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INDUSTRY OUTLOOK

Non Bank Finance Companies (NBFCs): Outlook and Challenges

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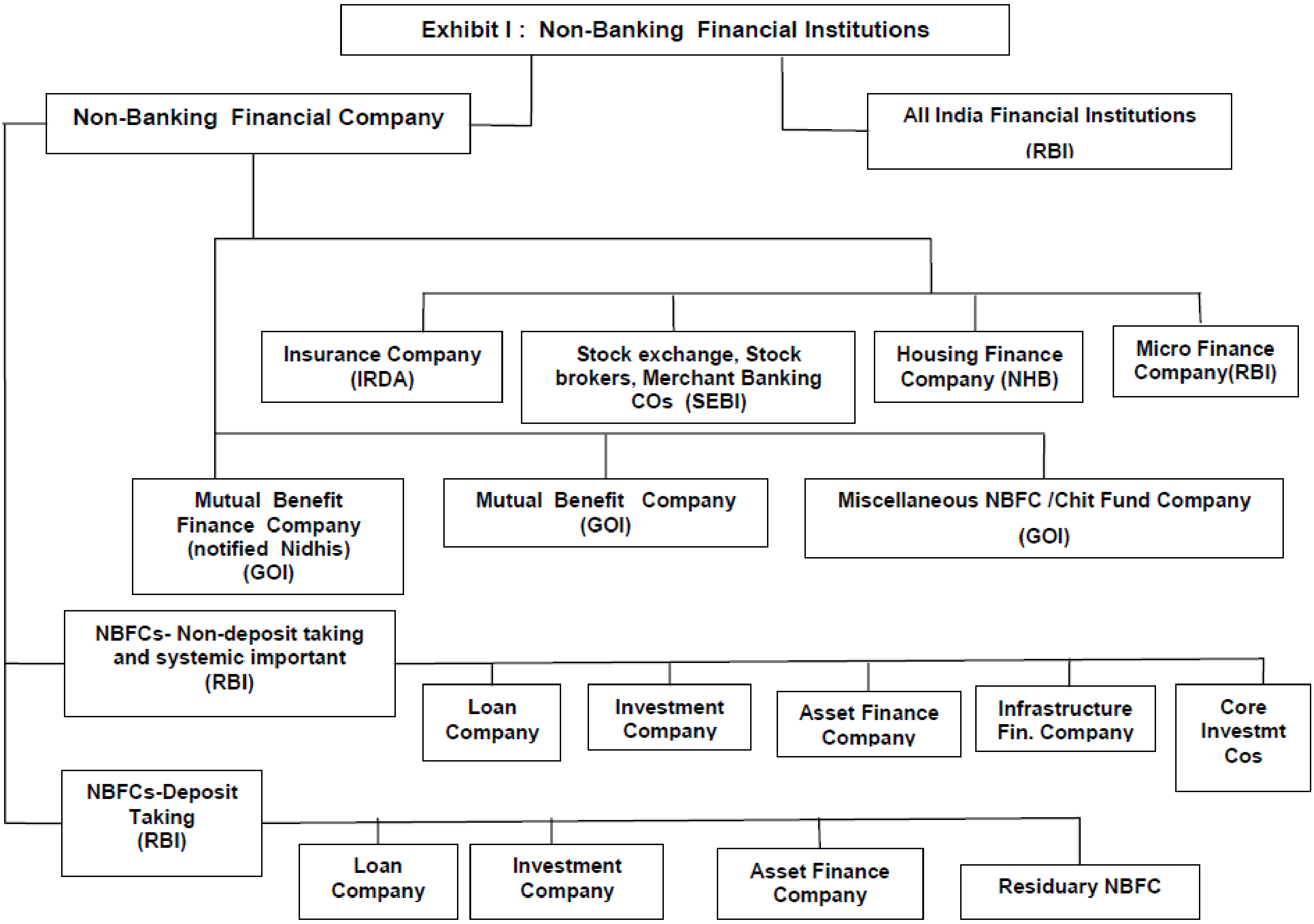
INDUSTRY OUTLOOK

It is widely agreed across the development spectrum that a sound financial system is a pre-requisite to a robust and sustainable modern economy[1]. A survey of literature of all advanced economies clearly reveals that sophisticated financial systems efficiently deliver a broad range of financial services and act as a critical pillar in contributing to macroeconomic stability and sustained economic growth and prosperity[2].



Note: The regulatory authority for the respective institution is indicated within the brackets.

Source: A. Karunagaran. (December, 2011) WPS (DEPR): 21/2011. RBI Working Paper. "Inter-connectedness of Banks and NBFCs in India: Issues and Policy implications."

Non-banking finance companies (NBFCs) form an integral segment of the Indian financial system. NBFCs, which have emerged as the driving force behind India's rapid economic growth in areas ranging from customer satisfaction to social engagement, play a catalytic role in nation building and financial inclusion by complementing the banking sector in reaching out credit to the unbanked segments of society, especially to the micro, small and medium enterprises (MSMEs), which form the cradle of entrepreneurship and innovation. Further, NBFCs provide an important avenue for the investors to park their funds at more attractive returns in comparison to the bank deposits. Historically NBFCs "…enhance the resilience of the financial system to economic shocks by providing it with an effective 'spare tyre' in times of need…[3]"

The NBFC sector in India has undergone a significant transformation over the past few years. It has come to be recognised as one of the systemically important components of the financial system and has shown consistent year-on-year growth. NBFCs play a critical role in the core development of infrastructure, transport, employment generation, wealth creation opportunities, and financial support for economically weaker sections.

NBFCs can be classified on the basis of a) their asset/liability structures; b) their systemic importance; and c) the activities they undertake. In terms of liability structures, NBFCs are subdivided into deposit-taking NBFCs (NBFCs-D) - which accept and hold public deposits - and non-deposit taking NBFCs (NBFCs-ND) - which rely on markets and banks to raise money. Among NBFCs-ND, those with an asset size of INR 500 crore or more are classified as non-deposit taking systemically important NBFCs (NBFCs-ND-SI).

Important NBFCs in India are: The Indian Railway Finance Corporation, Reliance Capital Limited, Kotak Mahindra Finance Limited, Manappuram Finance and Leasing Limited (Manappuram Finance Ltd), the Industrial Finance Corporation of India (IFCI), Tata Motors Finance Limited, Hinduja Leyland Finance, Axis Finance Limited, Power Finance Corporation Limited, Shriram Transport Finance Company Limited, Bajaj Finance Limited, Mahindra & Mahindra Financial Services Limited (MMFSL), Muthoot Finance Ltd., HDB Finance Services, Cholamandalam Investment and Finance Company Limited, Tata Capital Financial Services Ltd., L&T Finance Limited and Aditya Birla Finance Limited.

Since NBFCs cater to niche areas, they are also categorised on the basis of activities they undertake. Till February 21, 2019, NBFCs were divided into 12 categories. Thereafter, these categories were harmonised in order to provide NBFCs with greater operational flexibility. As a result, asset finance companies (AFCs), loan companies (LCs) and investment companies (ICs) were merged into a new category called Investment and Credit Company (NBFC-ICC). At present, there are 11 categories of NBFCs in the activity- based classification.

Table 1: Classification of NBFCs by Activity

Sl No.	Type of NBFC	Activity
1	Investment and Credit Company (ICC)	Lending and investment.
2	NBFC-Infrastructure Finance Company (NBFC-IFC)	Provision of infrastructure loans.
3	NBFC-Systemically Important Core Investment Company (CIC-ND-SI)	Investment in equity shares, preference shares, debt or loans of group companies.
4	Infrastructure Debt Fund-NBFC (IDF-NBFC)	Facilitation of flow of long-term debt into infrastructure projects.
5	NBFC-Micro Finance Institution (NBFC-MFI)	Credit to economically disadvantaged groups.
6	NBFC-Factor	Acquisition of receivables of an assignor or extending loans against the security interest of the receivables at a discount.
7	NBFC-Non-Operative Financial Holding Company (NOFHC)	Facilitation of promoters/ promoter groups in setting up new banks.
8	Mortgage Guarantee Company (MGC)	Undertaking of mortgage guarantee business.
9	NBFC-Account Aggregator (NBFC-AA)	Collecting and providing information about a customer's financial assets in a consolidated, organized and retrievable manner to the customer or others as specified by the customer.
10	NBFC–Peer to Peer Lending Platform (NBFC-P2P)	Providing an online platform to bring lenders and borrowers together to help mobilize funds.
11	Housing Finance Companies (HFC)	Financing for housing.

Source: RBI

Although the NBFC sector grew in size from INR 26.2 lakh crore in 2017-18 to INR 30.9 lakh crore in 2018-19, the pace of expansion was lower than in 2017-18 mainly due to rating downgrades and liquidity stress in a few large NBFCs in the aftermath of the IL&FS event. This slowdown was witnessed mainly in the NBFCs- ND-SI category, whereas, NBFCs-D broadly maintained their pace of growth. However, in 2019-20 (up to September) growth in balance-sheet size of NBFCs-ND-SI as well as NBFCs-D moderated due to a sharp deceleration in credit growth.
Over 40 per cent of the retail portfolio of NBFCs is vehicle and auto loans. The slowdown in auto loans could be attributed to a slump in aggregate demand, exacerbated by postponement of vehicle purchases in anticipation of the implementation of BS-VI norms, the sharp increase in insurance costs in case of passenger vehicles and two wheelers, and sizeable enhancement in permissible axle load for commercial vehicles. In the consumer durables segment, a decline in credit extended was observed, reflecting muted consumer demand. NBFCs' credit to commercial real estate decelerated in recent years, reflecting their risk aversion in light of the slowdown in real estate sector despite expansion of bank credit to the sector.

INSTITUTIONAL INITIATIVES

After the IL&FS defaulted on payments, the government stepped into help the sector with the problem of liquidity crunch. The government provided a partial credit guarantee for six months to the public sector banks to buy high rated pooled assets from NBFCs, in order to help the NBFCs to liquidate their assets and meet their liabilities. The first scheme is a INR 30,000 crore special liquidity facility for NBFCs and HFCs, under which a Special Purpose Vehicle (SPV) would acquire investment grade debt of short duration (residual maturity of upto 3 months) of eligible NBFCs / HFCs. Through another scheme, which is an extension of already existing Partial Credit Guarantee Scheme (PCGS), Government would guarantee up to 20 percent of first loss for purchase by public sector banks of bonds or CPs with a rating of AA and below (including unrated paper with original/ initial maturity of up to one year) issued, among others, by NBFCs.
In March 2020, RBI announced that loans given by banks to NBFCs for on-lending to agriculture, micro and small enterprises, and housing to be classified as priority sector lending (PSL). Further, the on-lending by banks to NBFCs and HFCs (other than MFIs) will be allowed up to an overall limit of 5 percent of individual bank's total priority sector lending. In August 2019 to boost credit among small and needy borrowers, RBI had decided that the bank credit to registered NBFCs for on-lending will be considered as priority sector lending. The loans can be disbursed to Agriculture, MSME & Housing sector.
Under the Atmanirbhar Package-I (13 May 2020) announced by the government, a special liquidity scheme of Rs. 30,000 crore was announced, where investment would be made in primary and secondary market transactions in investment grade debt papers fully backed by the GoI. Further, INR 45000 crore liquidity infusion to NBFCs by way of partial credit guarantee scheme was announced, which was extension of the existing scheme wherein the first 20% of loss to be borne by GoI and AA rated and below including unrated papers to be included.

"The facility will not be available for any paper issued after September 30, 2020 and the SPV would cease to make fresh purchases after September 30, 2020, and would recover all dues by December 31, 2020; or as may be modified subsequently under the scheme."

The RBI said to be eligible under the scheme, NBFCs and housing finance companies (HFC) must have a minimum capital adequacy ratio of 15 per cent and 12 per cent respectively, as on March 31, 2019. The net non-performing assets should not be more than 6 per cent as on March 31, 2019. Also, the entities must have made net profit in at least one of the last two preceding financial years (i.e. 2017-18 and 2018-19). The entities availing this facility should not have been reported under Special Mention Account (SMA)-1 or SMA-2 category by any bank for their borrowings during last one year prior to August 01, 2018. The NBFCs must be rated investment grade by a rating agency.

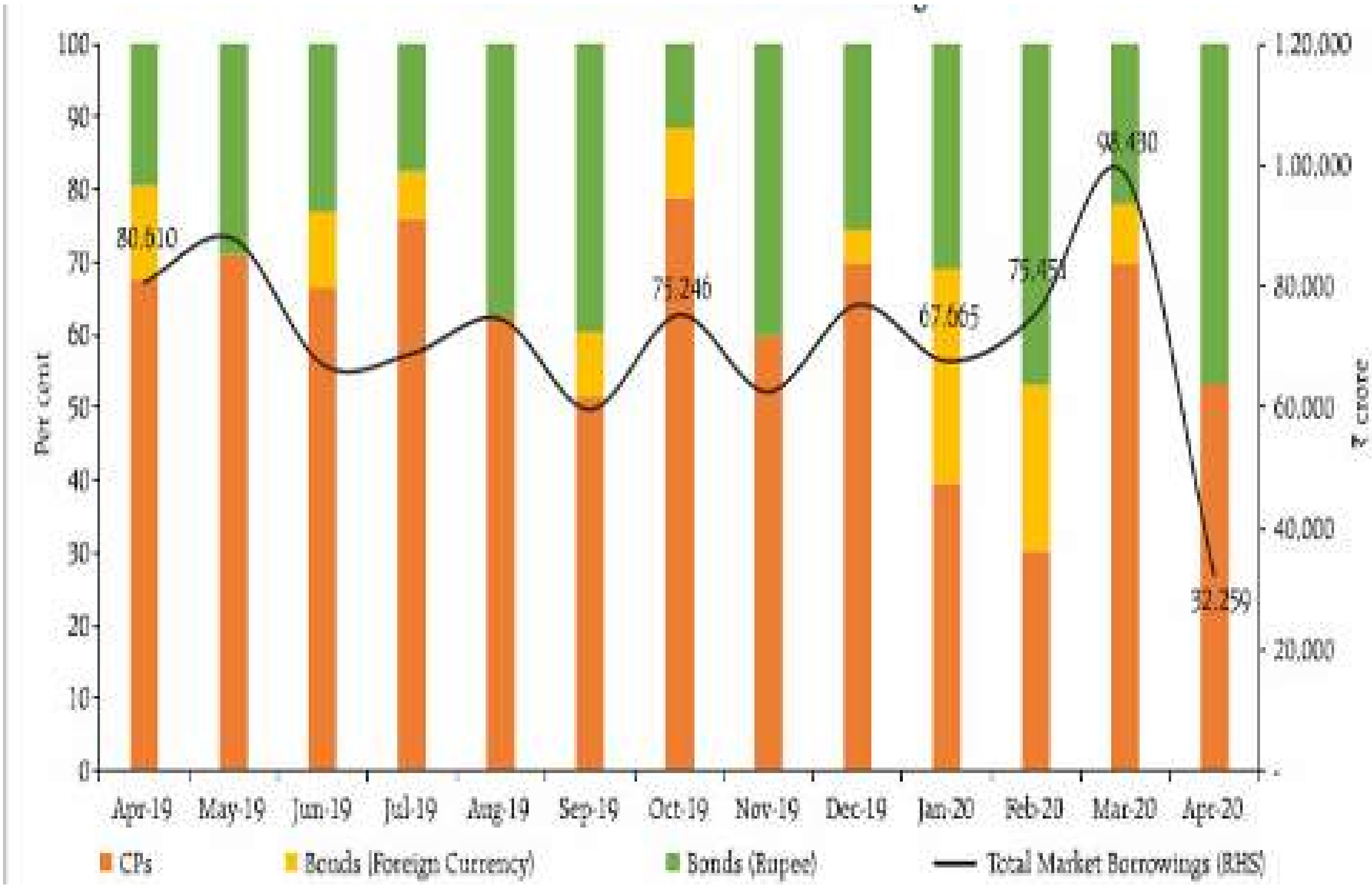
MARKET FINANCING CONDITIONS

As on April 30, 2020, outstanding market borrowings for major NBFCs (top 100), through Commercial Papers (CPs) and bonds (both onshore and offshore), stood at around INR12.6 lakh crore, marginally higher than INR 12.5 lakh crore a year before. Monthly market borrowings, during the past one year, remained in the range of INR 60,000 crore to INR 1,00,000 crore[7]. In April 2020, however, such borrowings fell to less than INR 33,000 crore (See, Chart 1: Trend in Market Borrowing by NBFCs).

Offshore borrowing has increased especially in the last quarter of FY 2019-20. Over the last one year, the share of foreign currency bonds issued by NBFCs in their total outstanding market liabilities has increased even as the share of CPs has reduced. An analysis of the maturity pattern of outstanding market liabilities of NBFCs shows that, on April 30, 2020, INR 1.08 lakh crore (or close to 9 per cent of total outstanding market borrowings) is expected to mature within the next three months, while another INR 1.6 lakh crore (or 13.4 per cent of total outstanding market borrowings) will become due for repayment in the following nine months.

Mutual funds, which are the largest investors in the CP market, except during the month of January and March 2020 when banks were major subscribers, have brought down their share in AA and below rated NBFCs from 94 per cent in December 2019 to 74 per cent in April 2020.

Chart 1: Trend in Market Borrowing by NBFCs (INR Crore)*



Note: * Top 100 NBFCs were identified based on asset size computed from RBI Supervisory Returns.
Source for CP data: FIMMDA Trade Reporting and Confirmation System (F-TRAC) Platform; and RBI report "Market Financing Conditions for NBFCs: Issues and Policy Options" (10th June 2020).

CORPORATE BONDS AND NON CONVERTIBLE DEBENTURES (NCDS)

Corporate bonds and non-convertible debentures (NCDs) account for 29 percent[8] of the total liabilities of NBFCs indicating the crucial role of this market in providing funding to the sector. Though the financing conditions in the corporate bond market, which have remained under stress since the IL&FS event, gradually becoming eased in the period December 2019 to February 2020, have shown again signs of deterioration amid the Covid-19 crisis, with a relatively greater impact on financing conditions for NBFC-Private - their share in overall corporate bond issuances fell sharply to 5 per cent in April 2020 from 26 per cent in February 2020 (Table 2).

Table 2: Financing Condition for NBFC-Private through Corporate Bond (CP) Market (in Per Cent)

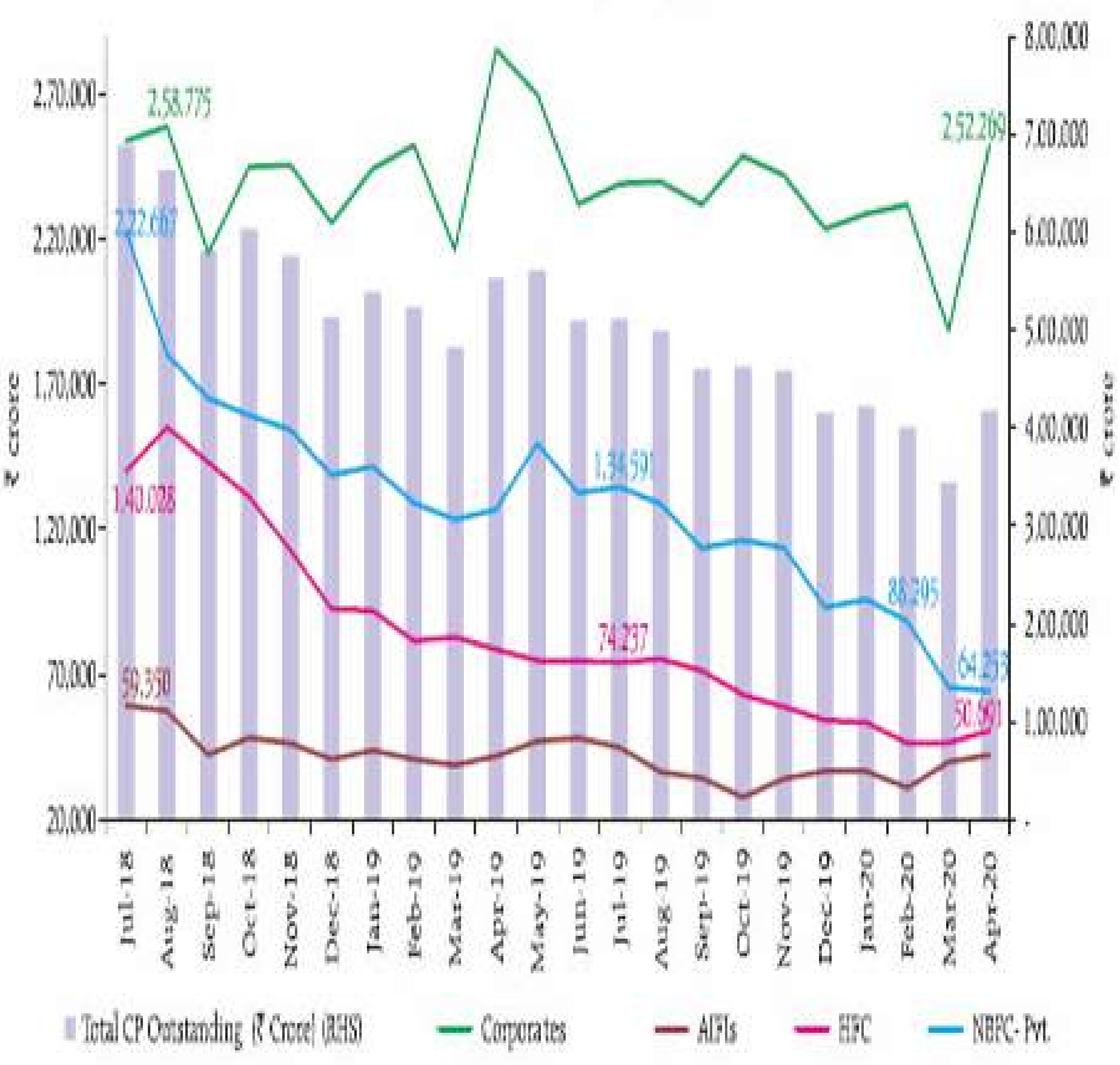
Sl No.	NBFC-Private	Sept 2019	October 2019	November 2019	December 2019	January 2020	February 2020	March 2020	April 2020
1	Share in total issuance by NBFC-Private	13	4	19	13	10	26	11	5
2	Share in total issuance by all NBFCs	38	36	45	51	42	61	37	26
3	Share of AAA-rated bonds in total issuances by all NBFCs	23	17	31	28	38	41	18	26
4	Share of AA+ and below rated bonds in total issuances by all NBFCs	15	20	14	23	4	20	20	–

Source: RBI report "Market Financing Conditions for NBFCs: Issues and Policy Options" (10th June 2020).

Commercial Paper (CP)

Post the developments related to IL&FS, total outstanding CPs, which stood at INR 6.88 lakh crore as on July 31, 2018, declined by 39 per cent to INR 4.17 lakh crore as on April 30, 2020 primarily in the case of NBFC-Private; and Housing Finance Companies (HFCs). Issuances by corporates and All India Financial Institutions (AIFIs) remained largely unchanged. Outstanding CPs of NBFC-Pvt. in particular, fell by 71 per cent (from INR 2.22 lakh crore as on July 31, 2018 to INR 64,253 crore as on April 30, 2020).

Chart 2: Category-wise Commercial paper Outstanding (INR Crore)



The share of NBFC-Private issuances in total issuances has fallen sharply, especially during February and March 2020. There has been a sharper reduction in issuances by lower rated NBFCs, possibly a manifestation of the increasingly challenging financial conditions faced by them[9].

A recent RBI paper (June 2020) maintained:

"As on April 30, 2020, outstanding market borrowings for top 100 NBFCs, through CPs and bonds (both onshore and offshore), stood at around INR 12.6 lakh crore, marginally higher than INR 12.5 lakh crore a year before. Monthly market borrowings, during the past one year, remained in the range of INR 60,000 crore to INR 1,00,000 crore. In April 2020, however, such borrowings fell to less than INR 33,000 crore. There were increased offshore borrowing too, especially in the last quarter of FY 2019-20. Consequently, over the last one year, the share of foreign currency bonds issued by NBFCs in their total outstanding market liabilities has increased even as the share of CPs has reduced[10]."

DEPLOYMENT OF FUNDS BY MUTUAL FUNDS

An analysis of SEBI's data regarding deployment of funds by all mutual funds in respect of NBFCs via CP issuances reveals that total funds came down to INR 54,232.56 crores in June 2020 from INR 1,01,809.60 crores in June 2019. The proportion of CPs with NBFCs for less than 90 days in total funds declined slightly from 85.2 per cent in June 2019 to 83.3 per cent in June 2020[11].

Since CPs with NBFC for less than 90 days usually account for over 80 per cent of total funds, we find a decline in CPs with NBFCs for less than 90 days in conformity with greater risk aversion caused by certain contraction in GDP this year and the devastating hit to important sectors of both manufacturing and services sectors.

Table 3: Deployment of Funds by Mutual Funds (CP) towards NBFCs

Year (end-June)	Deployment of Funds (CP) by MFs towards NBFCs (Amount in INR Crore)	Deployment of Funds (CP) by MFs towards NBFCs (Per Cent)
2020	54,232.56	3.65%
2019	101809.60	7.45%
2018	112381.56	8.12%
2017	93,575.21	7.70%
2016	2,319.96	0.26

Source: SEBI; https://www.sebi.gov.in/statistics/mutual-fund/deployment-of-funds-by-all-mutual-funds.html#

As of October 2019, the value of CP issuances by private sector NBFCs came down to 21.18% of the market share at INR 2.55 lakh crore, against 38.24% (INR 4.63 lakh crore) in the year-ago period (See Table 4). While top-rated NBFCs have been able to tap the CP market, others had to look for other avenues to raise funds, including bank credit and overseas markets[12].

Table 4: Commercial Paper (CP) issuances by different Entities (Up to 31st October 2019)

Sl No.	Issuer Type	2018 (amount in INR Crore)	Per Cent (%)	2019* (amount in INR Crore)	Per Cent (%)
1	All India FIs & Banks/subsidiaries-private sector	120626	9.95%	78292	6.48%
2	All India FIs & Banks/subsidiaries-public sector	268119	22.12%	222231	18.39%
3	State Financial Institutions	N.A.	N.A.	N.A.	N.A.
4	Public Sector Undertakings (PSUs)	133258	11%	327375	27.1%
5	State level undertakings	350	0.03%	1600	0.13%
6	**Private Sector-NBFCs/Financial Services**	463418	38.24%	255887	21.18%
7	Private Sector-Manufacturing/Services	226169	18.66%	255887	21.18%
	Total	**1211940**	_	**1208166**	_

* Up to 31st October 2019.
Source: Financial Express (1 January 2019)
https://www.financialexpress.com/industry/banking-finance/nbfc-commercial-papers-find-few-takers-psus-and-pvt-firms-gain-in-2019/1809274/

TLTRO 2.0 (Targeted Long Term Repo Operation)

TLTRO has been introduced by the RBI to help the NBFC's fight the liquidity crunch they are facing due to added disruptions due to COVID-19. RBI had announced TLTRO operations in order to ease liquidity conditions in the financial systems. The funds availed under TLTRO 2.0 conditioned to be deployed in investment grade bonds, commercial paper (CPs) and non-convertible debentures (NCDs) of Non-Banking Financial Companies (NBFCs).

Sl No.	Item	Auction Date	Tenor (Days)	Maturity Date	Amount (INR Crore)	Current rate/Cut-off rate
1	Long-term Repo Operations	24/02/2020	365	23/02/2021	25,021	5.15
		17/02/2020	1095	16/02/2023	25,035	5.15
		02/03/2020	1094	01/03/2023	25,028	5.15
		09/03/2020	1093	07/03/2023	25,021	5.15
		18/03/2020	1094	17/03/2023	25,012	5.15
2	Targeted Long-Term Repo Operations*	27/03/2020	1092	24/03/2023	25,009	4.40
		03/04/2020	1095	03/04/2023	25,016	4.40
		09/04/2020	1093	07/04/2023	25,016	4.40
		17/04/2020	1091	13/04/2023	25,009	4.40
	Targeted Long Term repo Operations 2.0	23/04/2020	1093	21/04/2023	12,850	4.40

Source: RBI

*TLTRO stands for Targeted Long Term Repo Operations. It is same as LTRO with a difference that the money borrowed by the banks under this scheme has to be deployed in investment-grade corporate bonds, commercial paper, and non-convertible debentures.

LTRO and TLTRO

The Reserve Bank of India (RBI) on 27th March 2020 introduced the Targeted Long Term Repo Operations (TLTROs) as a tool to enhance liquidity in the system, particularly the corporate bond market, in the wake of the COVID-19 crisis.

LTRO is a tool that lets banks borrow one to three-year funds from the central bank at the repo rate, by providing government securities with similar or higher tenure as collateral.

In 'Targeted' LTRO' or TLTRO, the central bank wants banks opting for funds under this option to be specifically invested in investment-grade corporate debt.

This helps banks get funds for a **longer duration** as compared to the short-term (up to 28 days) liquidity provided by the RBI through other tools such as liquidity adjustment facility (LAF) and marginal standing facility (MSF).

Is the Reserve Bank of India the first central bank to use LTROs?
No. LTRO was first introduced by the European Central Bank during its sovereign debt crisis that began in 2008. LTRO was an acronym coined by the ECB that stood for "long-term refinancing operations".

Source: Moneycontrol (17 April 2020).

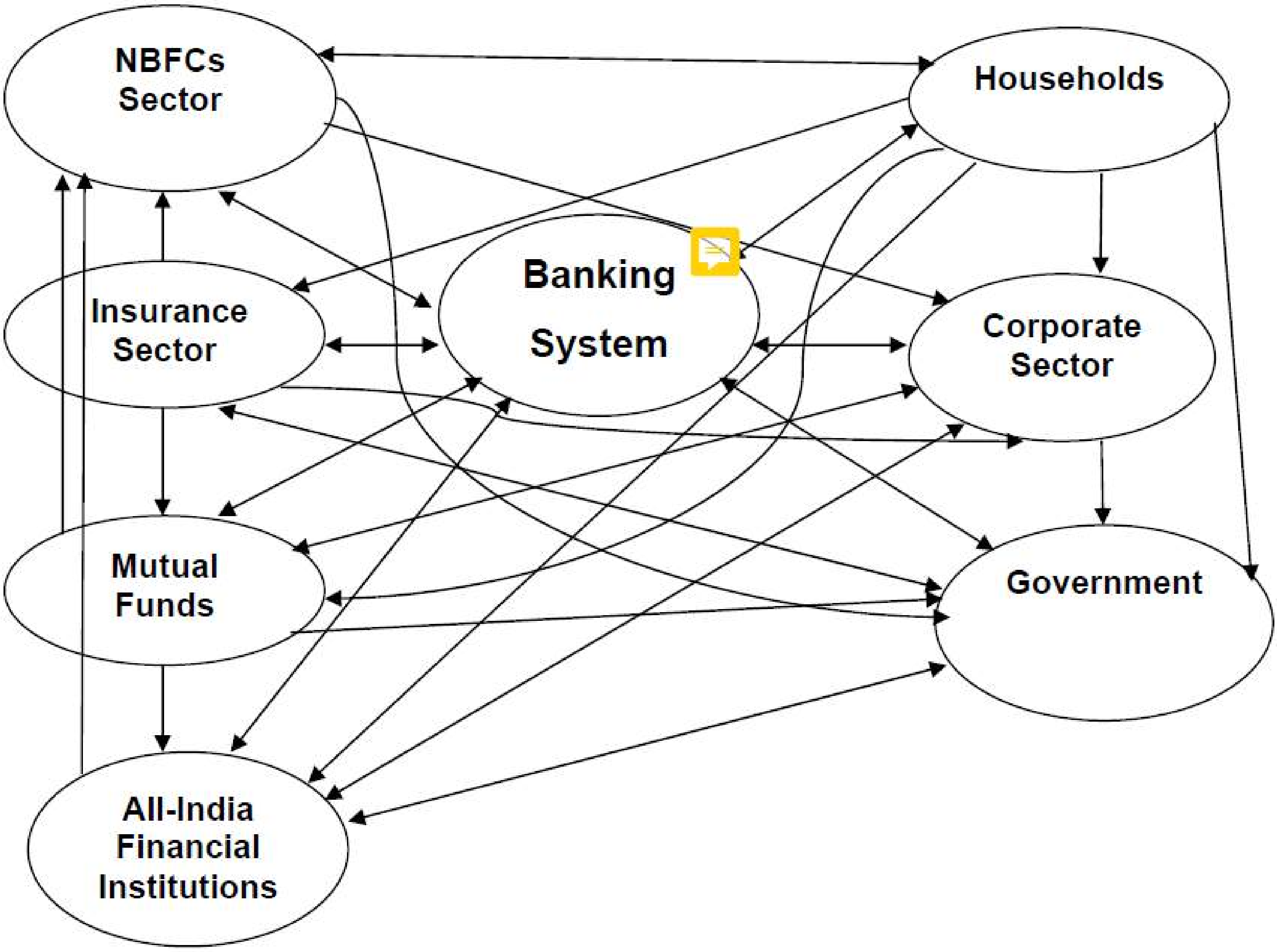
However, TLTRO 2.0 saw limited success due to few takers. For instance, in the first tranche of Targeted Long Term Repo Operation (TLTRO) 2.0 for an amount of Rs 25,000 crores with a 3-year tenor barely saw 50 percent subscription from banks. received a total of 14 bids today amounting to INR 12,850 crore against the INR 25,000 crore offered, implying a bid to cover ratio (i.e., the amount of bids received relative to the notified amount) of 0.5. While some banks said there was a lack of creditworthy small-sized NBFCs and MFIs where they could safely invest, others said they were already full upon their NBFC sector exposure limit. Risk aversion was the key reason for banks staying away from further exposure to weaker NBFCs[13].

Corporates (including banks) were the major category of issuers, followed by NBFCs and HFCs during March and April 2020. However, like in previous months, most issuances in March-April 2020 were by AAA rated entities and public sector undertakings, indicating that the bulk of the benefit of TLTROs accrued to higher rated entities.

INDUSTRY RISK

Considered in a proper historical and comparative perspective, most of the development discourse regarding the banks expansion into non-banking activities related to insurance, investment banking, etc. But of late, it has been increasingly realise that the issue of the inter-connectedness of the banking system with the NBFCs needs to seriously considered because of its systemic implications and the impact on financial stability. Both theoretical studies and cross-country empirical evidence clearly bring out that excessive inter-institutional exposure make the financial system susceptible to a complete collapse.

Inter-connectedness of the Indian Financial System



Source: A. Karunagaran. (December, 2011) WPS (DEPR): 21/2011. RBI Working Paper. "Inter-connectedness of Banks and NBFCs in India: Issues and Policy implications."

The NBFCs in India, particularly in the last decade, have been lurching from one crisis to the other, e.g., the global financial crisis (2007-09), the IL&FS collapse and now the COVID-19 pandemic. All these events and developments in quick succession have brought into focus not just the frailty and the infirmity of the NBFCs in India but also the larger systemic issue because of the financial inter-connectedness between NBFCs (both deposit taking and non-deposit taking) with the banking system. It has been demonstrated that both NBFCs-D and NBFCs-ND-SI are highly dependent on the banking system for their funding, though there are regulatory limits for the individual bank's lending to the NBFCs. The regulatory limits for the NBFCs have been changing over the years in conformity with changing needs and requirements[14]

NBFCs have various avenues for resource mobilization but deposit from banks is not an important element of their resource mobilization drive. The discouragement of NBFCs from raising public deposits led to substitution of public deposits with borrowings from the banking system. The high dependency of NBFCs on banks as a whole makes the financial system vulnerable in a stressful situation[15]. [16] This thesis can be substantiated by the severe liquidity crunch faced by the NBFCs in the aftermath of the IL&FS collapse in the not too distant past. Further, the COVID-19 pandemic has brought into focus the issue of the issue of the deterioration in credit quality because of defaults and delinquencies on a large scale. The transformed ground reality necessitates not just liquidity related policy measures but also credit related ones.

Strong measures adopted by the RBI had helped in eliminating weak and fly by night operators from the NBFC fold. A crisis of confidence and a trust deficit stemming from risk averse behavior of related parties necessitates effective credit policies. Such policies could help to restore the lost trust in the system and facilitate free flow of sanctions and disbursements at the ground level.

Post IL&FS, the market financing conditions for NBFCs became challenging. Rating downgrades, closer investor scrutiny and enhanced regulatory oversight led to greater market discipline, with the better rated and better performing companies continuing to have relatively easy access to market financing, while those with asset-liability mismatch (ALM) issues and/or asset quality concerns saw their borrowing cost spike. More recently, the disruptions caused by COVID-19 outbreak have caused apprehensions that credit profiles of NBFCs could deteriorate, given the moratorium extended by NBFCs on their assets, as well as the overall environment of heightened risk aversion. Recent developments in the mutual fund industry, which is a major source of funding for NBFCs, have also heightened rollover risks.

NBFCs maintain their liquidity through loan repayments; and an increased moratorium by the government can lead to disruptions in maintaining liquidity and reduce the solvency. It may also pose a risk to stability of the whole financial system as banks also have large exposures to them.

Low rated NBFCs may also face challenges as they are not active in the bond market. Many companies have started to default to NBFCs in the absence of a moratorium. There is around 1.75 lakh Crore of debt maturing by June 2020 which puts the NBFCs under risk[17]. Despite the RBI's efforts to increase liquidity in the bond markets and improve risk appetite at the system level, bond markets continue to stay illiquid and cost of liquidity remains high for NBFCs.

In the absence of a one-time restructuring, the cash flow implications of the moratorium, which have been extended to end-August 2020, might impact some NBFIs liquidity profiles more materially and hamper their ability to repay or refinance upcoming obligations. Accordingly, instead of a blanket moratorium, rescheduling customer contracts/instalments could be more effective. Moreover, large NBFCs with good track record, promoter backing and ratings have limited draw-down of loan issues; whereas smaller unrated NBFCs are severely dependent on banks for borrowing, and more vulnerable.

In the long run, these disruptions may lead to a weakening of the credit structure for NBFCs. An increase in moratorium may also hide defaulting and unsecured borrowers which will make it difficult to assess the quality of credit and weaken the credit structure and in turn damage even the financial structure.

Few NBFCs that have sufficient liquidity on their balance sheet may avoid taking moratorium due to risk perception issues and expected flow of funds under TLTRO. However, timid TLTRO bids show weak sentiment. Major challenges under TLTRO 2.0 remained finding investment grade papers in small/mid-sized corporates as well as risk aversion by banks to specific segments. One of the major lenders to NBFCs – the mutual fund industry – is also facing headwinds because of the certain contraction of 5 to 10 per cent in GDP this year (the first time in 41 years), the crippling of the industrial and financial sectors in general and several important sectors and segments of the economy in particular together with the debilitating impact of closure of some debt funds. In this context, there is a distinct possibility of the NBFC sector, at least some of the NBFCs, facing a resource crunch because of their overwhelming reliance on market borrowing necessitating appropriate measures to improve their strength and resilience.

The regulators in telecom, insurance and stock market were the developers of the respective sectors. Hence, it has sometimes been suggested that the Reserve Bank of India could follow the example of IRDA, SEBI and TRAI for representing the cause of non-banking finance companies in India. Towards this end, liberal bank funding at competitive rates and creation of a new refinance corporation for road transport financing on the lines of the National Housing Bank (NHB) would be helpful. The Indian Banks Association (IBA) had constituted a Working Group on Funding of NBFCs under the chairmanship of RV Shastri (Chairman & Managing Director of Canara Bank) at the behest of Finance Minister way back in 2001. This IBA working group in its report had made very positive recommendations for liberal bank funding of NBFCs, particularly Asset Financing Companies. But the recommendations of this Committee were not implemented.

Another persisting major factor hampering the functions and working of NBFCs has been their dual control. The NBFCs were registered with the RBI and there is no need to have a licence from the State Government separately. Hence a resolution of this issue of long-standing concern would help the functioning of NBFCs in India.

EMERGING CONTOURS

The Economic Survey 2019-20[18] suggested 'dynamic health index' or 'health score' that can provide an early warning signs for liquidity crisis in a non-banking finance company (NBFC) to tackle the problem of financial fragility in the so-called shadow banking sector. The 'health score' can predict the constraints on external financing (or refinancing risk) faced by NBFC firms. This ranges from -100 to +100, with higher scores indicating higher financial stability of the firm/sector. The 'health score' employs information on the key drivers of refinancing risk such as asset-liability management (ALM) problems, excess reliance on short-term wholesale funding (commercial paper) and balance sheet strength of the NBFCs.

Last year, the defaults by Infrastructure Leasing and Financing Services (IL&FS) and by Dewan Housing Finance (DHFL) triggered panic across the entire gamut of NBFC-financiers, thereby causing a funding (liquidity) crisis in the NBFC sector. The survey stressed that the problems faced by the NBFCs stemmed from their over-dependence on short term wholesale funding from the liquid debt mutual funds (LDMFs). "While such reliance works well in good times, it generates significant risk to NBFCs from the inability to roll over the short-term funding during times of stress," the Survey said.

“An asset-side shock not only exacerbates the Asset Liability Management (ALM) problem but also makes investors in LDMFs jittery and thereby leads to a redemption pressure that is akin to a “bank run”, it said. “This run on LDMFs then precipitates the refinancing (rollover) risk for NBFCs and further exacerbates the initial problems caused on the asset side”. In the case of the housing finance companies (HFCs), it was found that the Health Score of the HFC sector exhibited a declining trend post 2013-14. The trend of the Health Score showed early warning signs, well before the HFC sector eventually faced constraints on external financing from 2017-18 onwards.
Other than its utility as a leading indicator of stress in the NBFC sector, the Health Score can also be used by policy makers to allocate scarce capital to stressed NBFCs in an optimal way to alleviate a liquidity crisis.
The survey pointed that NBFCs raise capital in the short-term (1-3 months) commercial paper (CP) market at a lower cost, as compared to the long term (5-10 years) nonconvertible debenture (NCD) market but face the risk of rolling over the CP debt at short frequencies of a few months. The frequent repricing exposes NBFCs to the risk of facing higher financing costs and, in the worst case, credit rationing. Such refinancing risks are referred as Rollover Risk.
When an asset-side shock reduces expected future cashflows for an NBFC, it adversely affects the ALM problem in the NBFC and thereby risk perceptions about the NBFC. Such a shock amplifies the NBFC’s problems when its liability structure is over-dependent on short-term wholesale funding such as commercial paper, which requires frequent refinancing.

This risk arises in most financial institutions due to a mismatch in the duration of assets and liabilities. Liabilities are of much shorter duration than assets which tend to be of longer duration, especially loans given to the housing sector. This mismatch implies that an NBFC must maintain a minimum amount of cash or cash-equivalent assets to meet its short-term obligations.
Interconnectedness Risk is a measure of the transmission of systemic risk between an NBFC and the LDMF. Measures of financial resilience of NBFCs are commercial paper (CP) as a percentage of borrowings, Capital Adequacy Ratio (CAR) and provisioning policy, while measures of operating resilience are cash as a percentage of borrowings, loan quality and operating expense ratio (Opex Ratio). Apart from employing the health score methodology, there should also be set prudential thresholds on the extent of wholesale funding that can be permitted for firms in the shadow banking system.

Given this macro-economic landscape, stressed NBFCs seek about INR 10,000-crore financing support under special liquidity scheme[19] . The finance ministry said financing requests of close to INR 10,000 crore have been received under the special liquidity scheme worth INR 30,000 crore for stressed NBFCs and HFCs whose financials further deteriorated due to the COVID-19 crisis.

The RBI has provided funds for the scheme by subscribing to government-guaranteed special securities issued by a trust set up by SBI Capital Markets Limited (SBICAP). "RBI has also issued a circular to NBFCs and HFCs on 1st July 2020 itself on the Scheme[20]. SBICAP has received 24 applications requesting about INR 9,875 crore of financing as on July 7, 2020[21] which are being processed," the finance ministry said. The first application has been approved and the remaining are also under consideration. The Investment Committee of Special Liquidity Scheme (SLS) Trust has approved investment of up to INR 200 crore in commercial paper issued by the applicant.

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