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A STUDY OF THE NON-BANKING FINANCE COMPANIES IN INDIA

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ABSTRACT: An eminent non-banking financial institution (NBFC) in India declared bankruptcy in late 2018, causing a credit constraint in the country's economy. The situation calls into question NBFCs' business strategies and their economic position in comparison to banks. This study explores the historical growth of non-bank financial enterprises (NBFCs) in India, their role in growing lending, and potential causes of the 2018 crisis. We are working to understand the benefits and drawbacks of the NBFC business model, as well as the factors that have contributed to their recent rapid growth and the issues that come with it. We also explore the possible consequences of the Covid-19 pandemic on the Non-Banking Financial Company (NBFC) sector. To sustain their position in India's financial market, non-banking financial companies (NBFCs) must be reinforced by learning from past mistakes.
Keywords: Non-banking financial company, financial intermediation, financial regulation, systemic risk, liquidity crunch.

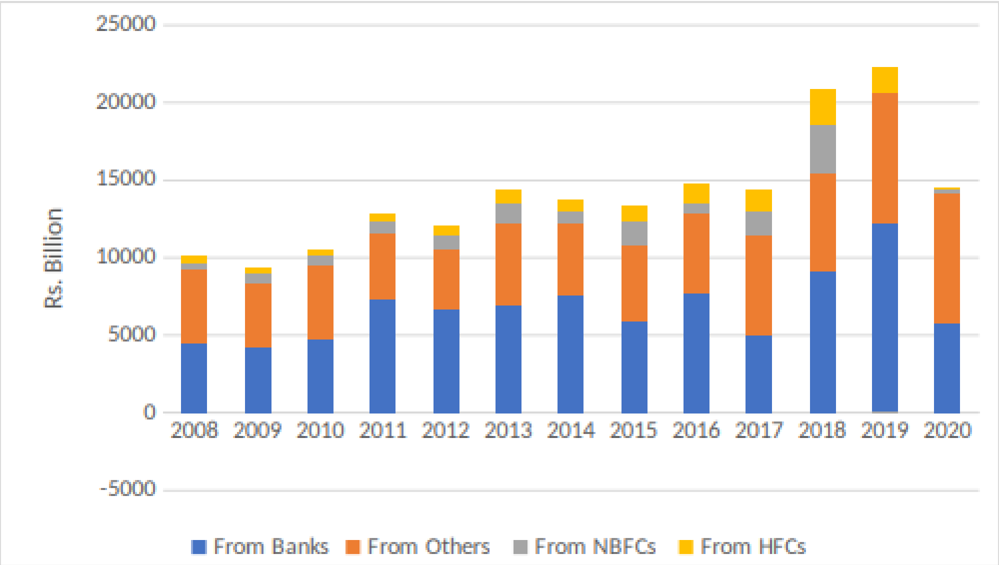
I- INTRODUCTION

The unwavering financial commitment of the private sector is an important accelerator for the growth of a developing country like India. Having a constant and stable source of finance is critical for starting and maintaining ventures. Credit in the Indian economy has regularly increased faster than the GDP. Between 1962 and 2019, the average ratio of bank loan growth to nominal GDP growth was 1.42. The ratio ranged between one and two percentage points. Throughout this time, banks were the principal source of credit in the formal economy, with bond markets and non-bank lenders playing a limited role in facilitating lending. The fundamental reason for the slow expansion of credit in the banking industry in recent years, particularly after 2014, has been the rise of non-performing assets (NPAs) on banks' balance sheets, particularly public-sector banks (PSBs). Prior to 2018, loans from non-banking finance companies (NBFCs) helped to compensate for a lack of credit in the banking sector. In September 2018, Infrastructure Leasing & Finance Co. (IL&FS), a well-known Non-Banking Financial Company (NBFC), failed to pay its debt obligations. This event sparked a crisis that impacted the whole non-banking financial firm (NBFC) industry. As a result, both commercial banks and NBFCs provided much less supplementary loans during the first half of fiscal year 2019-2020 (2019-20), which ended on March 31, 2020. The onset of the Coronavirus (Covid-19) pandemic in India caused tremendous disturbance, which quickly spread throughout the country beginning in March 2020. This occurred during a period when the non-banking financial firm (NBFC) sector was still dealing with the fallout from the 2018 crisis. The Indian government initiated a comprehensive lockdown on March 25 in response to the highly transmissible disease outbreak, which lasted more than two months. During this time, the majority of economic activity came to a sudden halt. Non-essential enterprises were forced to close, while required ones saw significant decreases in operations. The recent shock is projected to have a negative impact on the NBFC sector, resulting in financial constraints and an increase in non-performing assets. There has been little study performed to analyze the NBFC sector and describe the structural issues it faces in the aftermath of the 2018 crisis and the ongoing pandemic crisis. This contrasts with the vast literature available on NPA difficulties in the Indian banking sector after 2008 (see Sengupta and Vardhan 2017 and 2019b for additional information). This article examines the evolution of India's non-bank finance company (NBFC) industry, focusing on its role in providing commercial loans. Furthermore, it aims to shed light on the 2018 crisis, briefly analyze the probable effects of the Covid-19 outbreak on this sector, and make recommendations for the industry's future. The study's goal is to examine the benefits and drawbacks of the NBFC business model, as well as the factors that have contributed to their recent rapid growth and the issues that have arisen as a result. In general terms, credit can be granted in two ways: (i) market credit, which includes the bond market and, in some cases, risk-pass-through products such as mutual funds; and (ii) intermediated credit, which is provided by financial institutions such as banks and NBFCs through their balance sheets. Financial institutions have long been the principal source of commercial borrowing in India, given to the limited depth and liquidity of bond markets.

Commercial banks have historically wielded tremendous power in the financial system by lending to both individuals and businesses. Commercial banks have traditionally acted as the primary and most sophisticated means of transforming personal savings into investments since they can accept deposits, which is the basic function of financial intermediaries. Nonetheless, the expansion of bank loans has recently slowed, resulting in an increased demand for non-bank credit sources such as NBFCs and HFCs as alternative credit providers (Figure 1).

Figure1: Flow of incremental commercial credit in India from various sources

Banks dominate but NBFCs and others expanded rapidly



Non-Banking Financial Companies (NBFCs), as the name implies, are businesses that provide credit services without being regular banks. Banks' funding mechanisms differ significantly from those of non-banking financial businesses (NBFCs). All banks take public demand and time deposits; however, NBFCs are not permitted to accept demand deposits and are generally prohibited from accepting time deposits. Only a limited number of Non-Banking Financial Companies (NBFCs) are permitted to accept public time deposits, and new licenses for NBFCs engaged in deposit-taking activities have not been issued since 1997.Public deposits are a minor fraction of NBFCs' total liabilities. Aside from equity capital, the majority of non-banking financial corporations (NBFCs) raise funds by borrowing from commercial banks and issuing bonds or debentures, which are commonly sold to mutual funds and banks.

Nature of business activities – Based on its operations, the organization has created ten different types of NBFCs. Three types of institutions play an important role in lending: investment and credit firms, home finance companies, and microfinance institutions (MFIs). MFIs primarily offer microloans to economically disadvantaged people, mostly women, through joint liability group lending programs. As a result, they have less influence in comprehending commercial credit, although non-banking financial businesses (NBFCs) and housing finance companies (HFCs), also known as credit and investment enterprises, have a significant impact on the commercial credit sector. Until July 2019, the National Housing Bank (NHB) was responsible for regulatory control of HFCs. Starting in August 2019, the regulation of HFCs was shifted to the RBI's jurisdiction, however the NHB continues to supervise them. In October 2020, the Reserve Bank of India (RBI) issued a circular classifying Housing Finance Companies (HFCs) as Non-Banking Financial Companies (NBFCs) if they invested at least 60% of their total assets in real estate and financed at least 50% of their total assets for individual residential properties.As of March 19, 2020, HFC's cumulative loan portfolio totaled more over Rs 20 trillion, accounting for a sizable part of all commercial loans.

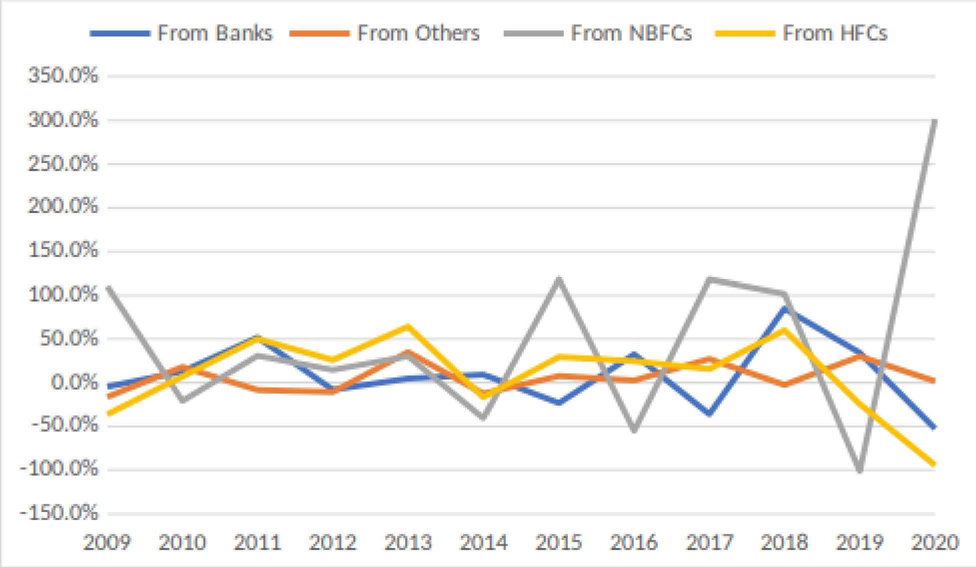
Access to public deposits – All non-banking financial firms (NBFCs) are divided into two categories: those that do not accept deposits (ND) and those that do. As of September 30, 2019, the Reserve Bank of India (RBI) had registered 9,462 non-banking financial companies (NBFCs), with just 74 classed as NBFC-D.

Size: Non-Banking Financial Companies (NBFCs) come in a variety of sizes. Unlike banks, which require a license and much more starting capital (currently Rs 5 billion for a universal bank), the minimum capital required to establish an NBFC is very low at Rs 20 million (approximately $270,000). Many non-banking financial companies (NBFCs) are classified as extremely small since their total balance sheet is less than Rs 1 billion. In 2006, the Reserve Bank of India (RBI) divided non-banking financial organizations (NBFCs) into two categories based on asset valuation. Systemically important non-deposit taking NBFCs (NBFCs-ND-SI) were NBFCs with assets more than Rs 1 billion. In 2014, the ceiling was increased to Rs 5 billion. Any non-deposit taking NBFC that did not fall into the category of NBFCs-ND was considered to be in its own category. Compared to Non-Banking Financial Companies - Non-Deposit Taking (NBFCs-ND), Non-Banking Financial Companies - Non-Deposit Taking Systemically Important (NBFCs-ND-SI) were subjected to less stringent prudential regulations due to their expected larger size and potential to cause more harm to the financial system. As of September 30, 2019, there were 272 Non-Banking Financial Companies-Non-Deposit Taking-Systemically Important (NBFC-ND-SI), the primary subject of this study. According to the RBI 2019 report, the combined assets of Non-Banking Financial Companies - Non-Deposit Taking Systemically Important (NBFCs-ND-SI) amounted to Rs 28 trillion, while the assets of NBFCs-D stood at Rs 4.5 trillion, and Housing Finance Companies (HFCs) had assets worth Rs 13.5 trillion in September 2019. ND and SI are the two largest Non-Banking Financial Companies (NBFCs), with the government owning more than 40% of each. Furthermore, it owns a controlling share in around 10% of Non-Banking Financial Companies (NBFCs), designated as D, but only 5% of Housing Finance Companies.

Non-Banking Financial Companies (NBFCs) have grown in importance as commercial loan providers over the previous decade, particularly after the banking sector's substantial asset quality difficulties arose in 2015. In March 2020, after subtracting bank credit to non-banking financial companies (NBFCs) and housing finance companies (HFCs), NBFCs and HFCs accounted for more than 20% of institutional credit, which comprises loans from both banks and non-bank financial institutions. Between 2014-15 and 2016-17, the average rate of increase in credit flows given by NBFCs was 13.5%, whereas bank credit increased by only 8.5% (Figure 2). This demonstrates the important role that NBFCs have played in the Indian financial system. The collapse of IL&FS, as well as the accompanying turmoil in the Indian credit markets in the fall of 2018, prompted several serious and fundamental issues about the role of NBFCs, their business model, and the most effective regulatory framework.

Figure 2: Growth of incremental commercial credit flows from various sources

Credit by NBFCs grew fast in recent years



The following is an outline of the paper's remaining sections. Section II compares NBFCs to commercial banks, concentrating on their financial structures, business procedures, and regulatory frameworks. Section III presents in-depth treatment of the Non-Banking Financial Company (NBFC) sector's exceptional growth since 2014, including an examination of probable drivers of this expansion. Section IV examines the causes and structure of the 2018 crisis episode, which greatly affected the NBFC business and ultimately impacted the financial system and the overall economy. Section V of the report also discusses a subset of Non-Banking Financial Companies (NBFCs) known as Housing Finance Companies (HFCs), which were especially vulnerable to the consequences of the crisis. Section VI outlines the regulatory changes implemented in response to the 2018 crisis. Section VII gives a succinct review of the likely consequences of the ongoing Covid-19 epidemic for this specific firm. Section VIII examines the consequences of recent events for the long-term viability of non-banking financial companies (NBFCs).

II. COMPARISON OF NBFCS WITH COMMERCIAL BANKS

Commercial banks and non-banking financial companies (NBFCs) are the main players in India's credit model, which directs savings through financial institutions' balance sheets. Analyzing the recent expansion and crises in the NBFC industry necessitates a full grasp of the differences and similarities between NBFCs and commercial banks, including corporate strategies and regulatory frameworks.

The fundamental difference between banks and non-bank financial enterprises (NBFCs) is that banks can accept public deposits, whereas the majority of NBFCs (NBFCs-ND) cannot. Household savings are India's major and most economical source of financing. Because of their inability to use consumer deposits, non-banking financial companies (NBFCs) pay significantly higher cash acquisition costs than banks. Even after accounting for the costs involved with keeping reserves such as the cash reserve ratio and statutory liquidity requirement, banks still have a 50-150 basis point loan pricing advantage over NBFCs. This is primarily owing to banks' access to low-cost deposits. Non-Banking Financial Companies (NBFCs) typically give credit to businesses in order to compete with banks due to funding constraints. Commercial banks are unable to enter or regard particular sectors as enticing, whereas NBFCs can acquire specialized knowledge to compensate for their inherent funding disadvantage.

Due to RBI regulation constraints, banks may be unable to serve a specific industry. One of the causes that allows non-banking financial companies (NBFCs) to dominate the "loan against share" business is the limit on how much banks can lend using shares as collateral. Commercial banks are unable to serve certain aspects of the informal or "cash" economy due to their lack of accessibility. Small truck fleet operators illustrate this dilemma because they mostly conduct business in cash and lack the necessary paperwork to receive bank credit, despite the fact that they require funds to purchase both new and used trucks. Non-Banking Financial Companies (NBFCs) frequently benefit from banks' inability to analyze loans with unofficial data. The commercial automobile business, notably the used vehicle market, the agricultural tools sector, small contractors who rely on construction equipment, and related industries all have limited access to financial services. Non-Banking Financial Companies (NBFCs), particularly in these regions, have gained substantial market knowledge and have long been focused on serving certain client niches.

Certain demographics, such as self-employed individuals, have been judged unfavorable by banks due to high operational expenses, a decreased willingness to take on credit risk, or an inability to assess credit risk without verified financial information from clients. Non-Banking Financial Companies (NBFCs) have a substantial presence in the highly competitive and dynamic sectors listed below:

- Commercial vehicle financing including used commercial vehicles
- Credit against gold collateral
- Affordable housing loans
- Consumer durable loans
- Loan against shares and margin financing for stock market traders
- Loan against property (LAP) for micro and small business owners as well as construction and real estate development firms

As a result, non-banking financial businesses (NBFCs) often operate in specialized markets where they may offset the disadvantage of higher funding costs by providing additional value in the form of superior risk assessment, faster service, specific industry experience, and so on. Banks rarely compete directly with them for the same customers. Non-banking financial businesses (NBFCs) supplement and even replace banks by increasing the accessibility and range of financial services.

Non-Banking Financial Companies (NBFCs) have higher risks due to their involvement in niche markets, which results in a greater concentration of hazards in their operations. Because NBFCs are so prevalent in these markets, any disruption to the NBFC model could result in a credit shortage in these regions, jeopardizing the firms' long-term viability. Any disruption in the operational activities of specific customer groups would result in an increase in the number of loan defaults for the non-banking financial companies (NBFCs) that lend to them.

Furthermore, because they lack direct access to consumer or retail finance, as well as household savings, NBFCs have relied on bond, commercial paper, and bank markets to fund their operations. The core problem stems from the Indian wholesale credit sector's low depth and liquidity. As a result, any disruption in the wholesale market will have a severe impact on the entire non-banking financial services (NBFC) industry. Even if the wholesale market experiences liquidity challenges that are not directly related to non-banking financial companies (NBFCs), funding for NBFCs will suffer.

Deposit products are not only limited, but non-banking financial organizations (NBFCs) are barred from using the payment system, unlike banks. As a result, they are unable to offer payment options like cash credit or overdraft, as well as credit products linked to deposit accounts. Non-banking financial companies (NBFCs) typically provide fixed-term loans. If they do give working capital, it will most likely take the form of term loans.

Unlike banks, NBFCs are not subject to the same regulatory monitoring. This is largely owing to the greater feasibility of properly supervising 10,000 Non-Banking Financial Companies (NBFCs) as opposed to 90 scheduled commercial banks. This is mostly due to the important role that Non-Banking Financial Companies (NBFCs) play in the overall lending market. Given that banks often deliver poor services in the locations where they lend, it is reasonable to expect Non-Banking Financial Companies (NBFCs) to be given significant regulatory latitude. However, regulatory differences between banks and NBFCs increase the probability of "regulatory arbitrage" between the two institutions. Non-Banking Financial Companies (NBFCs) are linked with a number of privately held banks that have large loan portfolios. These corporations express concern about the risk of exploiting regulatory gaps by making loans in places where their parent banks are not authorized to do so.

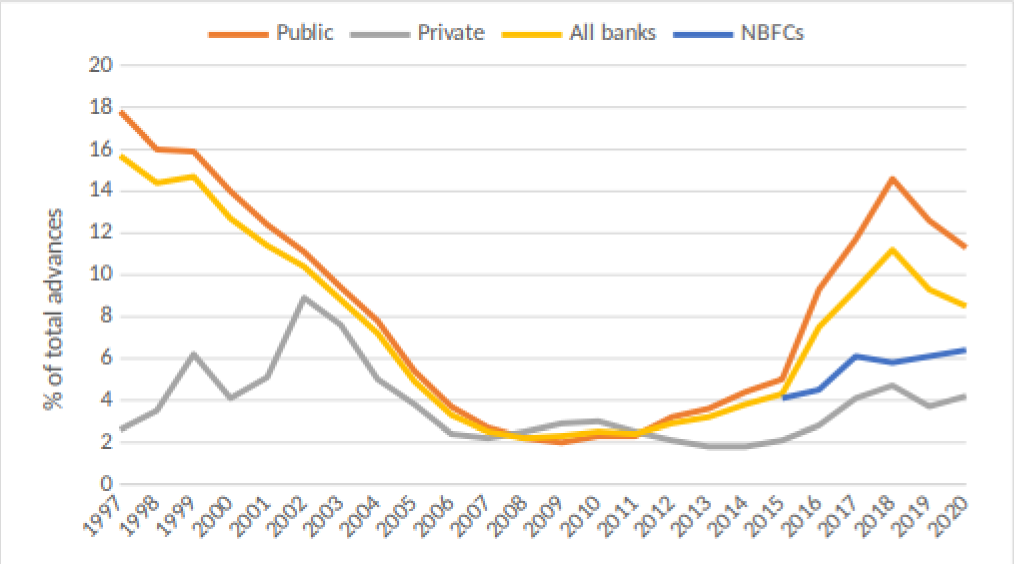
To reduce systemic risk and, if not eliminate, possible differences between the two models, the regulator must strike a fine balance between giving NBFCs enough autonomy and adaptability to cater to industries outside the purview of banks. The paradox is that banks give considerable amounts of money to NBFCs, while the banking system as a whole is at danger due to weak regulation of NBFCs.

In recent years, there has been a concerted attempt to bring the regulatory frameworks for banks and non-banking financial institutions (NBFCs) closer together. This was done to prevent any potential benefit or exploitation resulting from the distinctions between these two categories of financial intermediaries. The recent implementation of asset liability management and liquidity laws for NBFCs, as well as the adoption of revenue recognition standards, has resulted in an increased regulatory and supervisory focus on systemically important non-bank financial organizations (NBFCs). This emphasis is owing to their critical position in the overall financial system of the economy.

III. RISE OF NBFCS IN RECENT YEARS

Since the early 2000s, the rate of credit growth in India's banking sector has alternated between acceleration and deceleration. Between 2003 and 2008, bank loans to the commercial sector expanded at a rapid pace. However, it began to plummet with the global financial crisis of 2008. After 2014, concerns regarding balance sheets arose in the private corporate and financial sectors. As a response, the RBI launched the asset quality review (AQR) program, which compels banks to identify distressed assets in their financial statements. Both private and public sector banks (PSBs) undertook Asset Quality Reviews (AQR). Figure 3 shows an increase in non-performing assets (NPAs) across the whole banking sector. Between March 2015 and March 2018, the banking sector's gross non-performing assets (NPAs) more than doubled, accounting for 11.5% of all advances.

Figure 3: Gross NPAs in the Indian banking sector and NBFCs
NPAs rose sharply after 2015



PSBs, which account for 70% of the banking system's total assets, saw a larger growth in non-performing assets (NPAs) as a percentage of gross loans. In March 2018, the majority of financially challenged banks, nine out of ten, were government-owned. Gross non-performing assets (NPAs) peaked at 14.6%, while net NPAs for public sector banks (PSBs) decreased to around 8.5%. In addition to the bank's non-performing asset (NPA) status, there were indicators of financial irregularities in the corporation's books. According to a Credit Suisse research published in early 2017, about 40% of tracked corporate debt was owned by companies with interest coverage ratios less than one, indicating that their profits were insufficient to support loan interest payments. In its 2017 Economic Survey, the Indian government refers to this predicament as the Twin Balance Sheet (TBS) problem.

During the developing TBS crisis, there was a large decrease in the quantity of new bank loans provided to the business sector (as indicated in Figure 4), with the most significant drop occurring between 2016 and 2017. PSBs must drastically reduce their credit risk as a result of the large concentration of non-performing assets. Figure 5 shows that the allocation of bank loans to the industrial sector had the most negative impact. Despite a drop in bank credit to the industry, the banking sector expanded lending to non-banking financial institutions (NBFCs), notably after 2014-15. During this time, banks focused their loans mostly on the consumer sector and non-banking financial entities. From 2015 to 2019, the average growth rate of bank loans to individuals and Non-Banking Financial Companies (NBFCs) was approximately 17%, while lending to the industry increased at a pace of less than 3%.

Figure 4: Share of different types of banks in incremental credit flows
Credit flows from PSBs contracted in recent years

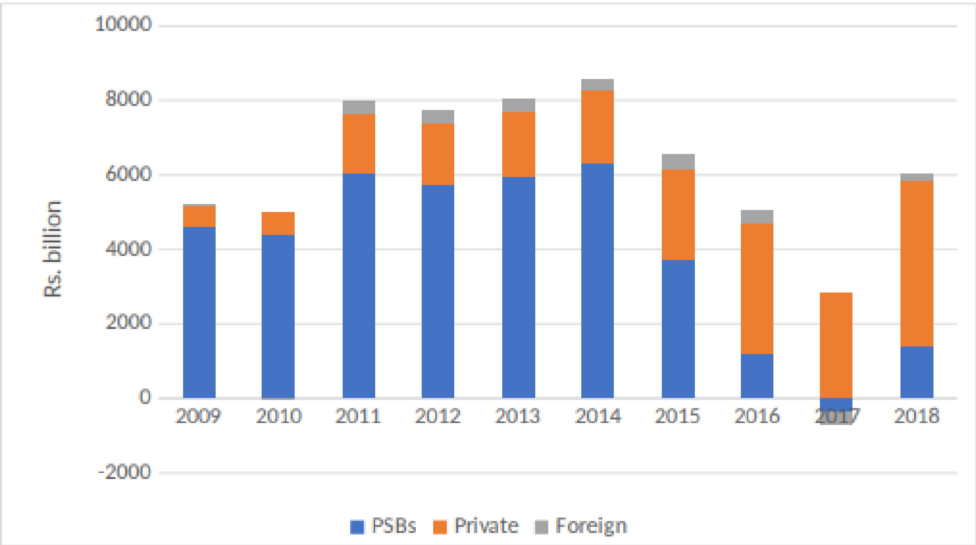
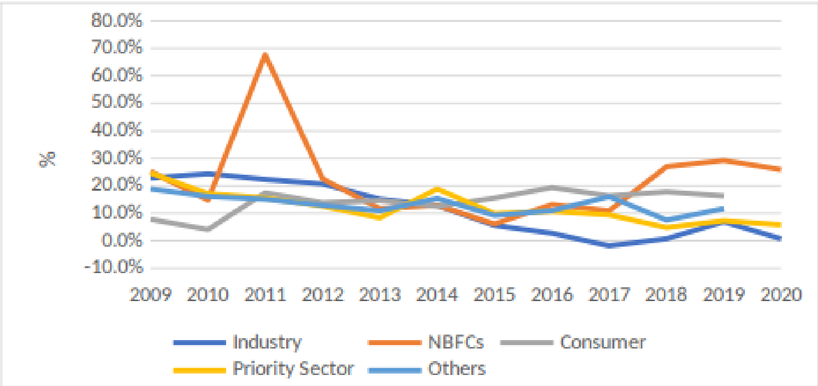


Figure 5: Growth of bank credit across key sectors
Credit to industry was sluggish



In 2010, the Indian financial system underwent a big and critical transformation. Mutual funds have emerged as significant contributors to the credit market. Their AUM increased significantly from 2012 to 2017, at a CAGR of 22.1% (Figure 6). The November 2016 demonetization process accelerated the existing secular growth trend. Bank deposits increased significantly during the fiscal year ending in March 2017, following the government's unexpected disclosure that about 86% of the money in circulation was deemed illegal. As a result, individuals and businesses were required to deposit their cash reserves in banks. Some of these deposits were placed in mutual funds, specifically debt funds, resulting in a significant increase in assets under management (AUM) for 2017.

Figure 6: Assets under management by mutual funds
Mutual funds expanded fast

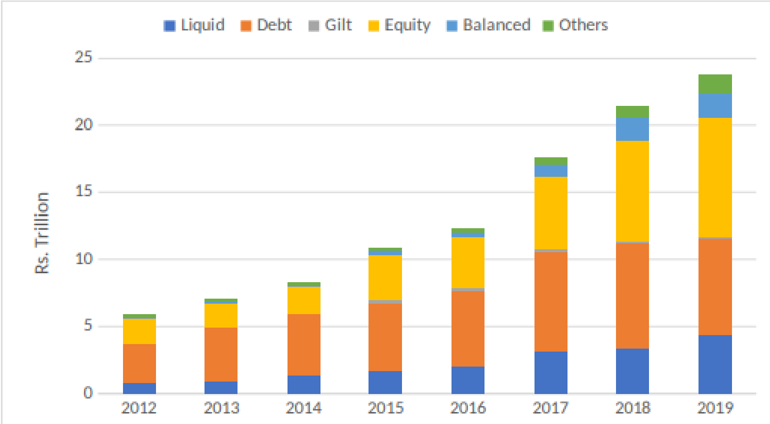


Figure 7 shows developments in the industries to which Non-Banking Financial Companies (NBFCs) provided loans. Approximately 55% to 60% of all NBFC loans disbursed between 2016 and 2019 went to industrial clients, accounting for the vast bulk. Consumer and commercial real estate credit rose dramatically, including loans for purchasing automobiles, white goods, and other items. Between 2014-15 and 2016-17, Non-Banking Financial Companies (NBFCs) expanded their lending to infrastructure more than the banking industry, resulting in less finance for infrastructure.More than 15% of non-banking financial companies' (NBFC) loans went to other NBFCs. The outcome is the result of large and established Non-Banking Financial Companies (NBFCs) lending money to smaller and newer NBFCs, owing mostly to the latter's stronger credit ratings.

Figure 7: Sectoral deployment of NBFC credit
NBFCs increased lending to consumers

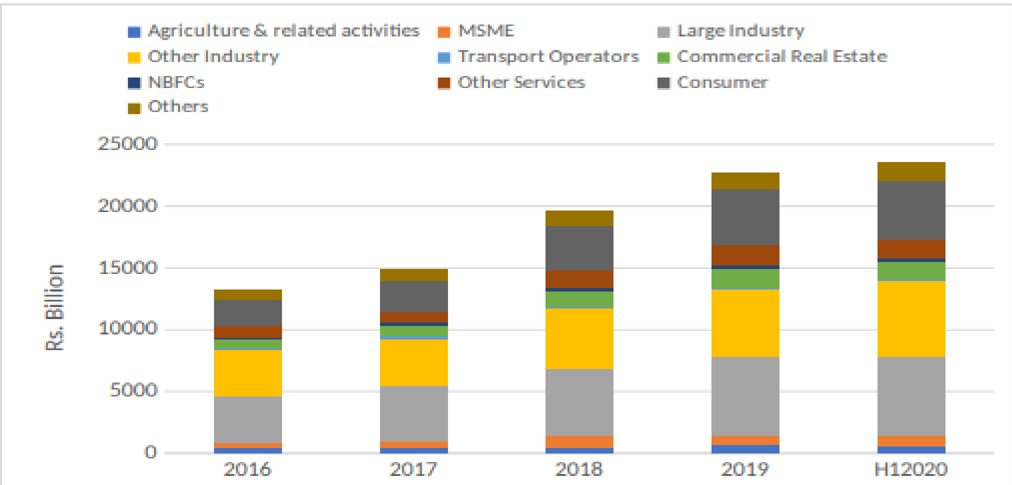
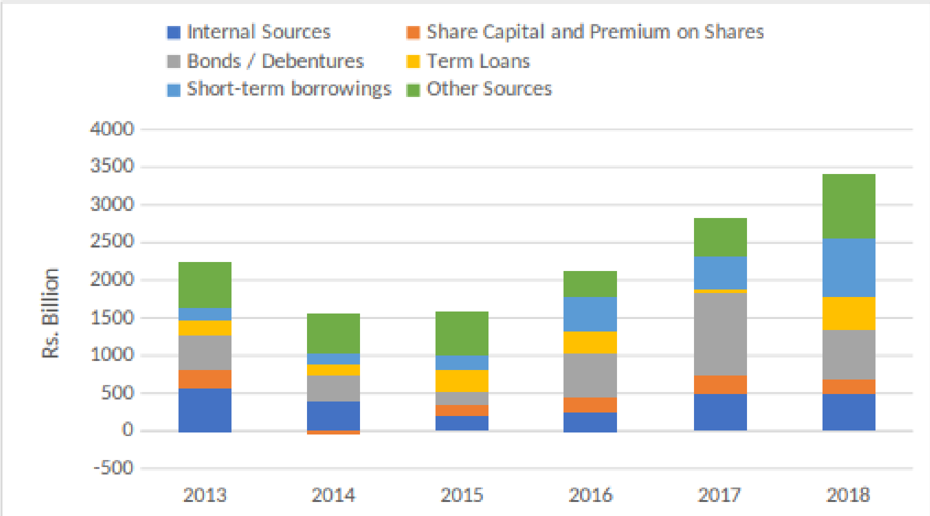


Figure 8 demonstrates how NBFC funding sources have shifted in recent years. Since 2013, NBFCs have mostly relied on the wholesale credit market to fund operations. In 2018, its market share rose from 51.45% to 58.5%. Bonds, debentures, and short-term commercial papers are examples of market-based borrowing that has become increasingly important over time. Ghosh et al. (2012) argue that because NBFCs rely on wholesale funding, they are intrinsically vulnerable to shocks. As the 2018 crisis continued, this particular component of NBFC borrowing suffered the most; this is detailed in greater detail in the section that follows. Commercial banks are the second major source of financing (Acharya et al., 2013). The ratio of bank loans has slightly grown, from 9% in 2013 to 12.6% in 2018.

Figure 8: Incremental funding of NBFCs

NBFCs rely on wholesale credit markets



Between 2014 and 2018, the fast development and greater competition in the NBFC market masked the risks they created. Evidence suggests that NBFCs started to undervalue loans. During this time, the credit premium of NBFCs to the risk-free yield declined (Sengupta and Vardhan 2019a). The abundance of liquidity and large capital infusion by private equity firms improved the competitiveness of NBFCs. This led in competitive credit pricing, particularly in relatively homogeneous industry sectors such as loans against property (LAP) for micro, small, and medium-sized businesses (MSMEs) and loans to real estate developers.

NBFCs lowered the term of their liabilities to lower borrowing costs and sustain profitability during this period of expansion. They began by lending long-term and borrowing short-term, resulting in an imbalance between liabilities and assets on their balance sheets. This meant they could default in the case of a liquidity shock, which would mean their creditors wouldn't be ready to provide new credit or roll over old debt. Since NBFCs' asset quality has been significantly dropping in recent years, rising competition among NBFCs has resulted in some relaxation of underwriting and collateral requirements. Gross non-performing assets (NPAs) rose from 2.9% of gross advances in 2011-12 to 6.1% in 2016-17 (see Figure 3).

IV. GENESIS AND ANATOMY OF THE NBFC CRISIS OF 2018

IL&FS, a renowned NBFC that finances infrastructure projects, defaulted on its loan obligations in September 2018. This resulted in a credit crunch, hurting the industry and the overall economy. Here's how the events unfolded and impacted the NBFC industry.

IL&FS prioritizes infrastructure development and funding. While IL&FS is the parent firm, the IL&FS Group operates mostly through independent companies. During the default, India had 169 legal corporations or subsidiaries with complex ownership arrangements.The number is 6. Due to its RBI registration as a "Core Investment Company," it is unable to engage in activities other than investing in group companies. Many of the businesses were special purpose vehicles (SPVs) that controlled infrastructure assets such as electricity generators and highways. IL&FS Financial Services Limited (IFIN), a big NBFC, lent to several SPVs in the group.

In September 2018, IL&FS' bank loans and bonds reached Rs 910 billion, or approximately $13 billion. IL&FS obtained debt capital market loans through short-term and long-term commercial papers. The majority of rating firms gave its debt securities the highest grade. Mutual funds, pension funds, corporate treasuries, charity trusts, and others purchased these bonds because of their high ratings and big sums.

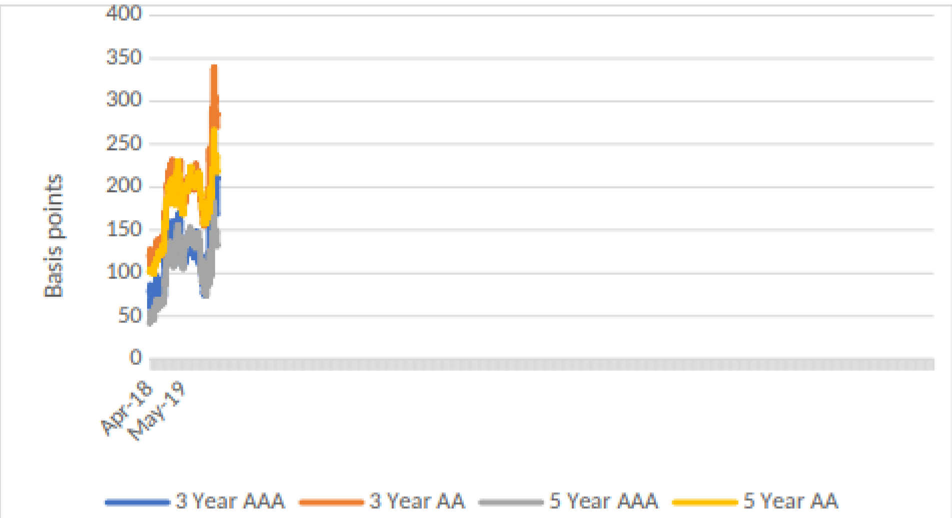
In June 2018, IL&FS stopped paying commercial papers and inter-corporate deposits of Rs 4.5 billion, signifying a threat. Within the last two to three months, at least two rating agencies have reduced its long-term ratings. On September 4, 2018, IL&FS failed to repay a 10-billion-rupee SIDBI loan and a 5-billion-rupee subsidiary credit.

IL&FS defaults shook debt capital markets. The failures increased the credit risk premium on all bonds dramatically. To prevent credit risk, debt mutual funds stopped renewing commercial papers with non-banking financial corporations (NBFCs). Rollover rates fell from 95 percent to 10 percent. The commercial paper market freeze left the debt market short of capital. Bond issuance dropped. Investor interest in mutual funds with strong NBFC exposure increased slightly. Many Non-Banking Financial Companies (NBFCs) lost all financial assistance between September and November 2018.

Due to risk-averse bond markets, only a few well-known and government-backed non-banking financial organizations (NBFCs) were able to raise further funds. Even top-rated Non-Banking Financial Companies (NBFCs) that received debt finance from the market saw borrowing costs rise and credit spreads on NBFC bonds expand. Figure 9 depicts how borrowing rates escalated following the IL&FS failures in October 2018. These rates remained high for much of 2019-20, particularly among AAA and AA-rated NBFCs. Following the dramatic decline in finances, insolvency fears surfaced.

Figure 9: NBFC & HFC credit spreads

NBFCs and HFCs' borrowing costs went up significantly after IL&FS crisis



The Reserve Bank of India (RBI) imposed reduced risk weights for non-banking financial companies (NBFCs) and increased bank lending to them to address the liquidity issue. Figure 10 illustrates that NBFCs and HFCs issued fewer non-convertible debentures (NCDs) to the public during the second half of 2018-19 and the first half of 2019-20. Figure 11 demonstrates how bank lending to NBFCs has increased over time. Many NBFCs and HFCs sold their loan portfolios to banks to alleviate the liquidity crisis. The buyers carefully selected portfolios from liquidity-constrained Non-Banking Financial Companies (NBFCs) and Housing Finance Companies (HFCs), creating the appearance that NBFCs' remaining loan books had lower credit quality. As a result, capital was scarce, limiting NBFCs' ability to lend to the broader economy. Figure 1 depicts how the IL&FS incident impacted the first six months of the fiscal year 2019-2020, from April to September. Bank and non-bank financial institutions' lending to the business sector dropped, while all other credit fell drastically.

As a result, the 2018 NBFC crisis exacerbated an already tight loan market. Industries that relied on NBFC credit faltered. Passenger car sales peaked in September 2018 at 244,279, but fell to 162,435 in August

2019. The GDP fell from 6.1% in 2018-2019 to 4.2% in 2019-2020 as NBFCs gained clout.

Figure 10: Public issuances of non-convertible debentures by NBFCs
Demand for NBFCs debentures fell after IL&FS crisis

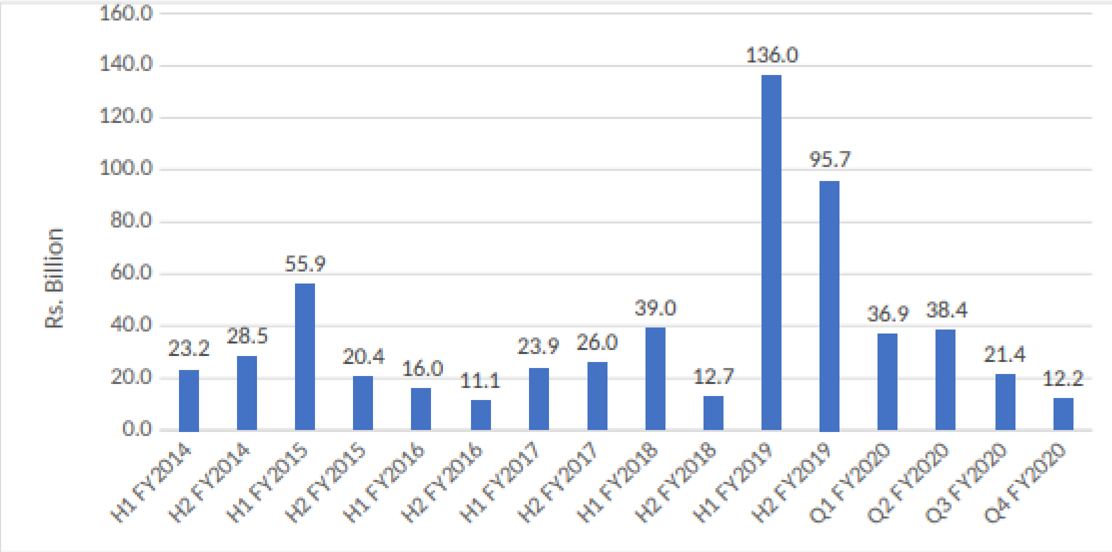
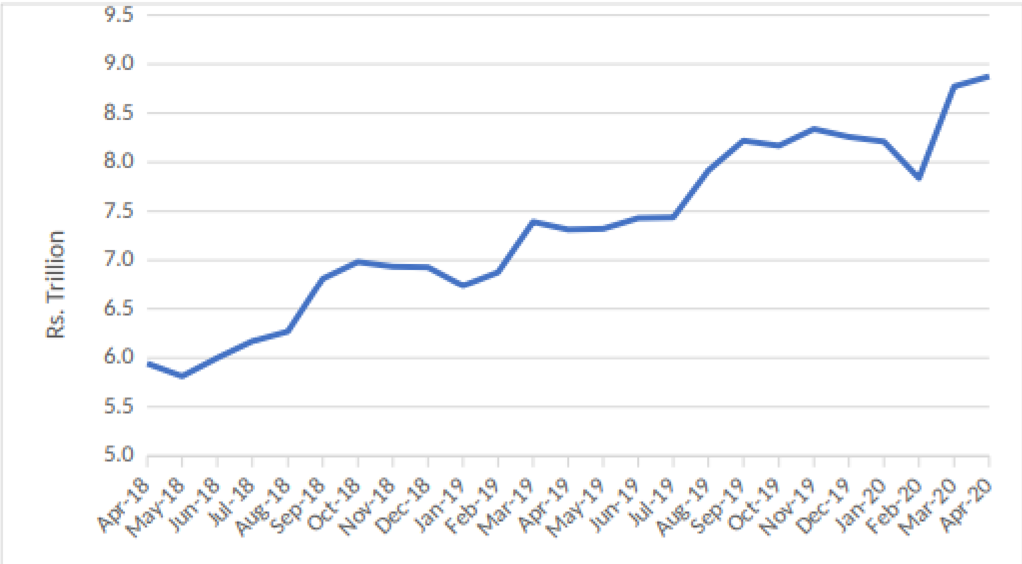


Figure 11: Bank lending to NBFCs
NBFCs borrowed from banks after October 2018



V. HOUSING FINANCE COMPANIES

Housing Finance Companies (HFCs) are major non-bank financial institutions in India. These companies began offering mortgages to homebuyers in the late 1970s. The National Housing Bank (NHB) was established in the late 1980s to regulate housing finance companies. The NHB approved new HFC construction, monitored operations, and provided financing. From 2013 to 2018, the number of Housing Finance Companies (HFCs) registered with the National Housing Bank (NHB) rose from 50 to over 100. The top six HFCs control over 85% of HFC loans, making the market highly concentrated.

Because of the intimate association between real estate developers and mortgage borrowers, most Housing Finance Companies (HFCs) lend to both.

HFCs, like NBFCs, are funded through bonds and bank loans. Prior to the IL&FS crisis and credit freeze, the top six HFCs received substantial loan capital from the markets. The remaining HFCs were bank-funded. Housing finance businesses (HFCs) suffer from asset liability mismatch (ALM) as a result of their long-term lending products. Residential mortgages typically last 15 to 25 years. Banks and bond markets provide financing to financial institutions for a maximum of five years. The IL&FS crisis had a significant impact on HFCs due to ALM concerns. Most heavily leveraged financial organizations, particularly smaller ones, experienced liquidity concerns. Several HFCs actively sold portfolios to banks. In early 2019, the RBI took over HFC regulation and administration from NHB.

VI. REGULATORY RESPONSE TO THE NBFC CRISIS

Recognizing the enormity of the problem faced by NBFCs and HFCs in light of the IL&FS crisis and its broader economic implications, the government and RBI took a number of steps to address the situation. The government implemented the following measures:

- A new scheme named the "first default loss guarantee" has been launched, with a value of Rs 1 trillion. This program insures against initial losses for NBFC loans that match the program's standards.
- The government intends to contribute Rs 100 billion to the establishment of an alternative investment fund (AIF) valued at Rs 250 billion. This money will be used to finance the completion of outstanding housing projects. The goal of this effort was to provide financial assistance to developers who were experiencing financial difficulties in completing their projects. This would eventually benefit the housing finance firms (HFCs) who had provided home loans to customers buying homes in these developments.

The Reserve Bank of India (RBI) has launched many initiatives to increase bank lending to Non-Banking Financial Companies (NBFCs). Some of these activities included:

- Banks' risk weights for lending to NBFCs were decreased and brought in line with those for other firms.
- Increase the maximum amount of Non-Banking Financial Companies (NBFCs) lending to a single borrower from 15% to 20% of the bank's Tier I capital.
- Banks were authorized to make loans to registered non-bank financial institutions (NBFCs) that did not qualify as microfinance institutions (MFIs), subject to specific restrictions. As a result, these non-banking financial companies (NBFCs) may use the loans expressly for lending in the priority sector. The maximum allowable amount for agricultural loans is Rs 1 million, which is confined to term loans only. For micro and small businesses, the maximum credit amount is Rs 2 million. Similarly, the maximum loan amount for homes will be enhanced from Rs 1 million to Rs 2 million.

In addition to direct steps, a number of indirect measures were implemented to improve the liquidity of Non-Banking Financial Companies (NBFCs). Some of the indirect measurements were:

- From October 2018 to March 2019, Open Market Operations (OMOs) were carried out to infuse around Rs 3.5 trillion into the banking system as liquidity.
- The maximum limit for securities eligible for both the statutory liquidity ratio (SLR) and the liquidity coverage ratio (LCR), also known as the Facility to Avail Liquidity for Liquidity Coverage Ratio (FALLCR), has increased. This adjustment allows banks to minimize the amount of securities they must retain as reserves while increasing the funds available for lending.
- Changes to securitization requirements include lowering the minimum length for which NBFCs must maintain their loan portfolios in order to incentivize securitization.
- The transfer of HFC laws from NHB to RBI was done to improve regulatory oversight across banks, NBFCs, and HFCs.

The majority of these efforts were implemented with the goal of improving the short-term liquidity of NBFCs. In the long run, substantial adjustments were made to the system, such as transferring authority for

HFC regulation from NHB to RBI and imposing liquidity-related duties on NBFCs, notably asset liability management (ALM). In the future, more long-term remedies, such as a stricter regulatory framework for HFCs and NBFCs, may be implemented.

Bank lending to Non-Banking Financial Companies (NBFCs) increased in the first quarter of 2019 as a result of these actions. As a result, lending by NBFCs increased proportionally. Bank financing remained biased towards well-known and respected NBFCs, while smaller, less established, and lower-rated NBFCs continued to face funding issues. Furthermore, liquidity in the bond market for Housing Finance Companies (HFCs) and Non-Banking Financial Companies (NBFCs) remained tight. Only government-sponsored non-banking financial organizations (NBFCs) with a AAA credit rating were able to raise funds by selling bonds in the market.

VII. IMPACT OF THE COVID-19 PANDEMIC

The Covid-19 epidemic struck India in January 2020, while non-banking financial institutions (NBFCs) and housing finance companies (HFCs) were still grappling with the fallout from the IL&FS crisis. On March 25, 2020, India launched a total statewide lockdown, causing all economic activity to halt abruptly (Sengupta and Dev 2020). Many efforts to reduce disease transmission, such as social separation, stringent movement restrictions, and temporary business closures, resulted in significant disruptions in supply chains and a noticeable fall in overall supply and demand. The lockout lasting more than two months posed considerable challenges for all economic participants (Sengupta 2020 and Sengupta and Vardhan 2020).

The bulk of Non-Banking Financial Companies (NBFCs) suspended operations due to the need to close their branch networks. Due to the temporary closure of the underlying companies, NBFCs that primarily focused on consumer lending, such as those offering loans for homes, automobiles, and consumer durables, were unable to lend. Passenger car sales in India were essentially non-existent in April and May, hindering expansion in the auto loan industry.

MSMEs have most likely been disproportionately affected by the economic crisis due to limited access to formal funding and insufficient demand. The businesses' struggle for survival would present issues for the NBFCs that have extended loans to them. There would be a greater emphasis on asset quality.

In late March 2020, the Reserve Bank of India (RBI) announced a six-month suspension of bank and non-bank financial company (NBFC) clients' repayment obligations. Nonetheless, given the protracted absence of any income creation over the last few months, there is a considerable likelihood that concerns about asset quality would worsen, despite the adoption of the embargo. The reduction in loan repayments would have a significant impact on the profitability of non-banking financial companies (NBFCs). Individuals working in unregulated industries with no collateral or security are the most vulnerable to financial risk. This circumstance poses a substantial risk to Microfinance Institutions (MFIs) that operate within Non-Banking Financial Companies (NBFCs). In general, delinquencies are likely to rise significantly across all asset categories, potentially posing solvency issues for certain Non-Banking Financial Companies (NBFCs).

Non-banking financial businesses (NBFCs) are currently experiencing a liquidity constraint as their cash flows decline. Despite the RBI's stated policy objective of increasing liquidity in the banking sector by lending to NBFCs, this remains valid. Typically, the repo window allows banks to get short-term loans from the RBI. In April 2020, the RBI announced a new mechanism known as "targeted long-term repo operations" (T-LTRO) to improve this capability. This technique was also adopted in March 2020 (Sengupta & Felman 2020). The government has announced a Rs 500 billion Targeted Long-Term Repo Operation (T-LTRO) to purchase NBFC notes from both the primary and secondary markets. This was mostly focused on larger non-banking financial companies (NBFCs).

However, due to the banking system's cautious attitude toward risk, this technique has proven ineffective in providing Non-Banking Financial Companies (NBFCs) with the necessary capital. Even the most reputable non-banking financial companies (NBFCs) will be compelled to pay large credit spreads between April and

May 2020. This indicates the bond market's reluctance to take risks. Indeed, the spreads during the outbreak have exceeded the borrowing costs that NBFCs incurred as a result of the IL&FS default. Furthermore, mutual funds have reduced their stakes in non-banking financial companies (NBFCs).
Although anecdotal evidence suggests that the pandemic and lockdown had a significant and widespread impact, there is currently no publicly available data to fully illustrate the extent of the damage, with the exception of increased borrowing costs for the NBFC and HFC businesses. Larger, more established, and higher-rated NBFCs may purchase smaller ones, leading to sector consolidation. Furthermore, there may be an increase in the trading of investment portfolios and the conversion of assets into securities.
In May 2020, the Finance Minister announced a fiscal relief program known as Atmanirbhar Bharat, or Self-Reliant India. As part of this package, Rs 750 billion in liquidity strategies were included to minimize the negative effects of the Covid-19 crisis, particularly for NBFCs. The proposal includes a scheme that gives partial credit guarantees for the remaining Rs 450 billion, as well as a government-supported liquidity scheme worth Rs 300 billion. This policy initiative is aimed to improve the liquidity of non-banking financial companies (NBFCs).

VIII. FUTURE OF NBFCS

The non-banking financial firms (NBFCs) issue and credit scarcity in the economy raise questions about their business strategy, relevance, and existence. Why should specialty banks be allowed to operate despite their financial constraints rather than requiring conventional banks to serve the same markets? Banks have a financial advantage due to direct family wealth access. Thus, some banks may enter sectors previously served by NBFCs. When banks cannot serve all consumer sectors, what is the best alternative finance mechanism? A country's poor and illiquid bond market makes it unclear how non-banks can thrive when family savings are the most reliable and long-term funding. The majority of NBFC funding comes from banks, showing they can still get deposits. Should they still be regulated leniently, or should it be applied only to assets rather than liabilities? In light of the crisis, the RBI should reassess its stance on NBFCs.
Systemically important Non-Banking Financial Companies (NBFCs) need stricter regulation and oversight. NBFCs should undergo rigorous annual inspections and periodic regulatory procedures, like the "asset quality review" (AQR) commercial banks underwent in response to the 2015-16 NPA crisis. We must distinguish between systematically important Non-Banking Financial Companies (NBFCs) and those that may be too huge to fail and implement separate regulatory measures for each. Some experts feel that turning interconnected NBFCs into commercial banks or decreasing their network externalities could stabilize the financial system. However, these networked NBFCs may be better at lending to industries banks don't lend to. Economic efficiency and regulation must balance.
Non-Banking Financial Companies (NBFCs) need a regulatory oversight framework to handle liquidity shocks. Non-bank financial entities lack a clear system for receiving temporary liquidity from the RBI's repo operations. Due to the 2018 IL&FS crisis, non-banking financial enterprises (NBFCs) had little credit while the financial sector experienced a liquidity shortfall. As mentioned, NBFCs rely on wholesale funding, hence stagnant wholesale markets might cause liquidity shocks. If funds are tight, financially healthy NBFCs may fail. Most non-banking financial companies (NBFCs) lack high-quality collateral like government bonds. NBFCs struggle to create a bank-like repo operation due to asset shortage. In a financial system-wide crisis, non-banking financial enterprises (NBFCs) and the regulatory body may need to collaborate to create a formal liquidity mechanism. Structural finance stream diversification is essential to the long-term success of NBFCs. They only have commitments from banks and the domestic debt capital market. Mutual funds and insurance companies buy most NBFC loans in domestic capital markets. They need more credit sources—domestic and foreign—to create a solid financial plan. NBFC external commercial borrowing laws may need revision. Regulatory improvements that allow asset-backed securitization and similar procedures may also help NBFCs access pension funds and other debt finance. Alternative investment vehicles with higher risk tolerance can fund NBFC debt products.

This disaster should teach banks, mutual funds, auditors, the securities market regulator, and credit rating agencies (CRAs) important lessons. High-rated instruments defaulted, amplifying the IL&FS default shockwave across the system. SEBI must regulate instrumental corporations like Credit Rating Agencies more. All stakeholders developing the Non-Banking Financial Company (NBFC) model must understand the risks to construct a sustainable business. The unregulated flow of loans and equity into NBFCs could lead to a disaster as the industry saw. Commercial banks would continue to neglect several consumer sectors in India's fast-growing economy. Due to lack of expertise or access, banks may find it financially unfeasible to serve various consumer categories, as detailed in Section II. NBFCs were founded to assist underserved customer groups. For this, they must be more flexible than commercial banks in operations and balance-sheet management. They need fundamentally different regulatory control than commercial banks. Because they employ bank loans, Non-Banking Financial Companies (NBFCs) threaten the banking system. The larger these NBFCs, the greater their systemic danger. The regulatory strategy for Non-Banking Financial Companies (NBFCs) must balance financial and operational adaptability with systemic risk management. The difference between larger NBFCs with systemic importance and those without is needed to reach this balance. This distinction lets regulators and supervisors focus on enterprises with a big impact on the system. Over time, successful NBFCs have gained credibility, expertise, and talent. As funding costs rise and is limited, most weaker and homogenous NBFCs will fail. A few financially stable, specialist NBFCs may survive the crisis and grow their market share. The current pandemic could worsen the 2018 crisis and induce a systemic shift.NBFCs are crucial in emerging nations like India, where many people and businesses lack access to traditional banking services. Due to increased risk and lower profitability, Indian NBFCs serve market sectors that commercial banks do not. Due to their nature, non-banking financial enterprises are vital to an economy's financial sector. The 2018 crisis and rise of NBFCs in India offer other emerging countries important lessons. Debt and equity capital must be disciplined to avoid the 2018 catastrophe. Capital sources like markets and banks must be more cautious while backing NBFCs.

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