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STUDENTS' ECONOMIC FORUM

A monthly publication from South Indian Bank

To kindle interest in economic affairs...
To empower the student community...

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SEPTEMBER 2019

Theme 334

"The NBFC Crisis"

28th Year of Publication

Theme No: 334: **The NBFC Crisis**

A well informed customer will make the policy makers as well as organizations which produce goods and render services more responsive to the customer needs. This will also result in healthy competition among organizations and improve the quality of its products. The "SIB Students' Economic forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly meeting of the "Forum". Topic of discussion for this month is "**The NBFC Crisis**".

What is a NBFC?

- A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business & chit business.
- It does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.
- NBFCs have to be registered with RBI. But there are NBFCs which are regulated by others agencies like SEBI, IRDAI. To avoid dual regulations, they are exempted from the requirement of registration with RBI.

What is the difference between Banks & NBFCs?

NBFCs lend and make investments and hence their activities are similar to that of banks; however there are a few differences between them:

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

What is the Importance of NBFCs in Indian Economy?

- NBFCs (Non Banking Financial Companies) play an important role in promoting inclusive growth in the country by catering to the diverse financial needs of bank excluded customers. Further, NBFCs often take lead role in providing innovative financial services to Micro, Small, and Medium Enterprises (MSMEs) most suitable to their business requirements.

- They play an important role in channelizing the scarce financial resources to capital formation. They supplement the role of the banking sector in meeting the increasing financial needs of the Corporate sector, delivering credit to the unorganized sector and also to small local borrowers.
- NBFCs do play a critical role in participating in the development of an economy by providing a fillip to transportation, employment generation, wealth creation, bank credit in rural segments and to support financially weaker sections of the society. Emergency services like financial assistance and guidance is also provided to customers in the matters pertaining to insurance.
- When public sector banks were reeling under pressure from bad loans and withdrawing from the lending space, NBFCs were the first to answer the call. They plugged the funding gap and helped continue to propel growth.
- While regular banks take deposits from people and cover a wide gamut of responsibilities including providing payment and settlement systems, savings accounts, cheques, credit lines etc., NBFCs specialize in particular fields. Manappuram finance specialises in gold loans, Bajaj Finance in automobile loans and this specialization allows NBFCs to occupy a special place in the industry.
- The NBFC sector has grown considerably in the last few years despite the slowdown in the economy.
- In terms of year-on-year growth rate, the NBFC sector beat the banking sector in most of the years between 2006 and 2013. On an average, it grew 22% every year. This shows, it is contributing more to the economy every year.
- NBFCs are more profitable than the banking sector because of lower costs. This helps them offer cheaper loans to customers. As a result, NBFCs' credit growth - the increase in the amount of money being lent to customers is higher than that of the banking sector with more customers opting for NBFCs.
- NBFCs contribute largely to the economy by lending to infrastructure projects, which are very important for a developing country like India. Since they require large amount of funds, and earn profits only over a longer time-frame, these are riskier projects and deters banks from lending. In the last few years, NBFCs have contributed more to infrastructure lending than banks.
- NBFCs cater to a wide variety of customers - both in urban and rural areas. They finance projects of small-scale companies, which is important for the growth in rural areas. They also provide small-ticket loans for affordable housing projects. All these help to promote inclusive growth in the country.

How do NBFCs aid economic development in the country?

- Mobilization of Resources - It converts savings into investments.
- Capital Formation - Aids to increase capital stock of a company.

- Provision of Long-term Credit and specialized Credit.
- Aid in Employment Generation.
- Help in development of Financial Markets.
- Help in Attracting Foreign Grants.

What led to the current NBFC crisis?

- The NBFC business model has its own shortcomings. It raises short term funds which are then lent out as long term loans.

For example an NBFC raises money by selling 6 months debt papers and on-lends this as a car loan with tenure of 5 years. The NBFC has now to renew the 6 months debt paper or raise fresh loans to repay the old debt paper. In good times this happens in a smooth manner. But when times are tough, this cycle gets broken.

- The cycle was broken by the default of some firms of the IL&FS group (IL&FS was a big NBFC with 169 domestic subsidiary companies). They delayed payment of loans due to SIDBI, which resulted in the downgrading of IL&FS from AAA rating to directly BB (downgraded more than 10 notches). Any rating less than BBB is not recommended as an investment grade.
- This led to fear among the Banks and Mutual funds that more such entities could default. Due to this, many institutions refused to lend to NBFCs.
- There were large redemptions from Mutual funds and they stopped refinancing the loans of NBFCs immediately after the IL&FS crisis according to economic survey. Similarly Banks also didn't have enough money to lend to NBFCs.
- Because of this there was a big blow in the NBFC business model which primarily depended on bank borrowings, debentures and commercial papers as major source of funding. The loans which NBFCs give are typically long term loans and there is an asset-liability mismatch. So NBFCs faced liquidity crunch, which led to the NBFC crisis.

Why should we care?

- The cost of NBFC borrowings is going to increase. This can lead to a set of problems because when the cost of NBFC borrowings increases, NBFCs might also have to cut back on their lending. For some sectors such as commercial real estate, a continuous flow of credit is needed. When they cut off the supply, these players could probably default.
- If they default, that means that NBFC will have non performing loans. They in turn could default on their own borrowings. That is why there is this big concern about the crisis which should be contained.
- This caused a reduction in the flow of credit to the economy.
- Currently our economy is flying on only one engine, which is consumption. So if the credit growth is constrained, consumption also comes down which in turn will affect economic growth.

What measures are taken by RBI & Government to address the NBFC crisis?

- Acknowledging the role of NBFCs in sustaining consumption demand as well as capital formation in SMEs, Finance Minister announced that the government will provide a one-time six-month partial credit guarantee (PCG) to PSBs for a first loss of up to 10 per cent for the purchase of high-rated pooled assets of financially sound NBFCs amounting to Rs. 1 lakh crore.
- At present, for banks, under Section 43(D) of the Income Tax Act, interest income on bad and doubtful debts is taxed only in the year it is received. But for NBFCs, such interest is charged to tax on an accrual basis. It is now proposed that deposit-taking NBFCs and systemically important non deposit-taking NBFC will be taxed on a receipt basis.
- The Budget has also done away with the need for NBFCs to create a debenture redemption reserve (DRR), setting aside 25 per cent of the amount raised through the issue of debentures through a public issue.
- The budget has also permitted investments made by FIIs and FPIs in debt securities issued by Infrastructure Debt Fund - Non-Bank Finance Companies (IDF-NBFCs) to be transferred or sold to any domestic investor within the specified lock-in period.
- The budget also proposed a unified regulatory body for both NBFCs and HFCs under the control of Reserve Bank of India.
- The RBI increased loan exposure limit of banks to a single NBFC (excluding gold loan companies) from 15% to 20% of its capital base, a move that will help increase credit supply to the crisis-ridden shadow banking sector.
- The central bank has also decided to allow, subject to certain conditions, bank lending to registered NBFCs, other than micro-finance institutions, for on-lending to agriculture (investment credit) up to Rs 10 lakh, micro and small enterprises up to Rs 20 lakh and housing up to Rs 20 lakh per borrower to be classified as priority sector lending.
- In order to address the liquidity crisis in the market, the Union Finance Ministry has announced that the National Housing Bank (NHB) will infuse an additional Rs 10,000 crores in non-banking financing companies, to improve the flow of funds for housing loans.

The banking sector would always be the backbone of the economy because of its credibility in supporting manufacturing, infrastructural development. But despite this, the role of NBFCs is critical and their presence would only boost the economy in the right direction.


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