Difficult time for Non-Banking Finance Companies (NBFCs)

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Manifest Pedagogy

With increased stress in both banking and NBFCs, it is imperative to understand the key differences, aspects related to their regulation, recent events and aspects of RBI and government policies in these regard.

In news

IL&FS issue

Placing it in the syllabus

Banking Sector Reforms

Static dimensions

- Difference between NBFC and a Bank
- Regulation of NBFC in India

Current dimensions

- Asset quality in NBFCs
- Cost of funds of NBFC
- Lack of oversight of NBFC
- IL&FS, DHFLs problems
- NBFC merging with banks

Content

Difference between NBFC and a Bank

Basically, banks and NBFCs are financial intermediaries. Banks are regulated under the Banking Regulation Act, although most of the company laws apply to banks as well. and the NBFCs are registered under companies Act, **Both NBFCs and Banks are regulated by RBI.** following are the differences between them.

Meaning

- 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 but 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.
- Bank is a government authorized financial intermediary(incorporated under Banking Regulation Act 1949) that aims at providing banking services to the general public.

Demand Deposits

- NBFC does not accept deposits, while the banks accept the deposits.

Deposit Insurance facility

- Unlike the banks, Deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs.

Credit creating

- Banks are termed as creators of credit through money multiplier activity whereas NBFCs are not.

Foreign Investment

- NBFC are allowed with 100% foreign investment, while for private sector banks it is only 74%.

Reserve Ratio

- NBFCs are not required to maintain it. But it is compulsory for the banks to maintain it.

Transaction services

- Unlike banks, NBFCs do not provide these services.

Payment and settlement system

- NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself. But for banks it is an integral part of the system.

Regulation of NBFC in India

In India, **NBFC registration is regulated by the Reserve Bank of India.** NBFCs provide the people concerned with a variety of banking and non – banking services. **They do not hold a banking license, but they must comply with RBI's rules and regulations.**

RBI regulates and supervises the functions of NBFCs in accordance with the provisions of the RBI Act 1934. The registration of NBFC shall be carried out in accordance with the rules and regulations set out in Section 45-IA of the RBI Act 1934. And it must be properly registered in accordance with the 2013 Companies Act.

Asset quality in NBFCs

According to a report, Financing difficulties will halve the growth of assets of non-bank lenders to about 10% in the second half of the current financial year.

The asset quality of retail loans is resilient, but the NBFCs' (non-banking finance companies) non-retail book has to be monitored for potential stress, domestic rating agency Crisil said in its report . The report comes amid difficult times for the NBFCs, which started with the crisis at infra lender IL&FS, which extended to worries for the entire sector.

Cost of funds for NBFCs

Cost of funds is a reference to the interest rate paid by financial institutions for the funds that they use in their business.

Para banks would face **tighter liquidity, higher funding costs** and thus **lower net interest margins** (NIMs) **in FY20** as they revised their balance sheets towards longer – term borrowing.

Some Non-banking finance companies (NBFC) are tapping retail investors to raise funds as banks have tightened lending to the sector after the IL&FS default crisis and investors became wary about investing in NBFCs. **NBFCs' cost of funds has gone up post IL&FS default with their blended cost rising 0.75%-1%.**

Lack of oversight of NBFCs

Historically, NBFCs have what is often referred to as **regulation of light – touch.** The **regulatory oversight on NBFCs was decidedly light compared to their closest peers – banks**. The recognition that NBFCs serve client segments that are unserved or underserved by banks underpinned this light approach. For a wider reach of credit, the role of NBFCs has been seen as critical. T**his has led to the difficult times for the NBFCs.**

IL&FS, DHFLs problems

Since October last year, what started as a unique event, with IL&FS defaulting on its dues, has snowballed into a liquidity crisis for many NBFCs.

The sharp rise in the yield on the secondary market of certain debt papers issued by Dewan Housing Finance Company (DHFL), shortly after the outbreak of the IL&FS episode, raised concerns about liquidity issues at NBFCs. While bonds of DHFL were not downgraded until recently, the ongoing turmoil has led to a peculiar predicament for many debt funds.

NBFC merging with banks

- Gruh finance with Bandhan bank
- Capital first with IDFC bank
- Lakshmi vilas bank with Indiabulls Housing Finance