFCs within the framework of the Reserve Bank of India Act, 1934 along with any amendments. The RBI has been regulator of NBFC sector and the related Act was amended in 1997 to provide comprehensive regulatory framework for NBFCs according to which the RBI can issue directions to NBFCs & their auditors; prohibit deposit acceptance and alienation of assets by NBFCs; and initiate action for winding up of NBFCs.

In parallel with the banking system, NBFCs are the backbone of India's financial system as they serve diverse needs such as housing finance, infrastructure sector finance including infrastructure debt fund, micro finance, and retail loan finance. As per the RBI designed framework for NBFCs, different Non-Banking Finance Companies have been operational in the following Industrial structure.

1. Asset Finance Company (AFC)
2. Investment Company (IC)
3. Loan Company (LC)
4. Infrastructure Finance Company (IFC)
5. Systemically Important Core Investment Company (CIC-ND-SI)
6. Infrastructure Debt Fund: Non- Banking Financial Company (IDF-NBFC)
7. Non-Banking Financial Company-Micro Finance Institution (NBFC-MFI)
8. Non-Banking Financial Company – Factors (NBFC-Factors)
9. Mortgage Guarantee Companies (MGC)
10. NBFC- Non-Operative Financial Holding Company (NOFHC)

4. Role of NBFCs

NBFCs have played an important role in promotion of financial inclusion by addressing diverse financial needs of those customers who were out of the regular banking system; truly serving the poor and the un-banked citizens of the country. They have provided innovative and appropriate financial services to Micro, Small and Medium enterprises (MSMEs) based on their needs and suitability. NBFCs critically support the development of Indian economy by helping employment generation, wealth creation, especially in the rural areas and for financial weaker sections of the society by promoting savings, facilitating access to credit, and disseminating financial literacy among the relevant stakeholders.

Moreover, NBFCs have acted as financial intermediaries for channelizing the scarce financial resources to capital formation, and supplementing the Banking sector to meet the increasing financial needs of all sectors of the economy such as the corporate sector, the unorganized sector, small borrowers at the local level. Although the Banking sector has been a dominant player in this field but despite this, the role of NBFCs is critical and their presence in our country will further boost the economy in the right direction. NBFCs have played a key role in employment generation, development of financial markets as well as breaking vicious circle of poverty by serving as governments representative. Top 10 NBFC in India based on profitability and market capitalization are presented as below in table 1 and 2.

Table 1 *Top NBFC in India based on Profitability. Source: Money Control*

Top 10 NBFC in India Based on Profitability		
Company Name	**Net Profit (Rs. Cr.)**	**Rank**
Bajaj Finance Limited	**3,890.34**	**1**
Shriram Transport Finance Company Limited	**2,563.99**	**2**
Muthoot Finance Limited	**1,972.14**	**3**
Mahindra & Mahindra Financial Services Limited	**1,557.06**	**4**
Sundaram Finance Limited	**1,126.31**	**5**
Shriram City Union Finance Limited	**988.88**	**6**
Manappuram Finance Limited	**790.46**	**7**
Bajaj Holdings Limited	**788.19**	**8**
Magma Fincorp Limited	275.13	**9**
L& T Finance Holdings limited	267.06	**10**

Table 2 *Top 10 NBFC in India based on Market Capitalization, Source Money Control*

Top 10 NBFC in India Based on Market Capitalization		
Company Name	Market Cap (Rs. Cr.)	Rank
HDFC Ltd	3,29,,767.12	1
Bajaj Finance Limited	2,00,998.67	2
Muthoot Finance Limited	46,033.79	3
Bajaj Holdings Limited	29,793.27	4
Shriram Transport	17,775.04	5
Sundaram Finance Limited	17,751.62	6
M&M Financial	16642.59	7
L&T Finance	13503.96	8
Mannapuram Finance	12521.29	9
Credit Access Gramin	10425,96	10

Timelines of NBFC crisis and collapse events are summarised below in the Table 3.

Table 3 *Timelines of NBFC Crisis in India. Source: Yahoo Finance*

	Timelines of NBFC `s Collapse in India
Date	Event
Jun-18	First time IL&FS default repayment of short term borrowing commercial paper
	and unsecured borrowing inter corporate deposit value Rs. 450 crore
Jul-18	Mr Ravi Parthasarathy resigned after 30 years of tenure at IL&FS and MD OF LICI
	Mr Hemant Bhargava replaced Mr Parthsarathy swiftly. Company was highly
	leveraged with high capital requirement by its subsidiaries
Sep-18	Second time IL&FS default value Rs. 1000 crore short term loan from SIDBI
	Credit rating agencies started downgrading the company and its subsidiaries
	Financial year 2018 loss to the tune of Rs. 1887 crore and total debt of 91091 Crore
	IL&FS strategy of funding long term project with short term borrowing leads to
	Increase in debt, cost of borrowing increased, short term liquidity dried up resulted in delayed
	project. DSP Mutual funds dumps 3000 crore worth of Commercial papers of Dewan Housing
	Finance (DHFL) at a discounted rate
	Between Sept .21st to 24th, 2018 the market cap of NBFC `s were eroded - HDFC 18600 Crore
	Bajaj Finance 13800 crore and other NBFC`s DHFL, L& T Finance holdings and India bulls also witness
	sharp fall in their market cap
	Reason for loss of trust and nervousness of investors in NBFC
Oct-18	Contagion Risk - NBFC crisis spread and adversely impacted stock and debt market.
	11th oct, 2018 - NIFTY fall to 10234 and Sensex fall to 34001 which was six-month low
Feb-19	Rs 40008 crore loan payment default by Anil Ambanni owned Reliance Home Finance to Punjab & Sind Bank
Apr-19	Care Ratings reported - Anil Ambani Group Reliance Commercial Finance also on the verge of default
May-19	large number of investors shifted to strong private NBFC`s such as HDFC and quasi sovereign financial
	companies like Power Finance Corp, Rural Electrification Corporation, National Housing Bank, NBARD
	and LIC Housing Finance
Jun-19	DHFL failure to repay Rs. 225 crore worth commercial paper short term borrowing
	Reason for failure Inability to raise new funds and lack of liquidity
Jul-19	RBI Governor ensured that various steps and initiatives being taken to further prevent collapse of other NBFC
Aug-19	Mutual funds Company became conservative and cautious in investing in NBFC which was their important source
	20% year on year basis drop in the exposure of debt mutual funds
Sep-19	Increasing borrowing cost for NBFC. Reliance Home Finance and Reliance commercial Finance declared insolvent
	Interest payment default by Real Estate Financier Altico Capital and credit rating downgraded to Junk status
Dec-19	RBI in their report on trends and progress of banking in India explained the increasing NPA between
	March 2018 and Sept 2019 for two important reasons - Increased Risk Aversion by Banks and NBFC`s and higher cost
	borrowing resulting in drop in credit growth
Mar-20	RBI declared three-month moratorium for EMI repayment of loans to fight the Covid 19 crisis
Apr-20	RBI clarified that banks can decide to offer a moratorium to shadow bankers
	Franklin Tempton shut down its six debt schmes worth Rs. 30000 Crore
May-20	SBI and PNB agreed to offer moratorium to NBFC`s. Bajaj Finance reported sharp fall in their profits and 27% of their
	Loan book declined and made 9000 crore provision for Coved 19 related crisis
	RBI further extended moratorium for three months more till the end of month August 2020
Jul-20	RBI released Fiscal Stability Report and issued clear warning that economic disruptions will intensify risks to NBFC
	firms and Shadow Banking forms leading to systemic and contagion risks to another segment of financial sectors
	RBI has taken over IL&FS AND DHFL for loan defaults as well as facing bankruptcy proceedings.

5. Overview of NBFC Crisis: Reasons of Failure

The crisis started from the default made on bonds payment by ILFS and other irregularities related to officials of the NBFC were pointed out. While the promoters of DHFL a well-known and one of the largest housing finance company has siphoned off money to other group companies for their vested interests. Some of the main factors leading to the NBFCs crisis were credit squeeze, over-leveraging, excessive concentration, inappropriate business model causing massive mismatch between assets and liabilities, which were exacerbated by misadventures by a few rogue promotors. For example, the asset-liability mismatch occurred when NBFCs borrowed with short repayment periods and provided loans with long repayment periods, which worked well in good times but collapsed in bad times leading to liquidity crunch and consequent default. And as the fear and the rumors spread, so did the squeeze on the availability of finance to NBFCs, which had to incur high cost of funds net interest margins to survive. The failure of these two NBFCs has led to credibility crisis. The crisis triggered was unique in the sense that it is both a driver and reflection of the economic slowdown.

Infrastructure Leasing and Financial Services (IL&FS) was a core investment company and served as the holding company of the ILF&S group, with most business operations domiciled in separate companies across infrastructure, finance and social and environmental services. It was sitting on debt of about Rs 91,000 crores. Of this nearly Rs. 60,000 crore of debit is at project level, including road, power and water projects. A major reason behind troubles of ILF&S was complications in land acquisition. The 2013 land acquisition law made many of its project unviable. Cost escalation also led to many incomplete projects. Lack of timely action exacerbated the problems.

DHFL (Dewan Housing Finance Limited) was a deposit taking housing finance company, it was established to enable access to economical housing finance to the lower and middle income groups in semi urban-rural parts of India. The NBFC had been facing a liquidity crunch since September,2018 because it has paid over Rs 41,000 crores to meet its financial obligations during this period-mainly through a combination of securitization of assets and repayment collections. The NBFC has delayed interest payment on debt instruments created for Mutual Funds. DHFL faced series of downgrades by rating agencies on its debt paper issued**.**

6. Impact of NBFC Crisis on Indian Financial Markets

The overall impact of the NBFCs crisis has led to squeeze on funding from banks to NBFCs, restricted buying of NBFCs' debt papers by mutual funds leading to a major liquidity crunch and disruptions in the overall business cycle. NBFCs saw their share prices tumbling over this period and investors losing their money as well as trust in NBFCs. The credibility crisis was evident in rating agencies downgrading ratings of even well-run/managed NBFCs.

In the aftermath of NBFC crisis, the overall exposure to different sectors has come down, which is very much visible in the following Table 4.

Sectoral Credit Deployment by NBFCs (Amount in Rs. Crore)

Table 4 *Sectoral Credit Deployment of NBFC. Source: Reserve Bank of India, www.rbi.org.in*

Sector	March,2019	September,2019	% Variation
Micro and Small	54,297	46,244	- 15.3
Medium	22,979	19,981	- 18.8
Consumer Durables	5,094	4,917	- 3.47

The ongoing liquidity crunch of NBFCs will lead to creation of non-performing asset for Banks, which have been relying of such lenders for funding. The spillover of stress from NBFCs to borrowers, and ultimately to banks will further affect banks' asset quality, profitability and capital. Such crisis will further force NBFCs to reduce lending to their target groups and cause funding constraints for borrowers who have been dependent on them, especially MSMEs. It will increase the risk of loan losses for NBFCs.

Systematic risk refers to the risk which impact the entire market segment and not to any specific industry. Systematic risk, also known as "undiversifiable risk" or "market risk" affects the overall market, not just a particular company or industry. The main features of this risk is that its unpredictable, uncertain and spread across the various sectors in the market that it become difficult to avoid. Asset liability mismatch of NBFCs (ILF&S and DHFL) alone could have become a systematic risk. Whereas entire NBFC sector has been grappling the issue of mismatch of ALM, hence this became a low-lying systematic risk for the sector.

Contagion risk which has also been referred to as systematic risk is defined the risk that financial difficulties at one or more NBFCs spill over to a large number of other NBFCs or the financial system as a whole. The Indian NBFC sector is facing rising risk of contagion and failure of any large finance company, it will adversely impact economic growth. The contagion effect has been witnessed after failure of ILF&S and DHFL, Banks have stopped lending to NBFCs and Mutual Fund houses are in the spree of selling debt papers issued by other NBFCs. To examine the risk of contagion between Banks and NBFCs, the RBI has constituted a committee under chairmanship of former RBI Governor Mr. Bimal Jalan. The committee has deeply examined the causes of NBFC crisis and its contagion risk on the overall industry.

The report of the committee stated that both the Central Government and the Reserve Bank of India (RBI) need to be mindful that new potential sources of financial instability from systematically important financial institutions cannot be ruled out. The committee also accepted that the interconnectedness in the Indian markets between banks and non-banking financial institutions is enlarging rapidly, thus increasing the risk of contagion in a financial crisis. Fitch Ratings reported that Indian financial sector faces a high risk of contagion with many financial companies who have lost over half of their equity in the past few years. S&P (Standard and Poor`s) have also cautioned that any failure of a large shadow lender could lead to solvency shock to other financial institutions and banks also. Both S &P`s and Fitch have reported that 30% approximately of banks' exposure to shadow lenders could turn into NPA and bad loans. This could further put pressure on their capital adequacy requirements and can reverse the various initiatives taken by the various stakeholders like RBI and Government of India. However, S&P in his report explained that contagion risk is not likely to affect much the public sector banks because of the confidence of depositing public for the sovereign ownership and support for capital infusion

The ongoing NBFC crisis has not been unique to India, in fact the problem faced by across the globe. The NBFC sector crisis issue has transcended to many countries.

7. Global issues of NBFCs

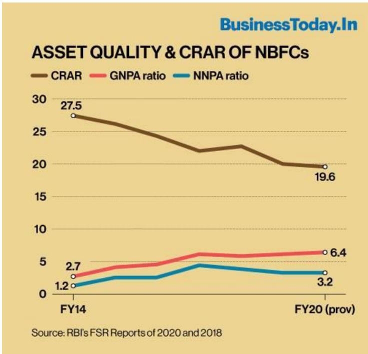
While examining the global issues faced by NBFCs across the Globe, we come across different type of Non-Banking Finance Institutions which have been functional across the globe. Our focus will be Asian countries which have different frameworks for these institutions. These NBFCs are present in deposit taking as well as non-deposit taking. In some of the countries like China and Russia these NBFCs are unregulated, while in countries like Philippines, Cambodia these are regulated by their Central Banks. South east Asia based NBFCs have been facing challenge on growing non-performing loans, as well as change in funding methods. These NBFCs have been facing major challenge on technology disruption also and forced to adopt digital platforms for disbursements and collection of payments.

Impact of Covid 19 on NBFC Sector

NBFC`S pain further likely to increase due to uncertainties emerging from the Covid 19 impact relating to economic slowdown due to lack of funding and increase in quality of bad assets. ICRA rating agency said that spike in delinquency in all asset classes including loans disbursed by Microfinance Institutions can result in challenges in sell down of their portfolios. S&P Global Market intelligence reported that NBFC funding continues to remain tight as the economy contracts and investors become more cautious and many NBFC`s may remain short of funds. Mutual Funds exposure to NBFC under debt asset management have fallen from 34 percent from September 2018 to 18% in April 2020. There is no escaping the long adverse impact on shadow banking firms in India in these difficult time of Covid 19 crisis induced economic disruptions. RBI in their Fiscal Stability report has mentioned that stress on non-banking financial companies had increased due to risk aversion safety approach by the banks leading to differentiation in market access and funding constraints. Under stress assets 11.2 % to 19.5% of NBFC will fail to comply with the minimum required capital to risk assets requirements (CRAR) of 15 %.

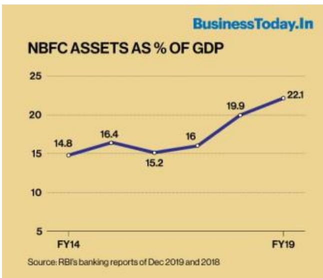
The following figures and graphs represents the NBFC`s asset quality (GNPA and NNPA) and CRAR ratio from the FY 2014 to FY 2020 (prov).

Table 5 *Asset Quality and CRAR of NBFC*



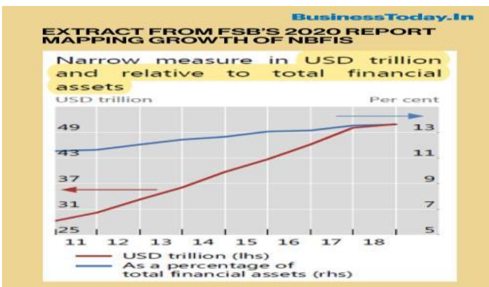
Source RBI`s FSR Reports of 2020 and 2018
Reported by Prasanna Mohanty, Business Today, 3rd Sept, 2020

Table 6 NBFC ASSETS AS % OF GDP



Source RBI`s Banking Reports of Dec 2019 and 2018
Reported by Prasanna Mohanty, Business Today, 3rd Sept, 2020

Table 7 *Mapping Growth of NBFC*



Source Extract from FSB Report 2020
Reported by Prasanna Mohanty, Business Today, 3rd Sept, 2020

8. Initiatives/Steps take to Resolve the Systematic and Contagion Risk in NBFC in India

Ministry of Finance and Reserve Bank of India have taken some very timely initiatives to resolve the systematic crisis and tried to contain its contagion impact on NBFC sector. These initiatives are:

- Appointment of Bimal Jalan committee to study and understand the ongoing NBFC crisis.
- The central government has taken various steps to extend support to NBFCs. Public sector banks have been sanctioned to purchase '21,580 crores of pooled assets as on October 16. Moreover, the National Housing Bank has also extended 30,000 crore worth of credit lines to NBFCs.
- The RBI has also permitted banks to use government securities, equal to their incremental outstanding credit to NBFCs, over and above their outstanding credit to them as on October 19, to meet the liquidity coverage ratio requirement.
- The RBI has allowed Banks to avail higher liquidity with effect from October 1 as it had enhanced the Facility to avail liquidity for Liquidity coverage ratio from the existing 11% to 13% of their deposits.
- RBI has announced that Bank can avail Rs. 50000 Crore through the targeted long term repo operations provided they invest 50 % of the funds in commercial paper, grade bonds and non-convertible debentures of small and mid-sized NBFC and micro finance institutes.
- RBI also announced special refinance facilities of Rs, 50000 Crore to SIDBI, NABRD and NHB for meeting their sectoral needs**.**

9. Suggestions and Recommendations

- Adoption of very sound due diligence on working of NBFC sector.
- Regular monitoring on business growth of the specific companies.
- Emphasis on very sound financial management of the sector.
- Proper Asset Liability Management (ALM) policies and its matching with demand and liability positions.
- The RBI should give approval on appointment of Audit Firms and to avoid related transactions.
- Company specific exposure limits for Banks and its regular monitoring by RBI.
- Checks and balances on day to day working of downgraded companies.

10. Conclusion

The NBFC crisis has highlighted the shortcomings that forced the Regulator and Government of India to rethink about regulation and monitoring of the sector. No doubt the crisis will pave the way for better corporate governance, adoption of proper due-diligence and proper policy frame work to consolidate the growth of the sector. It will enable the RBI for timely identification of Black sheep from the herd and prevention of any further damage to the system. Once the lockdown situation due to Covid 19 eases and economic activity start showing green shoots of recovery, the market is likely to recover. NBFC is an important part of Indian Financial System and plays an important role in meeting the diverse financial needs of customers and banks. NBFC promotes financial inclusion, innovative financial services to MSME Sector, employment generation and wealth creation. With the liquidity support and host of measure by RBI to NBFC`s will play an important role for resolving their liquidity problems. As per the PWC report "Building the NBFC of the future – A Scalable and Profitable Model" has explained the ten parameters that provides foundation for NBFC for sustainable growth and efficient operations in the uncertain times, dynamic and competitive market place. These ten considerations are Enterprise strategy, customer experience, process and operations, Underwriting, collections, Robust IT and digital capabilities, partnership with Fintech players, proactive risk management, agile organization design and effective government mechanism. The successful transformation of robust risks and governance model can build the NBFC of the future.