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INDUSTRY OUTLOOK

NBFCs AND THE TRAVAILS OF TRANSITION

23 March 2023

Introduction

"It is more profitable to be a lender than a spender." - Hendrith Vanlon Smith Jr.

In terms of the Companies Act, 1956, non-banking financial companies (NBFCs) provide banking services without a bank license. NBFCs provide diverse services, such as, loans and advances, saving and investment plans, credit facilities, insurance, acquisition of stocks, equities, debt, etc. issued by the government or any local authority or other marketable securities like leasing, hire purchase, insurance business, chit business, etc. In conformity with the steady growth of the Indian economy, the structural transformation of the banking sector, and the changing contours of financial intermediaries, the NBFC sector has gradually transformed in terms of size, operations, technological sophistication, and forayed into newer areas of financial services and products.

An NBFC is a company registered under the Companies act, 1956 or Companies act, 2013 and is engaged in the Business of financial Institution. Section 45I (f) of the Reserve Bank of India act, 1934 defines "Non-Banking Financial Companies" as:

A financial Institution which is a company;

A non-banking financial institution which is company, and which has its principal business the receiving of deposits, under any scheme or arrangement or in any order manner, or in lending in any manner;

(iii) Such other non-banking financial institution or class of such institution, as the bank may, with the previous approval of the central government and by notification in the Official gazette, specify. Section 45I(c) of the Reserve Bank of India act, 1934 defines the term "Financial Institution" as any non-banking institution which carries on as its business or part of its business any of the following activities, namely:

The financing, whether by way of making loans or advances or otherwise, of any activities other than its own;

The acquisition of shares, stocks, bonds, debentures or securities issued by government or local authority or other marketable securities of a like nature;

Letting or delivering of any goods to a hirer under hire-purchase agreement as defined in clause (c) of section 2 of the hire purchase act, 1972;

The carrying on of any class of business; (v) Managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kooris as defined as any law which is for the time being in force in any state, or in any business, which is similar thereto;

Collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lump sum or otherwise, by way of subscription or by sale of units, or other instruments or other any manner and awarding prizes or gifts, whether in cash or kind, or disbursing monies in any other way, to persons from 5 whom monies are collected or to any other person, but does not include any other institution, which carries on as its personal business:

- Agricultural operations; or
- Industrial activity; or
- The purchase or sale of any goods (other than securities) or the providing of any services; or
- The purchase, construction or sale of any immovable property, so however, that no other portion of income of the institution is derived from the financing of the purchases, constructions or sale of immovable property by other persons.

In view thereof, it emerges that the Reserve Bank of India defines NBFCs as a Non-Banking Financial Company (NBFC), which 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.[1]

A survey of economic literature clearly reveals that a properly functioning financial system is a prerequisite to a flourishing modern economy[2] (Kroszner, 2010). While the fast-paced expansion and diversification of the global financial system was fostered by various forces and factors, some crucial factors related to differential regulation, technological and financial progress, and innovative business models. This is why in countries across the development spectrum, sophisticated financial systems efficiently deliver a slew of financial services and foster macroeconomic stability and sustained economic growth and prosperity. The main task of the financial system is to channel funds from sectors that have a surplus to sectors that have a shortage of funds. In this process of transformation, the financial sector performs two main functions: (1) reducing information and transaction costs, and (2) facilitating the trading, diversification, and management of risk.

The global financial crisis (GFC) of October 2008 brought to the fore the deficiencies in the international financial architecture, particularly in regulation and supervision of systemically important entities and in assessment of their risks and vulnerabilities[3]. Accordingly, the G-20 group mandated the Financial Stability Board (FSB) to develop a comprehensive framework for regulation and oversight of the global financial system to prevent a recurrence of a crisis on this scale.

The seemingly straightforward process of banking, i.e., collecting deposits from savers and subsequently lending to borrowers, promotes the flow of funds to productive uses and investments. In the absence of banking, funds would lie idle in households, businesses would be unable to acquire capital, and regular individuals wishing to buy a new vehicle or house would be unable to do so. Hence banks have emerged as a catalyst of economic growth and structural transformation. In line with the global experience, banks have worked as an instrument of realizing the potential of the economy by facilitating sustained investment spearheaded by the private sector.

The rising spiral in (non-performing assets) NPAs[4] as a proportion of gross advances was particularly acute for PSBs, which accounted for 70 per cent of the total assets of the banking system in March 2018. The rise in NPAs as a share of gross advances was particularly acute for PSBs (with GNPAs of 14.6 per cent and NNPAs of 8.5 per cent), which accounted for 70 per cent of the total assets of the banking system. While the banks were saddled with high and mounting level of NPAs, the corporate balance sheets were also highly leveraged leading to a situation, which was characterised as the "twin balance sheet problem"[5].

Considered in a proper historical and comparative perspective, credit growth has exceeded the growth in the gross domestic product (GDP) with the ratio between the growth of bank credit and the growth of nominal GDP ranging from 1 to 2 and averaged 1.42 from 1962 to 2019. While banks were the major macroeconomic drivers of credit, bond markets and non-bank lenders also accounted for some part of the steadily burgeoning credit portfolio.

There is evidence to suggest that the growth of the NBFCs at a fast clip during the period FY2014 to FY2018 was facilitated partly by under-pricing of credit and the decline in the credit premium over the risk-free yield [6].

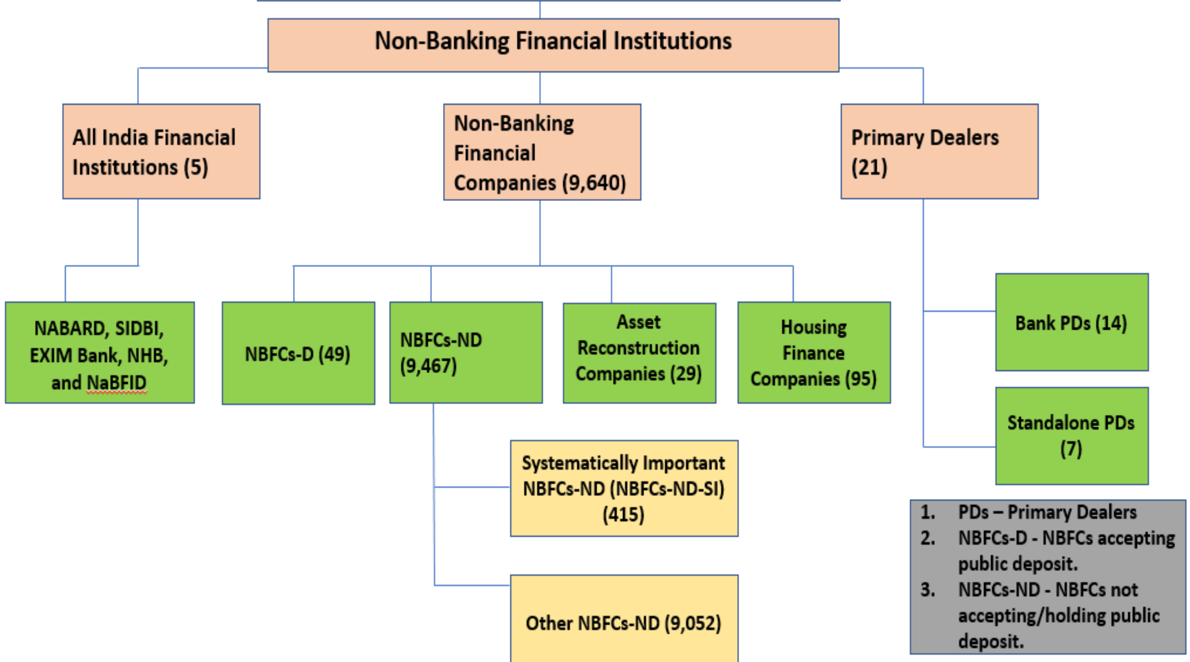
With the waning of the effect of the second wave and the third wave proving to be ephemeral, the NBFC industry regained Vigor in terms of higher capital, better asset quality and improved profitability, supported by constructive policy measures announced by the Central Bank and the Government as clearly brought out in the RBI's (Reserve Bank of India) recent Report on the Trends and Progress of Banking in India[7].

In view of the rapid growth and structural transformation of the NBFCs, the NBFCs have emerged as the sine qua non of the financial landscape. The NBFCs play a catalytic role in the core development of infrastructure, transport, employment generation, wealth creation opportunities, and financial support for economically weaker sections, especially to the micro, small and medium enterprises (MSMEs) and advancing the process of financial inclusion by complementing the mainstream banking system. The NBFCs are well-positioned to assess the differential needs of their customers and provide customized financial products and solutions (RBI, 2021) 8. Moreover, NBFCs give investors an avenue to invest their assets at higher yields than bank deposits. But it is important for NBFCs –as stressed by the RBI - "to remain prepared to face new challenges and reap emerging opportunities in this dynamic environment, keeping their focus on appropriate business models, adoption of new technologies, sustainability, stability, consumer protection and financial inclusion." "The Reserve Bank's forthcoming initiatives are expected to guide the progress of regulated entities in this direction, secure and preserve financial stability and enhance efficient functioning of markets" [9].

The RBI swiftly responded to the Covid 19 pandemic[10] by a series of contextually significant measures, viz., moratorium on loan repayments, infusing liquidity and implementing a loan restructuring programme with stringent timelines. While this process helped in the stability of the financial system, the process of the global monetary tightening to combat inflation and emergence of nimble fin-techs made the RBI modify its regulatory framework in the pursuit of affordable finance together with financial stability. As the RBI stressed "it is imperative that banks ensure due diligence and robust credit appraisal to limit credit risk." "The uncertainties characterising fast-changing macroeconomic scenario amidst formidable global headwinds during 2022-23 can pose new challenges to the banking sector. If downside risks materialise, asset quality could be affected" [11].

The constant upward bias on the interest rates dented the repayment capabilities of the borrowers. The double whammy of demand slowdown faced by Companies and the rising input costs severely squeezed profit margins. The unprecedented adoption of digital payments in India enhanced digital payments to a new and much higher orbit. But it also brought into its wake the perils of misuse and the need for much greater cyber security all along the line. As the RBI pointed out "with the success of UPI and mass adoption of digital banking services, various concerns such as unbridled engagement of third parties, mis-selling, breach of data privacy, unfair business conduct, exorbitant interest rates, and unethical recovery practices have emerged." "Banks need to develop appropriate business strategies, strengthen their governance framework and implement cybersecurity measures to mitigate these concerns" [12].

Figure 1: Structure of NBFIs under RBI regulations (As on July 31, 2022)



Note: NBFCs-ND include 62 core investment companies (CICs).
Although, Standalone PDs are registered as NBFCs under Section 45-IA of RBI Act, 1934, they also have been kept under PDs in this chart.
Source: RBI Report on Trend and Progress of banking sector in India 2021-22. Available at : https://rbi.org.in/Scripts/PublicationsView.aspx?id=21580#CH42

The basic structure of the NBFCs transformed in 2021-22 with the receding COVID-19. As per a disaggregated analysis done by comparing the structure of the Non-Banking Financial Institutions (NBFIs) as of September 2021[13] to the structure of the NBFIs as on July 2022, number of NBFCs has increased by a total of 22, number of deposits taking NBFCs (NBFCs-D) declined from 52 to 49, so does the number of non-deposits taking NBFCs from 9500 to 9467, etc. (refer to fig 1).

Table 1: Classification of NBFCs by Activity under the New Regulatory Framework

Sr. No.	Type of NBFCs	Activity	Layer
1	NBFC-Investment and Credit company (NBFC-ICC)	Lending and Investment	Any layer, depending on the parameters of the scale based regulatory framework.
2	NBFC-Infrastructure Finance Company (NBFC-IFC)	Financing of Infrastructure sector	Middle layer or upper layer, as the case may be.
3	Core Investment Company (ICC)	Investment in equity shares, preference shares, debt, or loans of group companies.	Middle layer or upper layer, as the case may be.
4	NBFC-Infrastructure Debt Fund (NBFC-IDF)	Facilitation of flow of long-term debt only into post commencement operations in infrastructure projects which have completed at least one year of satisfactory	Middle layer.
5	NBFC-Micro Finance Institution (NBFC-MFI)	Providing Collateral free small ticket loans to low income households.	Any layer, depending on the parameters of the scale based
6	NBFC-Factors	Acquisitions of receivables of an assignor or extending loans against the security interest of the receivables at a discount.	Any layer, depending on the parameters of the scale based regulatory framework.
7	NBFC-Non-Operative Financial Holding Company (NBFC-NOFHC)	Facilitation of promoters/promoter groups in setting up new banks.	Base Layer
8	NBFC-Mortgage Guarantee Company (NBFC-MGC)	Undertaking of mortgage guarantee business.	Any layer, depending on the parameters of the scale based
9	NBFC-Account Aggregator (NBFC-AA)	Collecting and providing a customer's financial information in a consolidated, organized, and retrievable manner to the customer or others as specified by the customer.	Base Layer
10	NBFC-Peer to Peer Lending Platform (NBFC-P2P)	Providing an online platform to bring lenders and borrowers together to help mobilize funds.	Base Layer
11	Housing Finance Company (HFC)	Financing for purchase/construction/reconstruction/renovation/repairs of	Middle layer or upper layer, as the case may be.

Notes: SPDs lie in the middle layer. And, Government NBFCs lie in either base or middle layer.

Source: RBI

NBFCs are categorized a) in terms of the type of asset/liabilities into Deposit and Non-Deposit accepting NBFCs, b) non-deposit taking NBFCs (NBFC-ND) by their size into systemically important and other non-deposit holding companies, i.e., NBFC-ND-SI with asset size of 500 crore or more and, and c) by the kind of activity they conduct represented in Table 1[14]. The performance of NBFCs is customarily analyzed by examining key indicators like Liquidity ratio, Profitability Ratio and Debt to Equity Ratio. Financial performance can be measured using solvency and profitability ratios and using statistical tools to analyze the results.

NEW REGULATORY FRAMEWORK

The revised regulatory framework followed the discussion paper that was issued by RBI in January 2021. The revised framework envisaged a progressive increase in the intensity of regulation and is thus visualized as a four layered pyramid. This came into effect from October 2022, where NBFCs were segregated into four layers namely, Base Layer (NBFC-BL), Middle Layer (NBFC-ML), Upper Layer (NBFC-UL) and Top Layer (NBFC-TL) (which is ideally expected to remain empty), based on their size, activity, and perceived level of riskiness. In terms of size, NBFC-

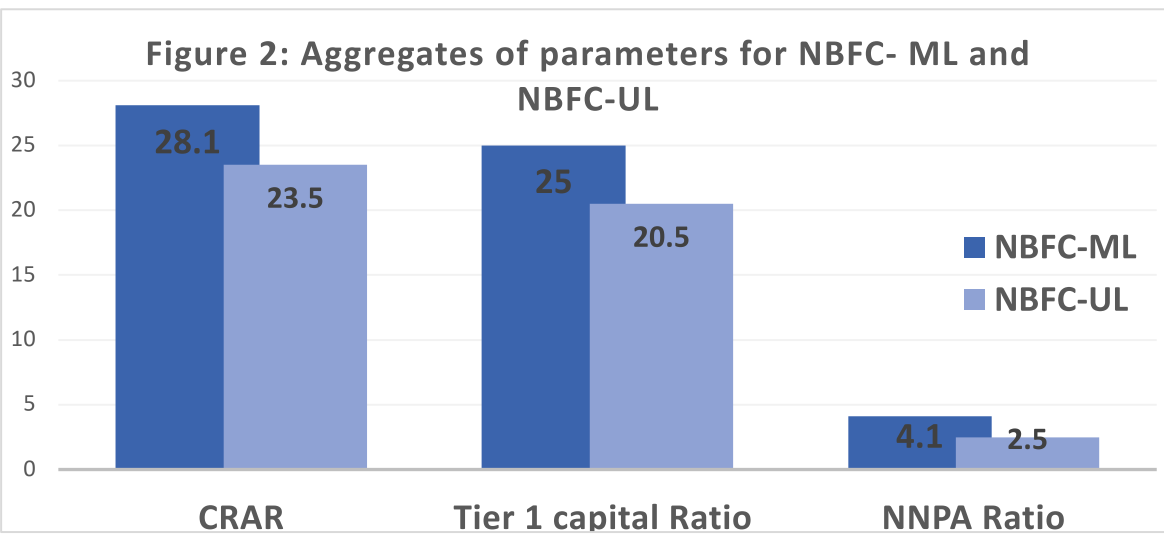
BL comprises all NBFCs-ND with asset size below 1,000 crores. NBFCs-ND with asset size above 1,000 crores and NBFCs-D are put in NBFC-ML. NBFC-UL comprises those NBFCs (including NBFCs-D) which are specifically monitored by the Reserve Bank based on a set of parameters and scoring methodology. Within this broad categorization based on scale and types of activities, the distinct types of NBFCs are given in Table 1[15].

Of late, India's NBFC industry has made remarkable progress toward financial inclusion by providing customized credit products to areas neglected by banks. However, in recent years, several NBFCs have attained systemic significance, with linkages throughout the financial sector. In keeping with the principle of proportionality, the Reserve Bank recently introduced scale-based regulation (SBR) for NBFCs[16], thereby narrowing the regulatory arbitrage between banks and large NBFCs while preserving operational flexibility.

Table 2: Risk Thresholds defined under PCA Framework for NBFCs-ND-SI and NBFCs-D.

Indicator	RT-1	RT-2	RT-3
CRAR	< 15% (i.e., regulatory minimum) , ≥ 12%	<12%, ≥ 9%	<9%
Tier 1 capital Ratio	< 10% (i.e., regulatory minimum) , ≥ 8%	<8%, ≥ 6%	<6%
NNPA Ratio	≤9%, > 6%	≤12%, > 9%	>12%

In the Report, supervisory data revealed that NBFCs residing in the middle and upper layers account for almost 95 per cent of the total assets and might pose systemic risks[17] (Refer to table 2 and 3). As a result, the Reserve Bank had extended its Prompt Corrective Action (PCA) framework, akin to that applicable to banks, to NBFCs in the middle and upper layers[a] to undertake corrective actions in a timely manner if vital financial parameters breach the prescribed thresholds[18]. In case of NBFCs-ND-SI and NBFCs-D, capital adequacy ratio (CRAR), Tier- I capital ratio and net non-performing assets (NNPA) ratio are the key parameters used to demarcate various risk thresholds (RT)[b]. As per the RBI Report on Trend and Progress of Banking 2021-22, (shown in fig. 2), both NBFC-ML and NBFC-UL fulfill all regulatory criterion in all three parameters given in Table 2.

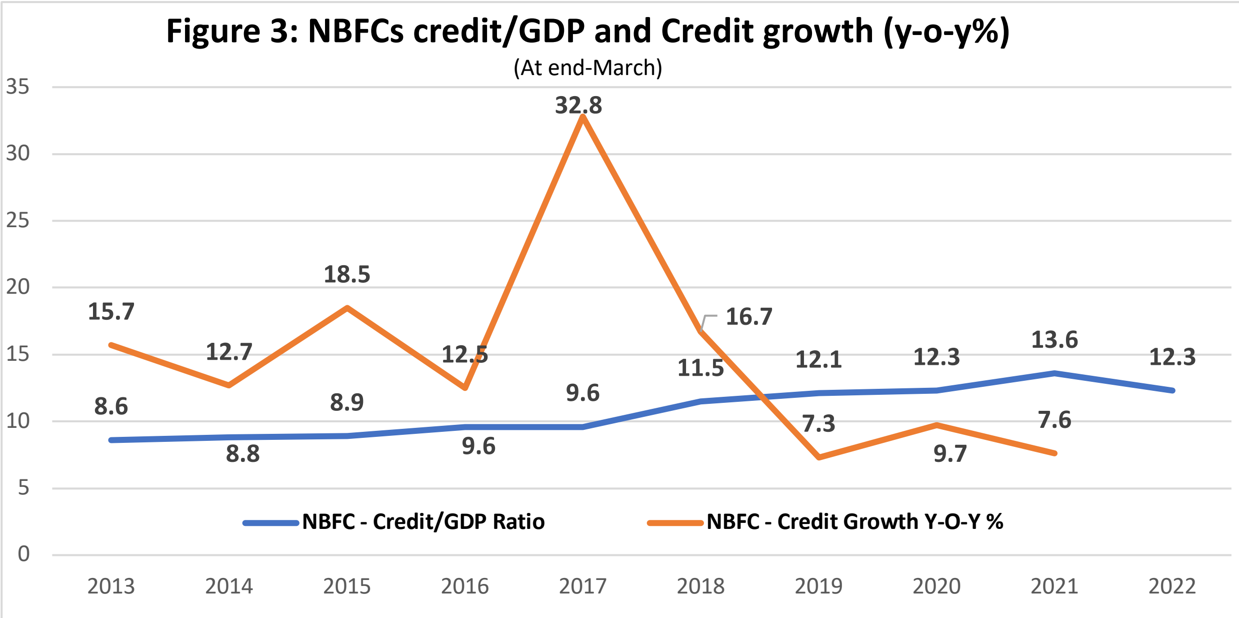


Source: RBI Report. Available at: https://rbi.org.in/Scripts/PublicationsView.aspx?id=21580#F5

[a] PCA framework is also applicable to NBFCs in the top layer (NBFC-TL). However, the top layer is currently empty. PCA framework is not applicable to government NBFCs, Standalone Primary Dealers (SPDs), Housing Finance Companies (HFCs) and NBFCs not accepting/not intending to accept public funds.

[b] For CICs, the monitorable criteria are Adjusted Net Worth/Aggregate Risk Weighted Assets, Leverage Ratio and NNPA.

1. Perspective on Credit



Source: RBI "Report on Trend and Progress of banking in India 2022." Available at:
https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/8NONBANKINGFINANCIALINSTITUTIONS29D59680580B4E74B8A2E07E62B59B38.pdf

There has been a consistent rise of NBFCs' credit both as a proportion to gross domestic production (GDP) and credit extended by SCBs as shown in fig. 3. By the end of March 2022, credit to the transport operators, retail trade, and commercial real estate (CRE) industries grew significantly. This rebound was assisted by renewed demand for office and retail and a positive base effect. A typical monsoon aided agricultural and related industries in obtaining finance.

In 2021- 22, credit growth to industry and retail sectors was muted relative to the previous year, while credit to the service sector recorded double digit growth. Industry remained the largest recipient of loans from the NBFCs, later, retail loans, services, agriculture and lastly by non-food credits as shown in table 3. Approximately 86 per cent of industrial credit is allocated to infrastructure, despite the sector's slowing growth of 1.6 per cent. Banks' retail segment's performance exceeded that of NBFCs, while loans to industries and services benefited from a promising base effect.

Table 3: Distribution of NBFC Credit (At end-March)

SECTORS	Share (in %)		Y-o-Y Growth rate (%)	
	March-21	March-22	March-21	March-22
Agriculture and Allied activities	1.4	1.7	9.5	33.6
Industry	39.2	38.3	10.6	4.9
Retail Loans	29.2	28.5	7.5	5
Services	12.2	13.9	-5.2	21.8
Other non-food credits	17.9	17.6		

Source: Trend and Progress Report by RBI 2022.

Provisions like revision in the income limit to ₹ 3 lakh and removal of the interest rate cap should help facilitate expansion in credit flows to microfinance. This came into effect with the new regulatory framework from March

2022. Subsequently, there was a sizable increase in the share of microfinance loans extended by NBFC- MFIs in 2021-22 from 31.1 per cent to 35.2 per cent.

Vehicular loans

Higher traction in automobile sales, like in the case of banks, also aided credit growth for NBFCs. For the last three years, car loans have been one of the largest segments, accounting for close to half of the NBFC lending portfolio. During 2021-22, vehicle loans, which generally constitute the largest portion of NBFCs' retail portfolio, decreased. Consequently, the proportion of vehicle and auto loans, which comprised around 45 per cent of NBFCs' retail portfolio at the end of March 2021, decreased approximately 40 per cent by the end of March 2022.
Increasing economic activity and vehicle use are positive indicators for the used commercial vehicles (CV) financial market. While banks remain important players in the market for financing brand-new CV, used CV financing is expected to remain a major chunk of the portfolio of NBFCs due to the latter's better pricing power and client loyalty.[19]

Micro Small and Medium Enterprises (MSMEs)

In the Budget 2023-24, the Government proposed spending a massive ₹ 22,138 crores on allocations directed at the Ministry of Micro, Small, and Medium Enterprises (MSMEs), which would play a crucial role in the nation's employment creation drive. Compared to the credit growth of larger firms, MSME credit growth has typically been stronger annually. NBFCs have been a key lender to MSMEs.

Government initiatives in this budget, viz., expanding the scope of Digi-Locker services, making the Permanent Account Number (PAN) a common identifier for authenticating KYC verifications, establishing a unified Skill India digital platform that will focus on demand-based formal skilling, reduction of over 39,000 compliances that MSMEs need to abide by, decriminalization of 3,400 legal provisions, restructuring of the Credit Guarantee Scheme, completing integration of Udyam, e-Shram, and National Career Service and ASEEM (Aatmanirbhar Skilled Employees Employer Mapping) portals and the non-tax benefits to MSMEs for up to 3 years, etc., will further harmonize the relationship between MSMEs and NBFCs.[20]

NBFCs have developed credit assessment and risk management systems to assess the creditworthiness of MSMEs more accurately, allowing for a quicker resolution. This facilitates financing through traditional methods. Specialized NBFCs serve segmented clients with customized goods and services. Effective sales and distribution networks allowed them to do this.

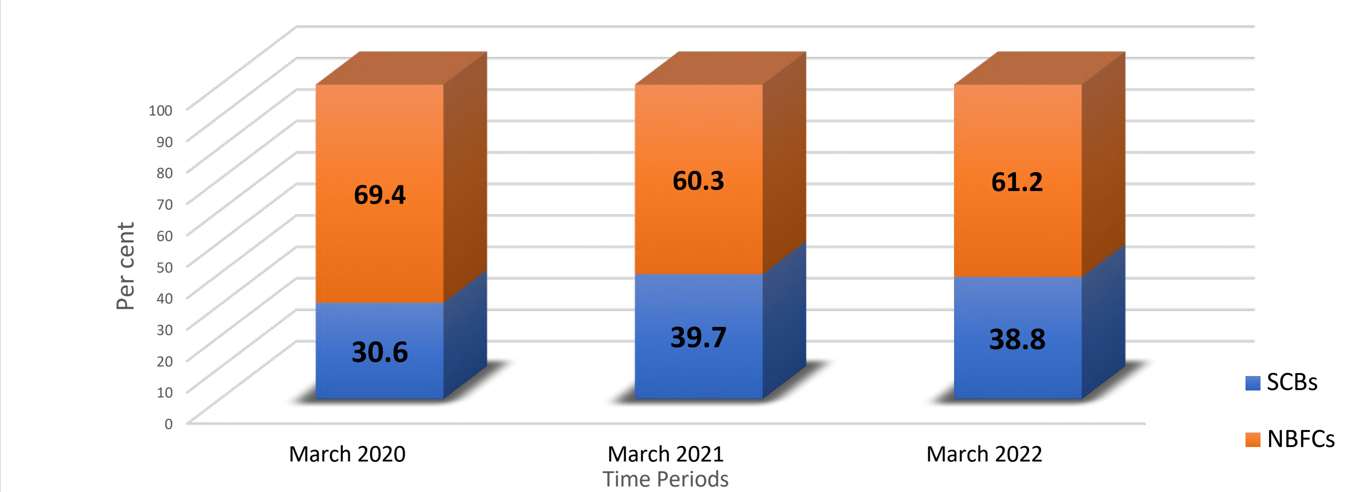
MSMEs, especially those in the service industry, rely heavily on NBFCs to fill the gap in their access to finances. The service sector shows tremendous growth vis-à-vis Industry. The Government’s Emergency Credit Line Guarantee Scheme (ECLGS) enabled enhanced access to credit. The Reserve Bank's co-lending approach, established in November 2020, also facilitated a greater influx of loans into the MSME industry. Guarantee cover was increased from 50,000 crores to 5 lakh crores in the Union Budget 2022-23, thereby extending the ECLGS till March 2023.

Traditionally, monetary, structural, administrative, and psychological barriers impede the growth of MSMEs. While NBFCs offer financing to MSMEs via guided marketing tactics and tailored loan packages, there is room for improvement. Therefore, the government should continue to collaborate with all stakeholders to expand financial inclusion.
Gold Financing

Borrowers who require either immediate or future access to cash may consider applying for a gold loan, often known as a loan against gold. The borrower in this case is putting up their gold possessions (within a range of 18-24 carats) as collateral.

According to the Reserve Bank of India, the maximum loan amount is 90 per cent of the value of the pledged gold. Till 2020, lenders were permitted a maximum loan-to-value (LTV) ratio of 75 per cent. After the Covid-19 epidemic, the RBI eased this rule. This meant that debtors may get more funds for the same quantity and grade of gold promised. This was consequently advantageous for both lenders and borrowers as the Indian economy and companies recover from the epidemic, the proportion has now returned to 75 per cent (typically 80 per cent).

Figure 4: Distribution of Advances against Gold: NBFCs and SCBs

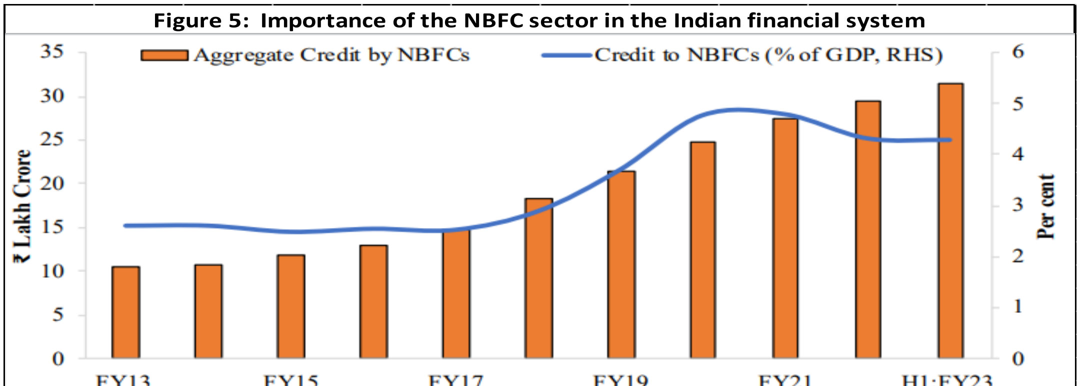


In case of loans against gold, NBFCs are a dominant player in the industry. Due to the easing of LTV standards during the Covid-19, banks saw a surge in demand for gold loans. NBFC market share in the gold loan category experienced a 10 per cent drop in 2020 – 21. After the relaxation was lifted in 2021-22, NBFCs saw a small rise in their market share as competition returned to the sector (Refer to fig. 4). Within the services sector, credit to NBFCs grew by 32.9 per cent y-o-y in November 2022 as NBFCs shifted to bank borrowings because of high bond yields as compared to 5 per cent during the same month in 2021.

NBFCs' Credit/GDP

As the importance of NBFCs in our financial system increases, it would be useful to examine NBFCs' credit as a proportion to GDP and in relation to credit extended by Scheduled Commercial Banks (SCBs). (Refer to fig. 5)[21]

Figure 5: Importance of the NBFC sector in the Indian financial system



Source: RBI

Note: Credit to NBFCs (per cent of GDP) for FY23 (H1) is estimated based on NSO's 1st AE for FY23 and cred by NBFCs as of September 2022.

Sectoral Credit Deployment by NBFCs

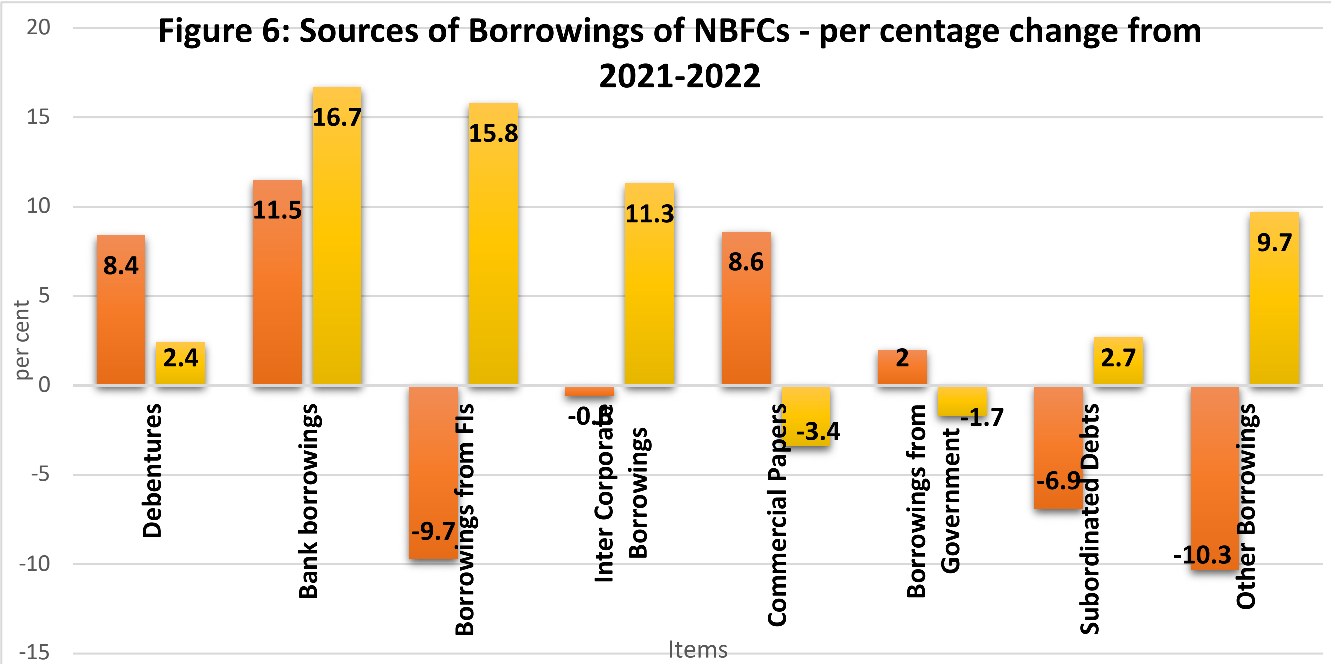
Sectoral Credit Deployment by NBFCs (₹ Crore)					
Types	**Mar'21**	**Mar'22**	**Sep'22**	**Percentage change (%)**	
				2020-2021	**2021-2022**
I. Gross Advances (II +III)	**27,02,618**	**29,08,743**	**29,37,051**	**9.7**	**7.6**
II. Food Credit	-	-	**1,752**		
III. Non-Food Credit (1 to 5)	**27,02,618**	**29,08,743**	**29,35.299**	**9.7**	**7.6**
1. Agriculture and Allied Activities	37,728	50,422	46,464	9.5	33.6
2. Industry	10,60,411	11,12,852	11,15,749	10.6	4.9
2.1 Micro and Small	44,235	46,967	49,966	21.4	6.2
2.2 Medium	14,91	17,186	15,103	5.9	15.3
2.3 Large	8,54,546	8,94,102	8,99,619	7.5	4.6
2.4 Others	1,46,720	1,54,598	1,51,061	30.1	5.4
3. Services *of which,*	3,30,758	4,02,935	3,81,485	-5.2	21.8
3.1 Transport Operators	65,313	1,02,742	90,059	2.1	57.3
3.2 Retail Trade	26,719	40,390	45,066	0	51.2
3.3 Commercial Real Estate	80,480	88,123	79,754	-20.7	9.5
4. Retail Loans *of which,*	7,90,073	8,29,485	8,79,571	7.5	5
4.1 Housing Loans	21,484	23,329	24,680	52.7	8.6
4.2 Consumer Durables	18,519	24,802	27,464	-3.4	33.9
4.3 Vehicle/Auto Loans	3,57,338	3,34,947	3,54,966	7.5	-6.3
4.4 Advances to Individuals Against Gold	1,12,899	1,18,918	1,18,723	49.6	5.3
4.5 Micro Finance Loan/SHG Loan	59,635	74.826	77,567	32.2	25.5
5. Other Non-food Credit	4,83,648	5,13,050	5,12,031	24.9	6.1
Source: Trends and Progress of Banking Report by RBI, 2022					

By the end of March 2022, there was a significant growth in the credit readily available for the transportation & logistics, retail, and commercial real estate (CRE) industries. This upswing was helped along by a favorable base effect and a rise in demand for office and retail premises. Lastly, credit to the agricultural and ancillary industries was sustained by a regular monsoon.

2. Source of Financing

Borrowings are a significant source of revenue for NBFCs apart from NBFCs-D but the borrowing mix of NBFCs has changed considerably in the 2010s. The primary source of capital for NBFCs since 2013 has been the wholesale credit market, with its share rising from 51.4 per cent in FY2013 to 58.5 per cent in FY2018. Market-based borrowing (i.e., issuing bonds, debentures, and short-term commercial papers) has become more important. Since wholesale funding constitutes the mainstay of the financing pool of NBFCs, it makes the NBFCs greatly susceptible to shocks and contagions[22].

The secondary source of capital for NBFCs is commercial banks, with the share of borrowing from banks rising marginally from 9.0 per cent in FY2013 to 12.6 per cent in FY2018[23]. At the end of March 2022, about 75 per cent of total borrowings comprised of loans taken out from financial institutions, such as, banks and financial markets. The then climate of low interest rates helped contribute to the rise in the amount of money borrowed from financial institutions (FIs). The acceleration in total borrowings that occurred during the first half of FY23 was mostly attributable to a rise in the amount of money borrowed from banks. Although NBFCs have been steadily shifting their reliance more towards long-term borrowings, the proportion of borrowings due in three months or less showed a little rise in 2021-22.



Source: Trends and Progress of Banking Report of RBI 2022.

Many of the total private placements made by private NBFCs comprised of non-convertible debentures (NCDs), and the highest possible ratings for these NCDs are AAA and AA. About half of the total NCDs issued during the second quarter of FY2023 were for two or three years. The vast majority of long-term NCDs with maturities of more than ten years were issued by well-known private NBFCs.

3. Institutional Initiatives

- The significance of NBFCs sustaining actual economic activity and functioning as a supplementary credit-intermediation conduit to banks is well acknowledged. Of late, the scale, complexity, and connectivity of this sector have increased, making certain of its organizations systemically pertinent. This prompted the implementation of scale-based regulation (SBR) on October 1, 2022. RBI produced a new regulatory framework already mentioned in the above sections. The module divides the NBFCs into four layers, viz., top, upper, middle, and base, with a decreasing level of intensity of regulations. The glide paths for NPA classification norms and minimum net owned funds requirement norms extend up to March 31, 2026, and March 31, 2027, respectively.
- On April 19, 2022, to enhance the quality of regulatory capital, NBFCs-UL are required to maintain common equity tier (CET)-1 capital of at least 9 per cent of risk weighted assets, the RBI issued guidelines providing detailed instructions on components as well as regulatory adjustments and deductions from CET-1 capital, applicable to all NBFCs identified as NBFC-UL, except Core Investment Companies (CICs), which will continue to maintain, on an on-going basis, adjusted net worth in terms of their extant directions.[24]
- Table 4 provides detailed guidelines on regulatory restrictions on lending and large exposures framework (LEF) for NBFC-UL revised on April 19, 2022.[25]

Table 4: Large Exposure Framework for NBFC – Upper Layer		
Sum of all exposure value to	Large exposure limit as per cent of eligible capital base	
	Other than Infrastructure Finance Companies	Infrastructure Finance Companies
Single counterparty	20 per cent	25 per cent
	Additional 5 per cent with Board approval	additional 5 per cent with Board approval
	Additional 5 per cent if exposure towards infrastructure loan/ investment	
	(Single counterparty limit shall not exceed 25 per cent in any case)	
Group of connected counterparties	25 per cent	35 per cent
	additional 10 per cent if exposure towards infrastructure	

- On June 6, 2022, standard asset provisioning norms for NBFCs-UL were established to harmonize their outstanding financed asset provisioning with commercial banks, where the provisioning rates varied from 0.25 per cent for individual home loans and SMEs to 2 per cent for teaser housing loans, effective from October 1, 2022.[26]
- After the amendment to the Factoring Regulation Act, 2011, on January 14, 2022, the RBI set criteria for providing factoring certificates of registration to NBFCs. In addition to NBFC-Factors, all non-deposit taking NBFC-investment and credit companies (NBFC-ICCs) with asset size of 1,000 crore and above were permitted to undertake factoring business, subject to meeting specified conditions. Any other NBFC-ICC intending to undertake factoring business must approach the Reserve Bank for conversion to NBFC- Factor.[27]
- On May 02, 2022, the approved rating was uniformly standardized to 'BBB-' for any of the SEBI-registered CRAs, resulting in better comparability with other long-term debt instruments and across CRAs.[28]
- On April 29, 2022, the Reserve Bank issued a set of principles for fixing compensation of key managerial personnel (KMP) and senior management of NBFCs. As per the guidelines, NBFCs are required to constitute a Nomination and Remuneration Committee (NRC), which will be responsible for framing, reviewing, and implementing the compensation policy.[29]
- The RBI prescribed certain principles, standards, and procedures on April 11, 2022. The guidelines, made applicable to NBFCs in the upper and middle layer, envisage putting in place a board approved policy and a compliance function, including the appointment of a Chief Compliance Officer (CCO), latest by April 1, 2023, and October 1, 2023, respectively.[30]
- In February 2022, RBI issued a notification regarding the implementation of 'core financial services solution' (CFSS) by NBFCs. This arrangement will lead to integration of the operation of NBFCs, seamless customer interface and centralized database which will help the customers to get better service anywhere and anytime. A Revised module for NBFCs' in which NBFCs with 10 or more branches were mandated to adopt Core Banking Solution.[31] NBFCs in the middle and upper layer with ten and more fixed-point service delivery units as on October 1, 2022, are mandated to implement core financial services solution (CFSS) by September 30, 2025, in a phased manner akin to the core banking solution (CBS) adopted by banks. NBFCs in the base layer and those in middle and upper layers with less than ten fixed point service delivery units were advised to consider implementation of a CFSS for their own benefit.
- "National Bank for Financing Infrastructure and Development Act, 2021" was enacted on 28th of March 2021 to enable setting up of a Development Financial Institution (DFI) to support the development of long-term

non-recourse infrastructure financing in India. In January 2022, the Rules were notified, and capital infusion of ₹ 20,000 crores was made.[32]

- The Credit Guarantee Scheme for MFIs (CGSMFI) was launched in June 2021, to fight against Covid-19 pandemic, to benefit the smallest of borrowers of Micro Finance Institutions by providing 75 per cent guarantee coverage through NCGTC (National Credit Guarantee Trustee Company) or till guarantee of ₹ 7,500 crores are issued, whichever is earlier. The Scheme is valid till 31st march, 2022 and so far, ₹ 10,000 crores have been sanctioned, of which ₹ 9,387.70 crores have been disbursed. The Scheme has reached its maximum sanction.
- In April 2022, RBI notified the net owned fund (NOF) requirement for NBFCs to commence or continue operations, that if investment and credit companies (ICCs), micro finance institutions (MFIs), and factors must have a NOF of ₹ 10 crore.[33]
- In October 2022, the RBI launched the Advanced Supervisory Monitoring System (DAKSH), a super-tech initiative, which is expected to make the supervisory processes more robust.[34]

Priority Sector lending (PSL)

NBFCs have a larger client base in terms of PSL industries like agriculture and MSMEs. Therefore, banks may guarantee indirect exposure in the PSL sector by providing them with funds subject to end use limitations and conditions of loan. Bank credit to NBFCs (including HFCs) for on-lending will be allowed up to an overall limit of 5 per cent of an individual bank's total priority sector lending in the case of commercial banks. In case of SFBs, credit to NBFC-MFIs and other MFIs (Societies, Trusts, etc.) which are members of RBI recognized 'Self-Regulatory Organization' of the sector, will be allowed up to an overall limit of 10 per cent of an individual bank's total priority sector lending. These limits shall be computed by averaging across four quarters of the financial year, to determine adherence to the prescribed cap. SFBs are allowed to lend to registered NBFC-MFIs and other MFIs which have a 'gross loan portfolio' (GLP) of up to ₹ 500 crore as on March 31 of the previous financial year, for the purpose of on-lending to priority sector. In case the GLP of the NBFC-MFIs/other MFIs exceeds the stipulated limit later, all priority sector loans created prior to exceeding the GLP limit will continue to be classified by the SFBs as PSL till repayment/maturity, whichever is earlier.[35]

The PSL limit for loans against negotiable warehouse receipts (NWRs) or electronic NWRs (eNWRs)[c] increased from ₹ 50 lakhs to ₹ 75 lakhs per borrower to encourage their use and to ensure greater flow of credit to the farmers against pledge or hypothecation of agricultural produce. This is to preserve the synergies between SCBs and NBFCs in providing credit to priority sectors, SCBs and small finance banks (SFBs) may use PSL categorization for loans to NBFCs and NBFC-MFIs for on-lending to priority sectors.[36]

4. Industry Risk

Compliance risk is 'the risk of legal or regulatory sanctions, material financial loss or loss of reputation' an NBFC may suffer because of its failure to comply with laws, regulations, rules and codes of conduct, etc., applicable to its activities.[37] The RBI issued over 27 regulatory updates specific to the NBFC sector in 2022. Also, an NBFC operating in a single state must comply with at least 621 compliances, which involves over 35 one-time registrations and approvals.[38]

On 11th April 2022, the RBI decided to introduce certain principles, standards and procedures for Compliance Function in NBFC-UL and NBFC-ML, keeping in view the principles of proportionality in the name of Compliance Circular. There are several disclosure and return filing exigencies imposed on NBFCs by the RBI circulars. To be in accordance with RBI circulars, issues of asset categorization standards for NBFCs must be addressed. However,

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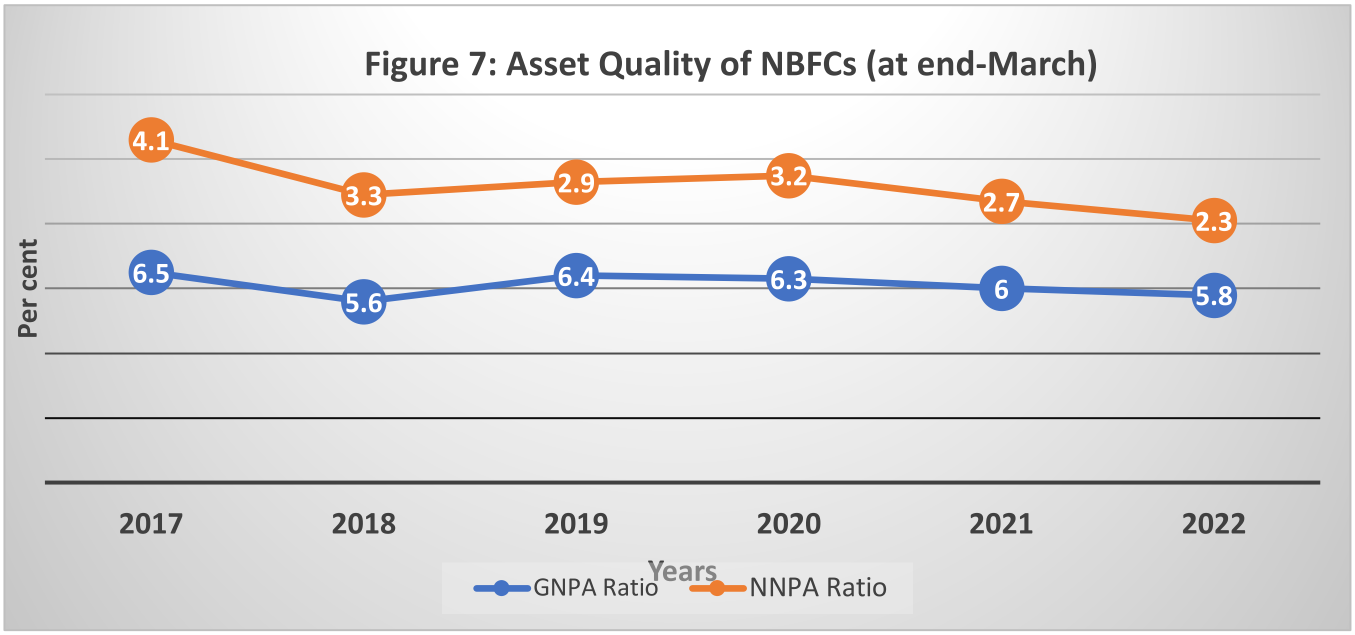
[c] NWRs and eNWRs are issued by warehouses registered and regulated by Warehouse Development and Regulatory Authority.

while it should be a primary priority, many compliance officers lack oversight for their company's compliance framework. NBFCs, specifically MFIs, operating on low-cost origination structures and having greater retail accessibility and outreach, have usually been feeders to banks for their PSL shortfalls.

The Budget proposed an additional avenue for PSL shortfall, like RIDF, an Urban Infrastructure Development Fund (UIDF) which shall be funded through such PSL shortfalls. The same shall be managed by the NHB for creating urban infrastructure in Tier 2 and Tier 3 cities through public agencies. It is expected to raise funding of around Rs. 10,000 crore per annum for this purpose.

Asset quality/ NPAs

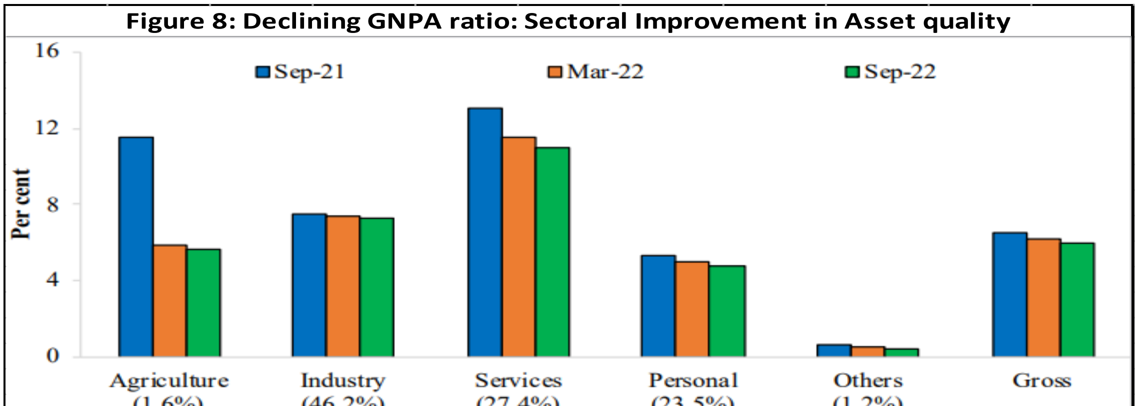
In 2021-22, the sector's asset quality improved, as reflected in the reduction in both the gross non-performing assets (GNPA) and net non-performing assets (NNPA) ratios. The steady recovery in asset quality is seen by the GNPA ratio of NBFCs falling from its high of 7.2 per cent during the second wave of the pandemic (June 2021) to 5.9 per cent in September 2022, coming near to its pre-pandemic level (Refer to figure 7).



Source: Report on Trend and Progress of banking in India by RBI, 2022.

As shown in figure 8, there has been a sectoral improvement in the asset quality as well, which is visible in the double digits of GNPA ratio in the service sector.

Figure 8: Declining GNPA ratio: Sectoral Improvement in Asset quality



Note : Numbers in Parentheses represents sectoral shares in GNPA in Sep-22.

Source: https://www.indiabudget.gov.in/economicsurvey/doc/eschapter/echap04.pdf

Standard, Sub-Standard, Doubtful and Loss Assets

The Non-performing assets (NPAs) can be categorized into sub-standard, doubtful and loss assets. In 2021-22, there was a marginal improvement in the proportion of standard assets, i.e., from 945 to 94.3 per cent. There was no change in sub-standard and doubtful assets from the previous year. The Loss assets have marginally declined.

Table 5: Classification of NBFCs' Assets (At end-March)			
Asset Type	March 2020	March 2021	March 2022
Standard Assets	93.8	94	94.3
Sub - Standard Assets	3	2.7	2.7
Doubtful Assets	2.7	2.7	2.7
Loss Assets	0.4	0.5	0.4

GNPA and NNPA trends of the Housing Finance Companies (HFCs)

In India, housing finance companies (HFCs) are specialized institutions which extend housing credit, along with SCBs. Effective August 9, 2019, HFCs are being regulated as a category of NBFCs, after the transfer of regulation of HFCs to the Reserve Bank by amendment of the NHB Act, 1987. Both GNPA and NNPAs decreased by the end of March 2022 because of the elimination of a significant HFC.

It is interesting to note that the "RBI Report on Trends and Progress 2020-21" brought out that (P.153), that in 2020 and 2021 the GNPA figures, respectively 6.7 per cent and 7.7 per cent would lower to 2.5 per cent and 3.1 per cent respectively, if two HFCs were excluded, which is evident from the figures of March 2022.

Table 6: HFCs' GNPA and NNPA Ratios (At end-March)					
	2018	2019	2020	2021	2022
GNPA Ratio	1.3	1.4	6.7	7.7	4.0
NNPA Ratio	0.6	0.8	4.7	2.8	1.8

Liquidity Risk - Stress testing

Table 7: Liquidity Risk in NBFCs			
Cumulative Mismatch as a percentage of outflows over next one year	**No. of NBFCs having liquidity mismatch**		
	Baseline	**Medium**	**High**
Over 50 per cent	2(0.4)	2(0.4)	2(0.4)
Between 20 and 50 per cent	0(0.0)	2(0.5)	6(1.5)
20 per cent and below	6(1.5)	22(8.4)	39(22.1)
Source: RBI Financial Stability Report December 2022			

5. Pathway to the Future

Going ahead, the transformation of NBFCs in the pursuit of a more resilient, efficient, and trusted financial system is both inevitable and desirable because of the inexorable process of change triggered by the headwinds stemming from market risk, technology, consumer protection and sustainability. The transformation of the form and substance of NBFCs in India is a tall order and necessitates synchronized efforts by all stakeholders with a sense of urgency. Towards this end, strong capital buffers, adequate provisions, and sufficient liquidity in their books augur well for the NBFCs.

Given the winds of change sweeping the globe, there must be an accent on digitization, including chatbots to enhance customer service, provide digital solutions, and develop alliance with fin-techs as partners in development. With increasing use of instruments, such as, eKYC (Electronic Know Your Customer), e-signature, and Aadhaar-based verification, NBFCs are driving financial inclusion, increasing penetration of financial assets, wider participation in equity markets and technology adoption. But this process is hampered by large NBFCs, which imperil the existence of some smaller players. Further, the spike in annual cancellations of NBFCs by the RBI occurs largely because of flawed lending practices and the widespread tendency to adopt short-term ad hoc measures. The RBI also proposed a scale-based regulatory framework for NBFCs to be effective from October 2022, to promote better governance and structural strengthening of the sector, with the long-term objective of bridging the gap between banks and NBFCs.

NBFCs grew significantly over the past decade by increasingly using digital solutions, flexible underwriting practices and leveraging data analytics for personalized products and offerings. But it needs no clairvoyance to perceive that the NBFCs do not constitute a monolithic whole39 and there continues to be a persisting skew in leveraging digital channels among the larger and smaller NBFCs. With India's 'Atmanirbhar Bharat' move going full steam ahead and the pursuit of US$ 5 trillion target by 2025, the NBFCs can help to plug the gaps in the lending eco-system. Surging borrowing costs because of normalization of monetary policy, however, constitute headwinds. There are also issues of regulation, Environmental, Social, and Governance (ESG) and emerging technological trends, such as, peer-to-peer lending, cybercrimes, etc. in the salubrious development of the industry.

In view of the increasing scale and complexity of NBFCs' operations along with their rising interconnectedness with other entities in the financial system, the RBI issued a notification on 22 October 2021 on 'Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCs '(SBR Framework). The SBR Framework came into effect from 1 October 2022 (except for certain compliance requirements relating to funding of initial public offerings (IPOs), which were effective from 1 April 2022). These regulations mark a paradigm shift from an activity-based regulation to one based on riskiness and scale of operations, following the principle of proportionality. These measures together with application of other regulatory prescriptions, such as, PCA and IRACP (Income Recognition, Asset Classification and Provisioning) norms would strengthen the NBFCs and make them more robust and scalable over the medium-term.

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