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"Analysing the NBFC Crisis vis-a-vis its Impact on Crippling Economy of India"

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Non-Banking Financial Company ("NBFC") are pseudo banks that are registered under the Indian Companies Act, 1956. These shadow started their operations in India in 1960s, however gained importance post 1991. Gradually, they grew as a crucial component of the Indian financial system and added a significant depth to it. NBFC's facilitate certain bank related financial services like granting of loans and advances but are restricted from taking demand deposits. In recent times, the NBFC's are going through imminent crisis with three major companies: IL&FS, DHFL and Altico downgraded and therefore had a domino effect on the Indian economy. As a result, the Central Government issued a notification to bring NBFC with Rs.500 crore assets or more under purview of Insolvency and Bankruptcy Code ("IBC"), which is a positive step, though not a completely apt solution.

Functioning of NBFC's

After liberalisation of the economy in 1991, investors gained a significant interest in NBFC's. They involve in the business of loans and advances, acquisition of shares, stocks, debentures, securities, leasing, hire-purchase, and chit business among various other. NBFC's started to largely assist the Indian economy by investing into real estate and infrastructure projects, which is a crucial sector for a developing country like ours. However, over time they started to have a major liquidity crunch thereby resulting into significant fall in their credit ratings. One of the noteworthy reason of such crunch was the asset liability mismatch. NBFC's raise funds by borrowing money from other commercial banks (long-term borrowings) or mostly by selling commercial papers, or issuing debt instruments like bonds, leases, non-convertible debentures etc. (short-term borrowings). In return, they lend these short term borrowings to long term projects like infrastructure projects which usually gets delayed over a prolonged period. As a result, they are unable to renew their cycle of funds and it leads to major liquidity crunch. Furthermore, weak financial management and lack of due diligence adds on to the collapse of such institutions. All these factors have heavily impacted the Indian economy and the series of continuous downgrades in NBFCs, have pushed housing finance companies and infrastructure projects in crisis as well.

Background of IL&FS, DHFL and Altico Crisis

Infrastructure Leasing and Financial Services Ltd. ("IL&FS") was formed as an RBI registered Core Investment Company in 1987, with its institutional shareholders like LIC, ORIX and a few Indian banks like SBI as well. It had several projects in different sectors including area development, e-governance, urban infrastructure etc.[i] In 2018, this core investment company and a three-decade infrastructure lending giant with a combined debt around Rs. 1 lakh crore started defaulting in payment obligations of bank loans, long term and short term deposits and also failed to meet the commercial paper redemption obligations. Post these defaults, rating agencies like CARE, ICRA, etc. abruptly downgraded IL&FS and its subsidiary from high investment grade (AA plus) to junk status, signifying impending crisis. These defaults also jeopardised the investors, mutual funds and banks linked to IL&FS and caused fear among them. In the light of the same, National Company Law Tribunal ("NCLT") suspended the existing Board of Directors of IL&FS [ii]and the Ministry of Corporate Affairs ("MCA"), on the basis of charge sheet submitted by Serious Fraud Investigation Office ("SFIO") moved against the auditors and 30 other parties for criminal conspiracy and misreporting financial statement of the IL&FS firms.[iii] However, as of now there has been no resolution or recovery of the defaulting amount done. The Supreme Court has disallowed the encashing of bank guarantees given by IL&FS firms in order to relieve the banks who stood as bank guarantors.[iv]

Dewan Housing Finance Corporation Ltd. ("DHFL") is one of the largest housing finance companies in India registered as a NBFC. Post IL&FS Crisis, the stock of DHFL was also majorly hampered, by around 50% downfall in it. On June 4, 2019, DHFL failed to pay around Rs. 900 crore of interest, forcing all rating agencies to downgrade its commercial papers and NCDs to default status. However, DHFL made several attempts to pay off its debt by selling off its assets and withdrew its mutual fund business. As on July 6, 2019, DHFL owed Rs. 83000 crores to banks, National Housing board, mutual fund and bond holders. Further, a forensic audit report was also conducted by KPMG initiated by a consortium of lenders, led by Union Bank of India, raised suspicions that DHFL has siphoned off the money.[v] Recently, the CMD of DHFL, Mr. Kapil Wadhawan has been arrested by the Enforcement Directorate, on the charges of money laundering and related party transactions. As of now, the Supreme Court has reversed its order stating that the fixed deposit holders to be paid off before the housing financial company starts lending.[vi]

Altico Capital Ltd. is another shadow financing bank that majorly finances real estate sector defaulted to pay interest amounting to Rs. 20 crores adding to India's yearlong NBFC crisis. Atlico owes around Rs. 4500 crores to the system. Currently, RBI is contemplating whether to refer Altico to NCLT as it is expected to work on some debt resolution plans internally.

Therefore, these examples of major NBFCs running short on credit and defaulting payments has significantly impacted the Indian economy and pushed it deeper into the economic pitfall.

Steps by Central Government/ RBI

NBFCs have played a substantial role in the Indian financial system by complementing the baking sector and by bringing in diversity and effectiveness into financial intermediation. However, in recent times, the capital position and asset quality of these NBFCs have deteriorated causing problems for both the banking and the finance sector. This poses a massive challenge for the Central Government and therefore requires stringent mechanism to regulate NBFCs. On November 15, 2019, the Central Government issued a notification to bring NBFC's under the definition of Financial Service Provider which in turn would bring any NBFC with assets worth Rs 500 cores or more under the ambit of IBC[vii]. It is a positive step and is expected to help limit losses for creditors as compared to liquidation. In light of the recent notification, on November 20, 2019, RBI commenced the insolvency proceedings against DHFL.

The rules laid down by the Central Government is a progressive approach to boost the economic downfall. Furthermore, a suitable resolution plan along with the latest rules will assist the creditors of distressed NBFCs in recovering a portion of their debt. Whilst the existing laws applicable to a financial service provider have proven to be unsuccessful in tackling the existing crisis, the current rules are far more beneficial. The IBC is a dynamic legislation and thereby the recent rules should help reduce the problems faced by creditors in recovering debt from these finance service providers (NBFCs) in distress. However, the exact scope of third party assets needs to be clarified and the notification in this regard from the Government is awaited. As stated previously, the rules are significantly crucial and will act as an interplay between resolution plans under IBC and the principles of financial firms. It will bring much needed respite for the stakeholders involved in NBFCs as they now have a clear path to implement a resolution plans. The current framework provides that this is an interim measure and a comprehensive legislation in this regard will be crucial. The implementation of this framework shall be scrutinised carefully as it evolves with the resolution of NBFCs being undertaken through these Rules

Way Forward

Currently, the NBFC Regulations are not as stringent as that of the banks. In order to have a stringent regulatory policy, there is a requirement of a chief risk officer who will periodically review the functioning of the NBFCs and an external audit team to keep a check on their books of accounts. Further, there shall be a system to assess the liquidity coverage ratio requirement in order to take care of asset liability mismatch which is a root cause of the current crisis. These shadow banks are yet to completely absorb the systemic shock following defaults by IL&FS and DHFL and a consequent liquidity crunch. Besides, considering that most NBFCs have borrowed short-term money to fund long-term assets, they were able to continually refinance their borrowings as long as liquidity conditions were easy. As liquidity tightened, they were left facing debt repayment challenges and prospects of rating downgrades. To ensure greater credit flow from banks to NBFCs, RBI shall increase exposure limits to a single NBFC from 20% to further 25% to allow banks to lend to NBFCs for on-lending to customers. This will ensure reinstatement of capital position of these struggling non-banks.

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