

## Revisiting the NBFC Crisis\*

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*Even while the effort to resolve the crisis resulting from non-performing assets in the banking sector was underway, India's financial sector was overwhelmed by failures of large non-bank financial companies. In the discussion that followed the collapse of these NBFCs, the emphasis has been on the absence of due diligence, poor financial management and downright fraud. While the environment these firms found themselves in did encourage such tendencies, there were structural reasons why these institutions accumulated bad assets, which are often ignored.*

The crisis that engulfed IL&FS and Dewan Housing Finance Limited focused attention on what was India's numerous but shadowy non-banking financial companies (NBFCs). The collapse of these two big entities not only affected the balance sheets of banks and mutual fund companies, but resulted in a credit crunch that dampened demand and pushed a slowing economy towards recession. Clearly these institutions had a role to play that was more significant than earlier perceived. Being leaders in the industry, their failure has tarnished the image of the NBFC sector as a whole, which is being compared with the worst examples of shadow banking, or the operations of entities that are not depository institutions but undertake bank-like lending and investment based on money mobilised from the 'market'.

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Totalling 9642 in number in September 2019, only 82 of India's NBFCs were deposit taking institutions (NBFCs-D) permitted to mobilise and hold deposits. For this reason, the majority of these institutions were not considered to be entities that needed strict regulation, since they did not have access to the savings of ordinary households. Of the large number of non-deposit taking NBFCs (NBFCs-ND), only 274 were identified as being systematically important (NBFCs-ND-SI), by virtue of having an asset size of Rs. 500 crore or more. The troubles being faced by this group of large NBFCs and the systemic fall-out of those difficulties has invited comparison between this sector and the shadow banking sectors in many other developed and emerging markets.

The role of the NBFCs is reflected in the relative combined asset position of the NBFCs-D and NBFCs-ND-SI. As at the end of March 2019 these two sets held assets that amounted to almost a fifth of that held by the scheduled commercial banks. This made them significant players in the web of credit as well as large enough as a group to affect the health of the financial sector. Non-deposit taking NBFCs must rely on resources garnered from the 'market', including the banking system, besides the market for bonds, debentures and short term paper. If we consider the total mobilised assets of this sector (that is, assets excluding share capital and reserves), less than 2 per cent came from deposits, whereas 37 per cent was garnered through the issue of debentures, 25 per cent was borrowed from banks and about 5 per cent mobilised

through the issue of short term commercial paper. Since individual investors would only be marginally involved in direct investment in these instruments, NBFCs were essentially extensions of the activity of other financial entities such as banks, insurance companies and mutual funds.

The lending and investment activities of the NBFCs were quite concentrated, focused on infrastructure, retail lending and real estate. Industry accounted for the biggest chunk of lending amounting to 57 per cent of gross advances in September 2019. Much of this lending to industry went to the infrastructural sector, as is clear from the fact that Infrastructure Finance Companies among the NBFCs-ND-SI and NBFCs-D accounted for 37 per cent of the total assets held by these institutions. A second major target for lending by the NBFCs was the retail sector, with retail loans accounting for 20 per cent of gross advances. Within the retail sector, vehicle/auto loans accounted for as much as 44 per cent of loans. Finally, lending to the commercial real estate sector and provision of housing loans accounted for 6 per cent of gross advances.

Interestingly, these were the areas into which commercial banks also diversified in the years after 2003. Following a surge in capital flows into India which began in 2004, banks were flush with liquidity, with a sharp rise in their deposit base. Under pressure to lend and invest to cover the costs of capital and intermediation and earn a profit, banks were looking for new areas into which they could move. The result was a significant increase in retail lending, with lending for housing, automobiles and consumer durables, as well as a substantial increase in lending to the infrastructural sector and commercial real estate. What the growth of the NBFCs indicates is that banks were unable to exhaust the liquidity at their disposal as well as the potential for lending to these sectors, providing a space for non-bank finance companies to flourish.

The willingness of the NBFCs to enter these areas suited the banks in two ways. First, it permitted the latter to use their liquidity even when they themselves were stretched and could not discover, scrutinise and monitor new borrowers. They could lend to the NBFCs, which could then take on the tasks associated with expanding the universe of borrowers to match the increased access to liquid funds. The second was that it helped the banks to move risks out of their own books. The lending to the new areas (auto loans, housing loans, real estate and infrastructure) was to different degrees of longer maturity and relatively illiquid. For banks accepting short term deposits with expectations of easy withdrawal on the part of depositors, there were limits to which they could increase their exposure to these sectors. On the other hand, these were the sectors to which additional credit could be easily pushed. Lending to NBFCs, that in turn lent to these sectors, appeared to be a solution to the problem. Bank lending to the NBFCs was short-term, and the latter used these short-term funds to provide long-maturity loans with the expectation that they would be able to roll over much of these loans, so that they were not capital short. What they needed for the purpose were ratings that ranked their instruments as safe. The ratings companies were more than willing to provide such ranks.

The NBFC-credit build-up was thus an edifice which was burdened with two kinds of risks. One was the risk that came from possible default on the part of borrowers, the probability of which only increases as the universe of borrowers is expanded rapidly to exhaust the liquidity at hand. The second was the possibility that developments in the banking sector and other segments of the financial sector would reduce the

appetite of these investors for the debentures, bonds and commercial paper issued by the NBFCs. Since the NBFCs banked on being able to roll-over short term debt to sustain long-term lending, and slowdown in or halt to the flow of funds would lead to a liquidity crunch that can damage the balance sheet of these institutions. The crisis that affected the NBFCs was a result of both kinds of setbacks, with loans to areas like infrastructure, commercial real estate and housing going bad, and with the non-performing assets problem in the commercial banking sector curtailing their access to bank lending.

Given the large number of NBFCs populating the NBFCs-SI-ND sector, there is no reason why all of them should have been adversely affected to the same degree. If yet the crisis turned 'systemic' it was because of the concentrated nature of the activity in the sector. Given the importance of ratings and 'image' in ensuring access to capital, some firms with the requisite image were able to mobilise large sums of capital and expand their business. Image could either be the result of reputation built over time, as seems to be the case with Dewan Housing Finance Ltd (DHFL), or it could be because of the firm concerned was seen as a government-sponsored entity of sorts, with state backing, as was the case with IL&FS. At the time of its collapse, IL&FS was a network of more than 150 companies within the country and more than a few more outside, with the domestic entities indebted to the tune of close to Rs. 1 lakh crore. The exposure of the public sector banks alone to the company exceeded Rs.35,000 crore. And DHFL's size had grown through leverage to such an extent where, when the crisis occurred, its quarterly losses exceeded its market capitalisation.

When entities like that go bust, the response of lenders and investors to the event tends to be drastic, with systemic effects on the sector as a whole. What we had therefore was a shadow banking crisis, even though two publicly owned companies, the Power Finance Corporation and the Rural Electrification Corporation, that operate with an implicit sovereign guarantee, account for 45 per cent of the assets of the NBFCs-ND-SI.

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