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# India's shadow banking sector likely to face shake-up after default

BY REUTERS | UPDATED: SEP 28, 2018, 02.31 PM IST

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By Krishna N. Das and Neha Dasgupta

India's burgeoning shadow finance sector is likely to face a shake-up after defaults at one major lender battered the nation's financial markets in the past week and reinforced worries about credit risk.

Industry officials and experts say they expect Indian regulators to cancel the licences of as many as 1,500 smaller non-banking finance companies because they don't have adequate capital, and to also make it more difficult for new applicants to get approval.

The [Reserve Bank of India](#) (RBI), which has been tightening rules for [non-banking financial companies](#) (NBFCs), did not respond to requests for comment.

Better capitalised and more conservatively run finance firms are likely to swallow up an increasing number of smaller rivals, the experts said. That could make it difficult for many small borrowers to get loans, especially in the countryside where two-thirds of India's 1.3 billion people live, and put the brakes on a surge in private consumption with a knock-on effect on growth.

[Infrastructure Financing and Leasing Services](#) Ltd (IL&FS), a major infrastructure financing and construction company, sent shockwaves through the NBFC sector when it defaulted on some of its debt obligations in recent weeks.

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Then last Friday, a large fund manager sold short-term bonds issued by home loan provider Dewan Housing Finance at a sharp discount, raising fears of wider liquidity problems.

"The way things are unfolding, there is certainly cause for concern and the sector could see consolidation," said Harun Rashid Khan, a former deputy governor at the RBI and now a non-executive chairman at Bandhan Bank Ltd, formerly a microfinance company specialising in small-value loans.

"The whole issue is they have to take care of their asset-liability mismatch," Khan said in reference to concerns that some of the firms have borrowed short-term when their revenue streams are longer-term.

The spotlight has now been turned on thousands of "high-risk" small players dominating lending in villages and towns.

The shadow banking sector now comprises more than 11,400 firms with a combined balance-sheet worth 22.1 trillion rupees (\$304 billion), and is less strictly regulated than banks. It has been attracting new investors, particularly as the nation's banks have had to slow their lending as they seek to work through \$150 billion of stressed assets.

The NBFC loan books have grown at nearly twice the pace of banks, and the cream of them, including IL&FS, had received top credit ratings.

Those credit ratings are now being called into question - IL&FS has suffered a series of downgrades in recent months - and there are growing concerns that many of these firms took on excessive credit risk by lending to people with little means of paying them back. There are also growing questions about whether lax regulation has allowed some of these firms to be used for money laundering.

## **WINNOWER OUT**

Rising borrowing costs, exacerbated by the turmoil in markets in recent days, will lead to a credit crunch in the sector and make it difficult for firms that aren't well capitalised to survive, according to top investors in the sector.

"Smaller NBFCs will face the problem of cost, their quantum of liquidity may not be the same as they are getting now. But medium and large-sized NBFCs should be able to achieve their volume as well as access to funds," said Rajesh Sharma, owner of Capri Global Capital, an NBFC that had a loan book of 12.5 billion rupees (\$172 million) in the last fiscal year.

He added that in the absence of any financial incentive for NBFCs from the government, those who "can't manage their portfolio performance will perish".

The RBI has already been cancelling licences of those who do not have a minimum capital base of 20 million rupees (\$275,330).

"RBI has issued show-cause notices, given them time and is now in the process of cancelling their registration. Ultimately up to 1,500 should go out," said Raman Aggarwal, chairman of Finance Industry Development Council, an industry body.

At the same time, Aggarwal said the central bank is "flooded" with hundreds of new applications to set up NBFCs.

He denied there was any wider asset-liability mismatch in the sector. But bankers and former central bank officials said the scrutiny will be higher for newer players now that "asset-liability mismatches have magnified among existing NBFCs".

Nearly 11,000 of India's NBFCs are small and medium-sized businesses with an asset base of less than 5 billion rupees. But the top 400, many of which are backed by banks and finance companies, control about 90 percent of the assets under management, Aggarwal said.

### **"NOT RIGID"**

NBFCs have been differentiating themselves from banks by forming personal relations with customers despite charging up to 2 percentage points higher interest, said Aggarwal.

"They know the local market dynamics, they understand the local economics, so you can take a credit call based on the first few minutes of discussion with the borrower," he said.

Unlike banks, NBFCs are "not rigid" and lend to even those borrowers who may never had a bank account, credit history or tangible assets, Aggarwal said. That could include someone buying a motorised rickshaw or setting up a small restaurant.

Analysts say the current uncertainty in the market will mean NBFCs with financially strong backers such as LIC Housing Finance Ltd, Power Finance Corp, Rural Electrification Corp, Bajaj Finance and Cholamandalam Investment and Finance will stand out.

And there is set to be an acceleration in deals, they said.

Over the past two years, [IDFC Bank](#) has bought Grama Vidiyal Micro Finance, [Kotak Mahindra Bank](#) bought BSS Microfinance, [RBL Bank](#) took over Swadhaar Finance while [IndusInd Bank](#) has announced the acquisition of Bharath Financial Inclusion.

"There should be some consolidation in the market and regulation," said S.S. Mundra, a former RBI deputy governor who is now on the board of Indiabulls Housing Finance Ltd, a home loan provider.

"That would be good for the system in the long run."

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