

# Shadow Banking: Why and how to strengthen NBFCs

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The spectre of shadow banking has once again reared its ugly head. The outcome has been a stock market rout, adversely impacting non-banking finance companies (NBFCs). Shadow banking is a wide-sweeping term used to describe any financial activity outside of the banking system. Globally, the Financial Stability Board estimates shadow banking to be worth \$45 trillion, representing 13% of the world's financial assets.

Shadow banking is often construed as dodgy or toxic assets which are out of the purview of regulators. NBFCs, too, get clubbed under shadow banking, despite being well under the regulatory ambit. Perhaps a more drill-down definition of shadow banking is needed. NBFCs do not have privileges of lender of last resort or of deposit insurance. Yet, it would be erroneous to deduce that NBFCs in India have light-touch regulation and are therefore riskier than banks. NBFCs largely perform the role of credit intermediation in spaces where bank funding has been lacking or absent. The financial needs of the Indian economy are diverse and cannot be fulfilled by the banking sector alone.

Despite various safeguards, globally, it is not unusual for a financial institution to go belly up. It is in these times that the strength of the sector gets best tested. Regulators and other mandarins of the Indian financial sector are already at work on the beleaguered IL&FS. At this juncture, it is anyone's guess as to how quickly the rest of the NBFC sector can get back to business as usual. NBFCs have got trapped by tight liquidity and rapid sell-offs in the equity markets. Mutual funds who have invested in market instruments of NBFCs have faced increased redemption pressures. One hopes that, from here on out, there will be no further cascading impact. Open market operations should increase liquidity and if this stabilises the sector, further backstop arrangements would not be needed.

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Every shake-up in the financial sector has led to an assessment of the regulatory framework. In 1996, following the collapse of a large NBFC, RBI mandated that no new NBFC would be permitted to raise deposits from the public. Subsequently, when the NBFC sector began relying heavily on the banking system for funding, RBI put in place exposure limits for lending to the NBFC sector. RBI also introduced asset side prudential guidelines for NBFCs.

A critical point of intervention was in 2008-09, when there was a liquidity freeze triggered by the global financial crisis. Even sanctioned credit lines from banks were frozen. To provide respite to systemically important NBFCs that were financially stressed, RBI set up a short-term liquidity support system through a special purpose vehicle (SPV). Few may recall that, in February 2009, it was IDBI Bank that was used to create the Stressed Assets Stabilisation Fund Trust. This SPV purchased short-term papers from eligible NBFCs to help meet temporary liquidity mismatches. The SPV window was for a three-month period, but markets stabilised much faster. That crisis emphasised the need for strong liquidity management mechanisms for NBFCs, particularly to tide over periods of stress. So what might be the way forward to strengthen the regulatory framework for NBFCs over the longer-term?

Firstly, there has already been a recognition that the number of NBFCs, currently at over 11,000, is far too unwieldy. The process of cancelling licences of NBFCs who have not met the minimum capital requirements is already underway. However, given the growing size and dominance of the NBFC sector, it is important that the threshold capital levels for entry be substantially increased. Currently, depending on the type of NBFC, minimum capital requirements range from as low as Rs 2 crore in the case of certain NBFC-Micro Finance Institutions, Rs 100 crore for asset reconstruction companies and Rs 300 crore

for infrastructure NBFCs. It may be prudent for RBI to evaluate the need to shore up minimum capital requirements for various NBFCs.

Secondly, while RBI has identified systemically important NBFCs, it needs to step up the monitoring of NBFCs which belong to large, diversified groups. Checks and balances are needed to ensure that risks do not build up in the sector due to structures which are too-complex-to-manage. When there are multiple entities, the ability to shift assets from one balance sheet to another increases, leading to opaqueness in determining the actual quality of the asset.

Lastly, RBI could consider re-visiting some of the unimplemented recommendations of the Working Group on Issues and Concerns in the NBFC Sector chaired by Usha Thorat in 2011. One such recommendation was the introduction of a liquidity coverage ratio for NBFCs. The objective was to ensure that NBFCs have cash balances and holdings of government securities which may fully cover gaps between cumulative outflows and cumulative inflows for the first 30 days. This would be the buffer in times of stress. At that time, this recommendation may have been resisted by the industry under the guise of being too onerous for a sector that was just recovering as it does entail additional costs. Yet, with the benefit of hindsight, one does wonder if the present crisis might have been averted if this recommendation had been accepted.

The contribution of NBFCs must not be undermined. The raison d'être of NBFCs in India is to supplement and complement the banking system. Fortunately, this time, RBI already has a blueprint in hand to further strengthen the NBFC regulatory framework.

*-The writer works for a leading housing finance company. Views are personal.*

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