



Challenges in India's Nonbank Financial Sector

MONETARY AND CAPITAL MARKETS DEPARTMENT

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Nonbank financial companies (NBFCs) remain a weak link in the Indian financial system. Signs of stress first emerged following unexpected defaults of two NBFCs (IL&FS in September 2018 and DHFL in June 2019) and have intensified more recently with market disruptions triggered by the COVID-19 global pandemic. Due to the size of the NBFC sector and its importance for credit provision, its distress has significant implications for the financial system and broader economy. NBFCs account for one-quarter of the assets of the financial system and were responsible for about half of the lending growth during 2015–17.¹ Thus, the strains in the NBFC sector have spilled over to the financial and real sectors, exacerbating the credit crunch. Meanwhile, bank exposures to NBFCs have risen significantly over the past two years, increasing the fragility of the financial system. The Reserve Bank of India (RBI) has taken steps to strengthen the regulation and supervision of NBFCs, along with providing liquidity to the system. However, policy transmission remains muted, impacting the effectiveness of monetary policy easing aimed at supporting the economy amid the COVID-19 crisis.

Funding Strains in the NBFC Sector

The NBFC defaults in 2018-19 heightened concerns about hidden vulnerabilities in the Indian NBFC sector, with the funding costs rising by about one-third for the lower-rated financial institutions (Figure 1, panel 1). The market dislocations due to the COVID-19 crisis (see [GFSR, April 2020](#)) led to a further widening of spreads to record high levels across the entire rating spectrum of NBFCs, with investors continuing to differentiate between higher- and lower-risk institutions (Figure 1, panel 2). New bond issuance by NBFCs in aggregate rose in February 2020 (after RBI's LTRO announcement) but has declined sharply in the last two months to almost the lowest levels since the IL&FS default (Figure 1, panel 3).

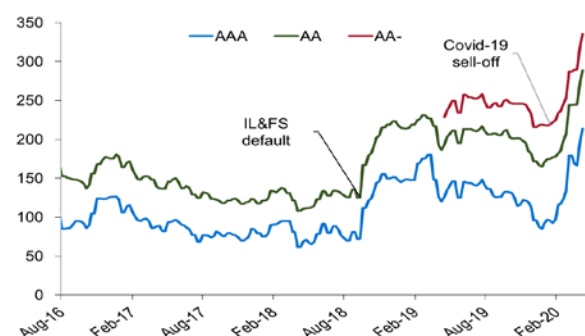
Mutual funds—which had been a key source of funding for NBFCs—have reduced their exposure to commercial paper (CP) issued by NBFCs by almost 65% since September 2018, with March 2020 seeing a 25% mom decline in these amounts. The maturity of the mutual fund holdings of CP issued by NBFCs has increased as well² (Figure 1, panel 4). However, almost 80 percent of the NBFCs' CP held by mutual funds is still short term, which entails high rollover risks and increases incentives for NBFCs to hoard liquidity. The broader decline in the market liquidity is also reflected in the voluntary closure of six Franklin Templeton's debt funds (\$4.1bn AUM) on April 23, 2020, citing severe market dislocation and illiquidity due to the Covid-19 pandemic. While this event was not systemic itself, it has increased concerns about other asset management firms. Equity prices for major listed asset managers have declined by more than 5% since April 23, underperforming the broader index by more than 7%. Mutual funds' troubles have added to the NBFC's concerns, considering that major NBFCs face as much as [\\$8.3bn of debt maturing](#) by September 2020.

¹ Morgan Stanley, 2019

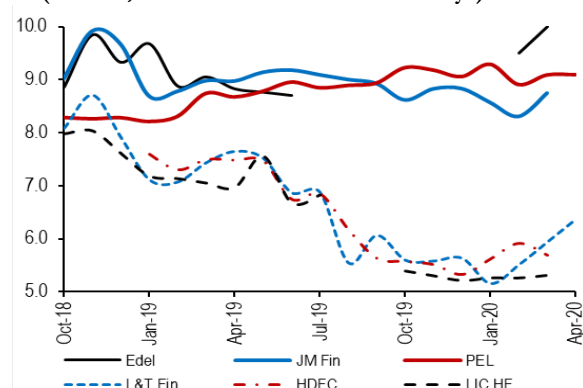
² This potentially reflects the fact that market access is now limited to high-quality companies, which are able to issue commercial paper of longer tenure.

Figure 1. Nonbank Financial Corporations' Funding Pressures

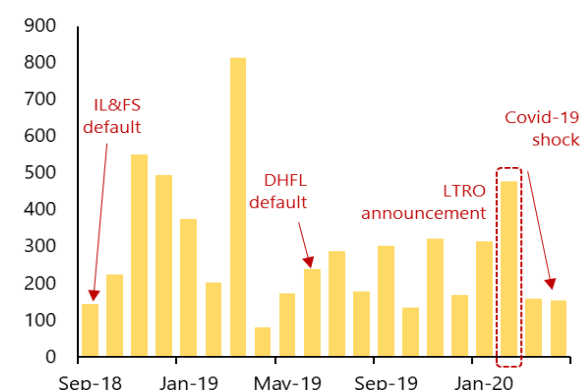
1. Nonbank Financial Companies: Commercial Paper Spread over Government Securities (Basis points)



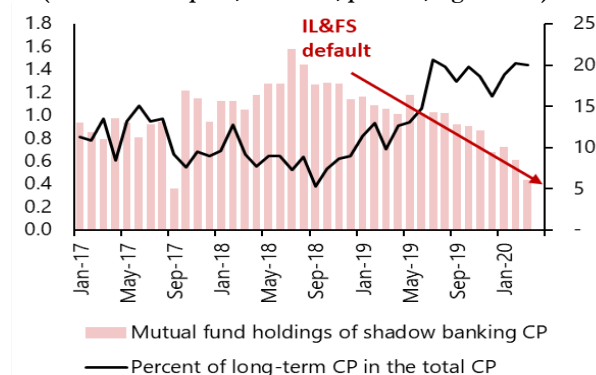
2. Commercial Paper Yields for major NBFCs (Percent; for maturities between 16-90 days)



3. New Bond Issuance by NBFCs / HFCs (Billions of rupees)



4. Debt Mutual Fund Holdings of NBFC Commercial Paper and the Maturity Profile of the Holdings (Trillions of rupees, left scale; percent, right scale)



Sources: Bloomberg Finance L.P.; Credit Suisse, Morgan Stanley, and Securities and Exchange Board of India.

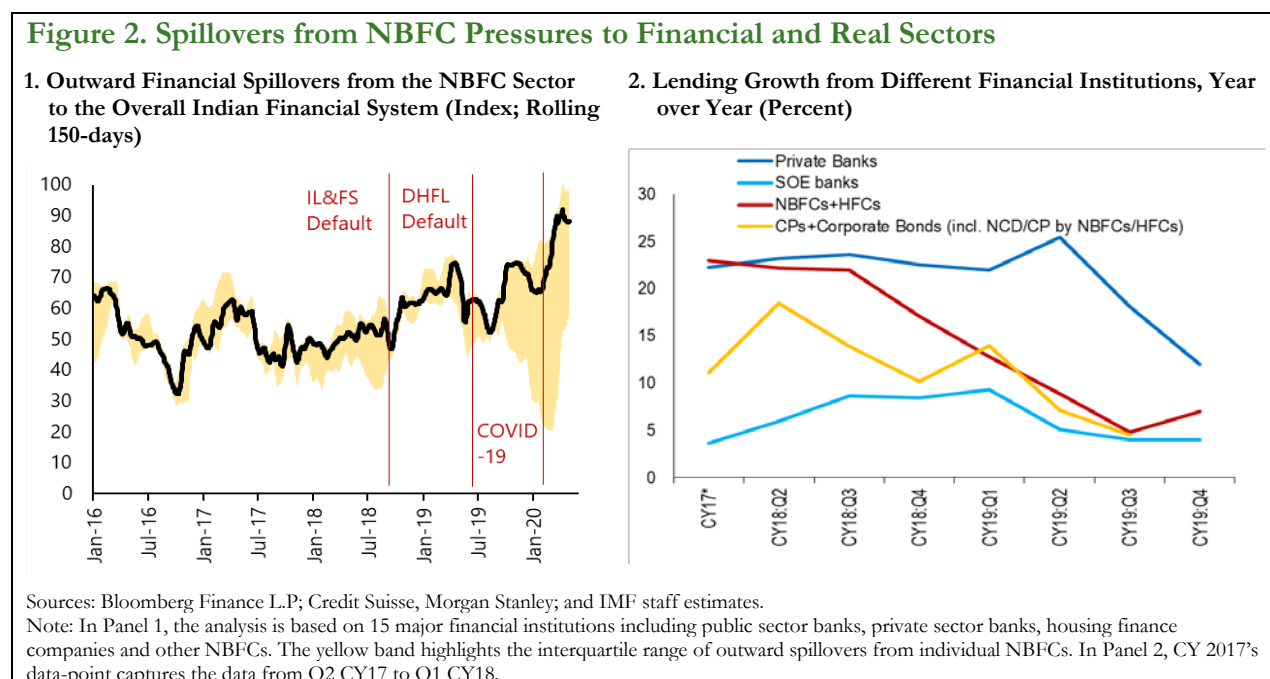
Note: CP = commercial paper. Panel 2 highlights select key major NBFCs (Edel = Edelweiss Financial Services; JM Fin = JM Financial Services; PEL = Piramal Enterprises Limited; L&T Fin = Larsen and Tubro Financial Services; HDFC = Housing and development Financial Corporation; LIC HF = Life Insurance Corporation Housing Finance)

Spillovers from the NBFC Sector

The pressures on NBFCs have spilled over to the rest of the financial sector. The spillover analysis based on equity prices of banks and nonbank financial institutions³ suggests that outward financial spillovers from the NBFC sector to the Indian financial system rose after the IL&FS default. The outward spillovers further increased sharply following the COVID-19 outbreak, and are at historical highs now (Figure 2, panel 1). The variation in the outward spillovers across different NBFCs also increased significantly, reflecting the market differentiation within NBFC sector, as well as potentially the extent of exposures to different financial institutions.

³ Spillover indices are calculated using the approach in Diebold and Yilmaz (2009, 2012), in which time-varying spillovers are constructed using rolling generalized forecast error decompositions. The index is the contribution from a shock to market X to the overall variability in any other market Y. The figure presents spillover indices for asset returns.

The strains in the NBFC sector also spilled over to the real economy, with lending growth by the NBFCs to the nonfinancial sector declining to less than 5% year over year in Q3 CY2019 from 20% year over year growth in CY2017/18 (Figure 2, panel 2)⁴. With limited access to funding, NBFCs were forced to prioritize preserving liquidity and containing the deterioration in asset quality over growing their balance sheets. This especially hurt the real estate and infrastructure sectors, which were heavily reliant on credit from NBFCs. At the same time, lending by the publicly owned banks has not picked up to offset this decline, exacerbating the credit crunch in India.



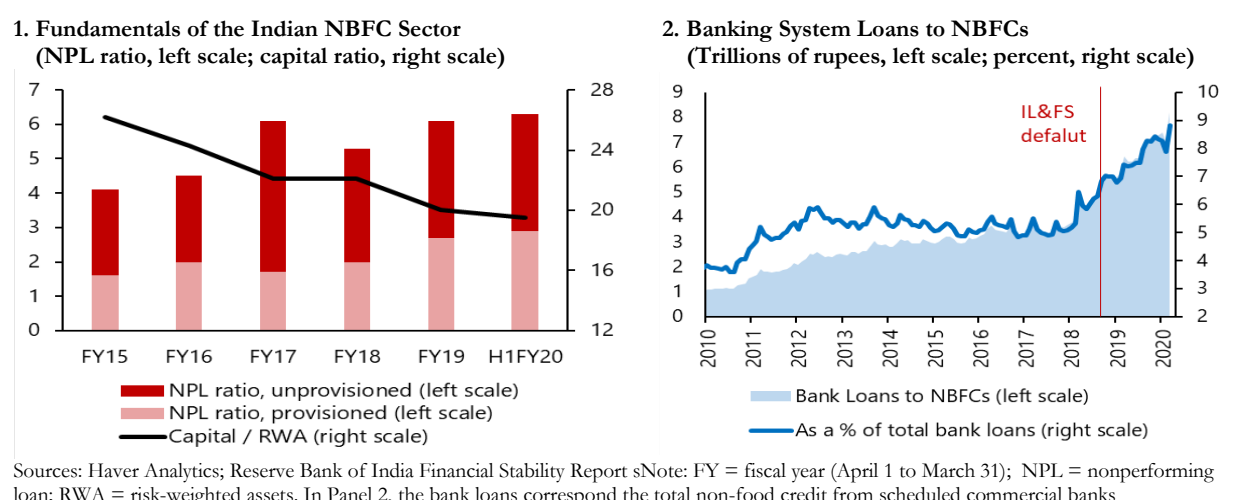
Risks and Vulnerabilities: Looking Ahead

The [underlying fundamentals](#) of the NBFC sector remain challenging, and the asset quality and capitalization of NBFCs will likely continue to deteriorate amid the COVID-19 induced economic slowdown. Over the last five years, the gross NPL ratio has risen by 2.2 percentage points, and the capital ratio has declined by 6.7 percentage points (Figure 3, panel 1). This has left the NBFC sector vulnerable to shocks.

Meanwhile, banks' exposures to NBFCs increased significantly in the past two years, with aggregate loans to the sector more than doubling to INR 8.2 tn (\$108 bn), driven in part by regulatory incentives aimed at supporting the NBFC sector. As a result, NBFCs now account for almost 9% of the total banking system loans, equivalent to more than 60% of Tier 1 capital (Figure 3, panel 2). This increased direct exposure of banks to NBFCs implies that strains at NBFCs can have a larger impact on the banking sector, increasing the overall fragility of the financial system.

⁴ India's financial year ends in March; so FY19 spans April 2018 to March 2019.

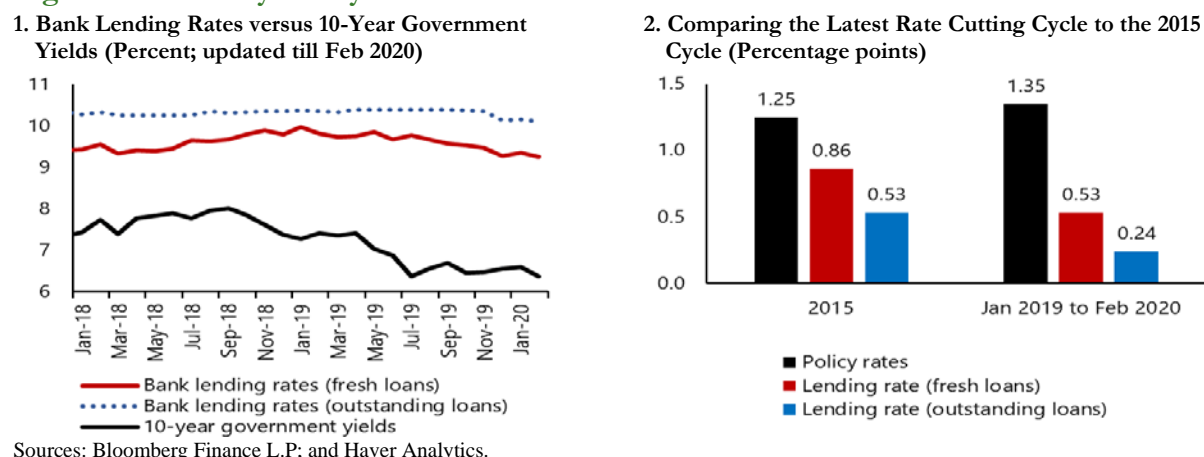
Figure 3. NBFCs' Asset Quality and Banking Sector's Exposure to NBFCs



Policy Transmission Still Muted

The transmission of monetary policy through bank lending rates appears to be clogged, reflecting in part long-standing structural challenges in the banking sector (weaknesses in governance, credit risk assessment, and management, as discussed in the IMF's and World Bank's recent Financial Sector Assessment Program ([FSAP/A-IV](#))). The RBI cut policy rates by 135 basis points in 2019 and extended significant liquidity support to the system. However, bank lending rates have declined only marginally during January 2018-February 2020 (Figure 4, panel 1), with the decline in lending rates with respect to a similar cut in policy rates only about half as large as the decline in 2015 (Figure 4, panel 2). In a bid to improve the transmission process, the authorities have also taken further steps including the [introduction of external benchmarking](#) of bank lending rates.

Figure 4. Monetary Policy Transmission in India



After the breakout of the pandemic, RBI has further cut rates by 75 bps and announced a host of [liquidity measures](#) including LTROs, CRR cut of 100 bps and an increase in the marginal standing facility. In addition, the RBI also opened a new credit facility for banks exclusively to meet the liquidity requirements of mutual funds following Franklin Templeton's shut down of six debt funds in late April. Despite the RBI's support measures, as well as strengthened [regulation](#) and [supervision](#) of NBFCs, the monetary policy transmission has remained muted.