Regulating NBFCs – II

What is the issue?

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NBFCs and banks need not be treated in the same manner and hence sector-specific measures are needed to revive the sector.

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Click here to know on the basics of NBFC sector

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Click here to know more on the issue

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What is the background?

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- Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note with a maximum validity of one year.
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- After the IL&FS default, the Indian bond market got very concerned about commercial paper issued by NBFCs.
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- This has translated into a tough stress test for NBFCs.
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- Bond market investors are now looking beyond credit ratings of NBFCs, which has resulted in better NBFCs getting capital while others are not.
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- NBFCs are fundamentally different from banks and insurance companies in that the NBFCs generally do not accept deposits, unlike banks.
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- Hence, there is no problem of an assured rate of return and the need to maintain liquidity for NBFCs.
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- This was also a major reason why a micro-prudential regulation on the operations of NBFCs was not deemed necessary.

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What are the concerns?

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- **Lack of IFRS accounting** - International Financial Reporting Standards provide a common global language for business affairs so that company accounts are understandable and comparable across international boundaries.
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- They are the rules to be followed by accountants to maintain books of accounts which are comparable, understandable, reliable and relevant as per the users internal or external.
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- Indian NBFCs need to move towards IFRS to have a clear picture of market-based valuation of their assets.
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- This would help the market investors to analyse the stress early in the concerned NBFCs and would avoid investing in them.
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- **Usage of credit ratings** - It is getting too easy for an institutional investor in India to make bad decisions based on mere credit-ratings.
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- Though Credit-rating agencies are a valuable opinion on the credit risk of an issuer, regulators should stop requiring that credit ratings be obtained.
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- This will make Institutional investors to think for themselves in assisting their decision process.
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- **Failure of Indian bond market** - Heavy growth of mutual fund investments in India results in a sharp collapse in purchases of bonds issued by NBFCs.
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- Collective investment schemes based on bonds issued by NBFCs need to be illiquid (not easily getting converted into cash) so that a stable investment is maintained.
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What should be done?

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- When an NBFC balance sheet exceeds about 1% of GDP, its default can have systemic consequences.
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- Thus, there should be a minimal form of micro-prudential regulation that will assist resolution for defaulting NBFCs.
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- NBFCs also require a specialised bankruptcy code operated by a resolution corporation to pave the way for quick bailouts.
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- Some NBFCs have household investors, and thus a consumer protection mechanism to address issues such as sales practices and coercive collection practices needs to be framed.
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- Thus the RBI needs to frame an overarching mechanism to pave the way for sound information disclosure on the operations of NBFCs, so that a stable investment gateway for this sector shall be ensured.
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- Also, in the future, deposit-taking NBFCs could graduate into banks as and when their financial portfolio gets increased as that of banks.
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Source: Business Standard

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