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SHADOW BANKING IN INDIA- A REVIEW OF THE CRISIS THAT ENGULFS OUR NBFCS

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ABSTRACT

Shadow banking via 'Non-banking Financial Institutions' or NBFCs in India has steadily increased in India, especially in the past decade or so. The term first gained popularity in the aftermath of the Financial Crisis of 2008, to throw light on those entities which performed bank like functions of lending, but were outside the realm of the traditional banking sector. The importance of the NBFC sector cannot be more understated, for it has subsumed a large chunk of the market as traditional banks cannot afford to take on the entire burden of credit creation, considering the size of the Indian economy and the ongoing liquidity crisis they are faced with. Equally important it is to note the dangers of the NBFC sector, in the backdrop of light regulations, due to banks receiving more importance in terms of protection of depositors, as they are seen as far more vulnerable owing to the direct impact that banks have in the scenario of a potential liquidity crisis. However, the recent near-collapse of some of the most prominent NBFCs- the IL&FS and DHFL default, have reignited discussions on the dangers of the sector and tightened the screws on the regulations. These defaults have also exposed the poor financial management, lack of proper due diligence and downright overtly risky behaviour undertaken by NBFCs. The paper delves into a comprehensive analysis of the NBFC sector, and looks into the structural reasons as to why IL&FS and DHFL defaulted, whether the environment these NBFCs found themselves in encouraged an overtly risky behaviour, and the way forward.

Keywords: *credit creation, defaults, financial management, liquidity, regulation, risk*

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Introduction

In a growing modern economy, the standard banking sector cannot take on the pressure to provide for all the credit and financial services required to fuel the large scale economic activity that takes place in a nation. As the economy grows, the need for credit also continuously expands as well, and this availability of credit must be fulfilled by entities other than banks. Much of the funding for large scale infrastructural projects and ventures comes from entities known as 'Non-Banking Financial Companies', or NBFCs. They are a part of the phenomenon, known as 'Shadow Banking'. The term was popularised during the financial crisis of 2008, as it brought to light many entities that mimicked the behaviour of banks but were outside the regulation of the formal banking sector. A more exhaustive definition has been adopted by the Financial Stability Board, where they define NBFCs as-"credit intermediation involving entities and activities (fully or partially) outside the regular banking system[1]."

In India, NBFCs constitute a significant proportion of our economy, as multiple sectors have been funded by shadow banks. Because of their increasing importance, NBFCs over the years have carved out niche areas for themselves in terms of funding and financing, for example-infrastructure financing, auto-financing, housing finance, insurance and venture capital companies, etc.

While NBFCs perform functions similar to banks, there are certain key differences. NBFCs generally do not accept demand deposits. Out of the total 9,642 NBFCs in the country, only 82 of them were deposit taking (NBFCs-D).[2] Further, NBFCs do not form part of the payment and settlement system and cannot issue cheques upon themselves.

It is because of these key differences that there are no strict regulations over this sector, since protection of depositors and public money is something that immediately mandates supervision by the central bank, be it in any economy.

Legal Framework for NBFCs

Non-Banking Financial Companies/NBFCs in India are formed and governed primarily by the Companies Act, 2013, as the Banking Regulation Act, 1949 has no mention of such institutions.

[1] Financial Stability Board (FSB), Global Shadow Banking Monitoring Report 2017, 5th March 2018.
[2] Reserve Bank of India, Report on Trend and Progress of Banking in India 2018-2019.

Additionally, all NBFCs are required to obtain a certificate of registration from RBI under Section 45-IA of the Act, subject to certain conditions.[3] RBI also holds the power to cancel the registration granted to NBFCs.

Apart from the Companies Act, 2013, NBFCs are also regulated by certain other authorities depending upon the sector they are servicing. The National Housing Bank, for example, regulates housing financing companies, whereas the Insurance Regulatory Development Authority of India regulates insurance companies (IRDAI).

RBI Regulations

The collapse of the IL&FS and DHFC, two major NBFCs in our financial sector, sent shockwaves in the market, throwing it into a spin. The collapse of these two entities not only resulted in a credit crunch, but pushed an already slowing economy towards recession. These were just two of the multiple NBFCs that are present in our country, yet their collapse brought to the forefront the significance these institutions hold in the modern economy, and how it is far more than what was perceived earlier.

As mentioned, the traditional perspective as to why NBFCs were subject to little to no regulations was because core banking sector assumed more importance, because at the heart of it, lies public interest in form of acceptance of deposits from them. Further, banks perform a key function of converting short term borrowings or deposits into long term credit or asset. This also poses a liquidity risk for banks, which is another reason why NBFCs are not required to maintain any CRR/SLR ratio. For these reasons, banks are subject to a much more stringent regulatory framework, than NBFCS.

Scale based Framework for NBFCs

In January 2021, RBI published a discussion paper on a revised regulatory framework for NBFCs for public comments, and based on the inputs received, the regulatory framework would now be made applicable to all NBFCs, effective October 2022. [4]The purpose of the discussion paper was basically to tighten the norms in the aftermath of the collapse of the two major NBFCs, to prevent any systemic risk spill-overs should a similar crises happen again.

Essentially, a regulatory structure comprising of a four layer pyramid structure, based on their size of operations, risk perception and activity has been proposed. All of this is based on the

[3] RBI Act, 1934, Section 45-IA.
[4] RBI Notification RBI/2021-22/112, Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCs, October 22, 2021.

principle of proportionality in regulation, where the degree of regulation of a financial entity is directly proportional to the systemic risk it poses to the financial system.

Coming to the four layered structure, the bottom tier NBFCs will be known as base layer (NBFC-BL), comprising of non-deposit accepting entities with an asset size less than 1000 Cr. The second layer, known as middle layer (NBFC-ML), would comprise of both deposit taking and non-deposit taking but systemically important NBFCS, where the regulatory regime will be stricter than the base layer but still not as stringent as the upper layer. The prudential norms will keep increasing as one moves up the pyramid. Around 25-30 NBFCs are expected to fill up this layer, as would be identified by the RBI.

In the upper layer, NBFCs specifically identified by RBI as having systemic spill-over of risks will be subject to stricter regulatory requirements, including top ten NBFCS based on asset size to be included in any case. Out of these NBFCs, certain specific ones might be pushed into the top layer for higher supervision, if they pose extreme systemic risk. But ideally, the top layer would remain empty, unless specifically communicated by the RBI.[5]

However, the categorization of the different layers in the proposed regulatory framework lacks a common criteria. For the base layer, the threshold is 1,000 Cr but also their inclusion based on the activities they undertake-BFC-Peer to Peer Lending Platform (NBFC-P2P), Non-Operative Financial Holding Company (NOFHC) and NBFCs not availing public funds and not having any customer interface, etc. For the latter set of entities, they have been included irrespective of their asset size. In the middle layer again, categorization is done on the basis of threshold of a 1,000 Cr and above for NBFCs-ND, as well as on the activity they undertake, which is primarily dominated by infrastructure finance companies. The upper layer, as mentioned, will include those NBFCs as identified by RBI which need a heightened level of supervision, while the top layer is expected to remain empty for now. Hence, there is an absence of a common criterion on the basis of which the NBFCs are categorized. [6]

Further, RBI expects at least 9,133 NBFCs to fall in the Base Layer, as they have asset size of less than Rs 500 Cr, thus by raising the threshold of systemic significance to Rs 1,000 Crores, the number of NBFC's finally expected to fall in the lowest level of pyramid is expected to be

[5] Reserve Bank of India, Discussion Paper on Revised Regulatory Framework for NBFCs: A Scale Based Approach, 2021 <https://m.rbi.org.in/Scripts/PublicationsView.aspx?id=20316> Accessed 22/03/22 at 12:00 P.M.

[6] Arvind Awasthi and Siddharth Shukla, Bank-like Regulations for Non-banking Financial Companies: A Cautionary Approach, Vol. 57, Economic and Political Weekly 7 (2022).

around 9,209. What this implies is that since majority of the NBFCs fall in the BL, they can get away with minimal regulations.[7]

Corporate Governance Framework

Along with the change in prudential norms for NBFCs, RBI has also proposed a new corporate governance framework for NBFCs, to allow these entities to implement best practises and increase transparency in their operations. This becomes all the more important for potential high-risk NBFCs, which, if left unregulated and unchecked, could have an adverse and negative impact on the financial system.

Firstly, the new framework mandates prior experience of at least one director of having worked in a bank/NBFC, while the rest of the board will have an adequate mix of experience and educational qualifications.

Further, every non-deposit systemically important NBFC as well as deposit taking NBFC, i.e., NBFC-ND-SI and NBFC-D , is required to form a Risk Management Committee, to analyse various risks, including that of liquidity.

Thirdly, the Key Managerial Personnel of one particular NBFC shall not serve in any other NBFC in the same capacity, except the ones falling in the Base Layer. As a corollary to this, to prevent any conflict of interest on part of Independent Directors, they shall not be allowed to be on board of more than three NBFCs, including that of competing companies. Again, this is not applicable to NBFC-BL.[8]

Lastly, amongst other various norms, all NBFCs in the middle and upper tiers must now appoint a chief compliance officer to lead an independent compliance unit. Further, they also have to now provide for a whistle-blower mechanism to report genuine concerns and bring to light the mismanagement of the board, if need be. It is important to note that there might be slight variations as to the corporate governance norms, depending upon which NBFC layer one is looking at. The idea behind such changes is that even if the regulations fall short, there is still a safety valve in the form of improved governance standards.

India's Shadow Banking Crisis-Recent Developments

[7] Supra Note 5.
[8] Ibid.

The IL&FS Collapse

The journey of Infrastructure Leasing and Financial Services Ltd, or IL&FS, from being a top rated NBFC to hurtling towards bankruptcy, is considered to be one of the main actors of the economic slowdown that we are currently faced with, as it started the liquidity crisis in India's shadow banking sector.

IL&FS had been facing a liquidity problem for quite a while, before it defaulted on the debt it owed to SIDBI-a short term borrowing of Rs 1,000 Cr taken from Small Industries Development Bank of India. Soon after, one of its subsidiaries delayed the payment of a Rs 450 Cr. of inter-corporate deposits, also taken from SIDBI. What followed soon was default on multiple repayment obligations by a financial entity-both the parent company and its subsidiaries, who had financed infrastructure project close to a lakh crore. The IL&FS enjoyed a triple-A rating from the rating agencies.[9]

The intense media scrutiny that followed the default of what once was arguably one of the biggest NBFCs, pointed towards serious irregularities in the way the management of the company took place. Soon after, the government used the power under Section 241[10], by applying to the National Company Law Tribunal, and dismantled the IL&FS board as 'the affairs of IL&FS were being conducted in a manner prejudicial to the public interest'. Kotak Mahindra Bank Ltd's MD and CEO Uday Kotak was asked to chair a new board, as part of an immediate rescue plan to save the company.

An investigation by the Serious Frauds Investigation Office, SIFO, a body under the Companies Act and controlled by the Ministry of Corporate Affairs, found serious lapses in the way the NBFC was functioning. It found "rampant evergreening of loans by the group; and it alleged "inflated profits, suppressed provisioning and non-disclosure of possible NPAs". What was essentially revealed was a modus operandi of a sort of pyramid scheme where the holding company borrowing loans, would lend the same loan to its subsidiaries at a higher rate of interest. Each loan taken was to service the loans taken earlier. [11]

Of course, there are far more complexities in the way the company functioned, but the fact of the matter is that the holding company managed to show itself as financially strong while its

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[9] Andy Mukherjee, India is having its own mini-Lehman moment on 10th anniversary of global financial crisis, The Print (13 Sept 2018) <https://theprint.in/opinion/india-is-having-its-own-mini-lehman-moment-on10th-anniversary-of-global-financial-crisis/117042/> Accessed 20/03/2022.

[10] Companies Act 2013, Section 241(2)- Application to Tribunal for relief in cases of oppression and mismanagement.

[11] Tamal Bandhopadhyay, Pandemonium: The Great Indian Banking Tragedy, Roli Books, 2020.

subsidiaries struggled under the weight of rising liabilities. The debt taken on by IL&FS had been increasing years before its collapse.[12]

Corporate 'Misgovernance' at IL&FS

As noted earlier, the default committed by the NBFC led to an instant action by the government taking remedial steps and putting in place a new board of directors, led by Uday Kotak.

However, the previous group of directors were in control of affairs of the company for over 20 years before the collapse took place. Ravi Parthasarathy, the chairman of the NBFC, who was a non-executive director since October 2017 and stepped down a few months before the default, along with Hari Sankaran, the former managing director were at the helm of affairs of the NBFC.

To understand the corporate governance failure in IL&FS, it is pertinent to also take a look at the corporate's shareholding pattern. LIC, CBI and SBI were some major shareholders in the NBFC. The board had nominees of these institutions as directors, and the independent directors included some of the most eminent and brightest in the business- RC Bhargava, the chairman of Maruti Suzuki, Sunil Mathur-former LIC chairman. Yet, there was a major oversight in terms of accountability, as the NBFC was laden with debts for the last few financial years before its crisis, as the company posed losses since FY 2016. Given the poor performance of the NBFC being in public domain, no one flagged any concern[13].

It was also revealed by SIFO in its investigation that the management of the now debt-laden NBFC enriched itself with hefty salaries and managerial perks.

The company and its subsidiaries gave jobs to IAS officers, in director-al roles. The SIFO revealed collusion by various such officers, and a failure of supervision on their part, making it a bureaucratical failure as well.[14]

Further, the Risk Management Committee of the NBFC, which is an important committee in any such institution, had only met once, in FY 2015. Since then, the committee did not hold a single meeting.

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[12] <https://economictimes.indiatimes.com/industry/banking/finance/banking/government-takes-control-of-ilfs-6-member-board-led-by-uday-kotak-set-up/articleshow/66028670.cms> Accessed 20/03/2022, 12:00 P.M.

[13] Hemindra Hazari, Behind IL&FS Default, A Board that Didn't Bark When It Was Supposed To, The Wire (17th Sept 2018) <https://thewire.in/business/behind-ilfs-default-a-board-that-didnt-bark-when-it-was-supposed-to> Accessed 20/03/2022.

[14] Sucheta Dalal, 'IL&FS: SFIO Investigation Throws up new leads on Insolvent Bank's Dealings' The Wire (5 April 2019) <https://thewire.in/banking/ilfs-mess-sfio-investigation-new-dirt> accessed on 20/03/2022.

What is even more shocking is the fact that IL&FS was registered with the RBI and categorized as a systemically important NBFC, yet it allowed the situation to continue for so long, even when the knowledge of it being in murky waters was in public domain.

Crux of the Problem-Liquidity Crisis

While corporate mismanagement might be part of the problem, there are several other market factors that led to the downfall of the NBFC. There is a fundamental problem that is unique to infrastructure financing in India-one of asset liability mismatch.

Infrastructural financing has in its inherent nature multiple risks- delayed implementation, high costs, delay in regulatory approvals, and of course other unforeseen contingencies that any business might have to face. The financial market for infrastructure financing in the recent years has seen a dip, following which IL&FS had to rely on short term loans to fund its projects. This can be attributed to the aftermath of demonisation, where banks were flooded with cash in form of deposits, mutual funds, and other short-term money.

Many NBFCs capitalised on this market condition, as public sector banks were already dealing with the crises of bad loans and non-performing assets-NPA. Thus as a result of this, NBFCs started lending more, much of this fund coming from mutual funds in forms of debentures and commercial papers.[15]

Where the problem for IL&FS began was it defaulted on its short term loans or liabilities while revenue from its assets were forthcoming in the longer term. IL&FS had to resort to short-term borrowings, including commercial paper. They are a form of unsecured debt, usually only lent to high-credit rated companies as they are not backed by any collateral guarantee. Banks usually have access to a stable form of short-term borrowing-known commonly as deposits, but not NBFCs.[16]

The problem was one of illiquidity, as a result of deployment of short term loans in long term assets. The asset-liability mismatch is particularly prominent in the infrastructure sector, which is an inherent feature of this market. Lacking liquidity, the short-term lender start demanding an early redemption and the investors lose confidence. This precisely is the fate that IL&Fs

[15] Supra Note 10, at pp 156-158.
[16] TT Ram Mohan, IL&FS was an Avoidable Crisis, Vol. 53 HT Parekh Finance Column 45 (2018).

met. To rescue the NBFC, the RBI and government acted quite promptly, otherwise it would have likely faced bankruptcy.

DHFL Crisis

Since the IL&FS financial crisis, the NBFC sector has suffered a loss of confidence. Inevitably, the default created a ripple effect in the market, but affecting other NBFCs. One such company, Dewan Housing Finance Corporation Limited (DHFL), another triple-A rated company, defaulted on its repayment obligations worth Rs 900 Cr.

A number of factors were involved, including that of market conditions and corporate mis-governance. A special review revealed that loans were disbursed in violation of internal corporate governance loans, to entities which hardly had any operations, as well as advances and fund diversion to entities linked to its promoters, making these entities untraceable.[17]

Nevertheless, this put the NBFC in a difficult position, as its collapse would carry substantial costs to the entire banking sector at large, a sector which is already beleaguered. It would have the effect of causing a turmoil in the entire financial market. To prevent that and for meeting financial obligations, DHFL sold its stakes in its non-core companies. As a remedial and quick action measure, the RBI sacked the entire board of DHFL citing corporate governance failures and its default.[18]

DHFL being the next major shadow bank after IL&FS, involving public money, cannot risk being bankrupt. As a result of the same, a draft resolution plan was proposed to rescue the debt-laden NBFC. In September 2021, DHFL merged with the Piramal Group, as the Piramal Resolution Plan was approved by the NBFC's creditors. DHFL will merge with Piramal Capital and Housing Finance Ltd. (PCHFL) and the merged entity will be named as PCHFL.[19]

The Fault Lines in our NBFCs

Limited Liability Structure a Risk for NBFCs?

[17] <https://www.bloombergquint.com/business/questions-raised-by-kpmg-on-dhfls-transactions> Accessed 20/03/2022 at 19.00 P.M.
[18] Rohan Venkataramakrishnan, What happened to finance firm DHFL – and what that means for the Indian economy <https://scroll.in/article/926444/scroll-explainer-what-happened-to-finance-firm-dhfl-and-what-that-means-for-the-indian-economy> Accessed 20/03/2022 at 19.00 P.M.
[19] Lalatendu Mishra, Piramal group acquires DHFL, pays ₹14,700 crore in cash <https://www.thehindu.com/business/Industry/piramal-group-acquires-dhfl-pays-14700-crore-in-cash/article36730639.ece> Accessed 20/03/2022 at 19.00 P.M.

Non-Banking Financial Companies in India are formed under and primarily governed by the Companies Act, 1956, or 2013, as the case may be. All major NBFCs are limited liability companies. This can in fact have the tendency to enable overtly risky behaviour by these companies, as it can create incentives for businesses to take excessive risks, especially considering the exposure of NBFCs to niche sectors. The rule is simple-because liabilities of shareholders are fixed and limited, it can influence the board to indulge into riskier investments, which if in case they pay off, would yield fruitful results. However, if they fail, the shareholders only have personal liability up to the shareholding they own.[20]

Thus in essence, the costs of taking risky business decisions is more or less externalised. Even in the event of default by a shadow bank, for third parties affected by the default-in most cases, there is an asset-liability mismatch and thus, limited liability has less practical repercussions, due to an inherently flawed functioning model of NBFCs. Thus, often third party financial institutions affected by the default might not be able to recover their funds, due to insufficiency of capital with that NBFC.[21]

This precisely seems to be the case with IL&FS, where even though its board included business luminaries as directors, and some of most eminent shareholders, they did not raise a flag of concern despite the fact that the NBFC's financial performance had been deteriorating a few years prior to its near-collapse. It covered up its bad loans by moving around funds within the company, as mentioned in the previous section.[22]

Further, linking the asset-liability mismatch with limited liability approach, the act of using short-term borrowing to finance long term-projects is a common practice resorted to by shadow banks, both in India and globally. Banks have access to stable short-term borrowings-deposits from the general public. On the other hand, for NBFCs, the possibility of long-term initiatives being funded on a short-term basis increases the likelihood failure as the possibility to pay back the debt is delayed by several years. [23] Therefore, limited liability creates systemic failure even outside the shadow banking sector, as it incentivises a liquidity risk. A failure to refinance or roll-over a previous debt can trigger a collapse of the entire system-what is traditionally known as a chain of failures or systemic consequences.

[20] Henry Hansmann and Reiner Kraakman, Toward Unlimited Shareholder Liability for Corporate Torts, Vol. 100 The Yale Law Journal 7 (1991)
[21] Steven Schwarcz, 'The Governance Structure of Shadow Banking: Rethinking Assumptions About Limited Liability' Vol 3 EY Global Financial Services Institute 1, (March 2015)
[22] Supra Note 13.
[23] Sayantan Chanda, The Wolf of Dalal Street: Re-Thinking Liability Frameworks for Shadow Banks, Vol. 7 NLS Business Law Review (April 2021).

Supervision and Compliance the Root Cause

The near-collapse of IL&FS and DHFL has been touted as a regulatory failure by many. One of the core reasons being the fact that IL&FS had been added to the non-deposit systemically important list of the RBI, making it subject to prudential regulations and allowing it to have greater control over the shadow bank.

Former Chief Economic Advisor, Arvind Subramaniam, has been a critic of the Reserve Bank's regulatory role in the IL&FS crisis. He believes that the problem is not with the existing regulations, but rather the compliance of those regulations. IL&FS prior to its default was not on anyone's radar with regards to its estimates of stressed assets.[24]

Further, as mentioned earlier, the modus operandi of the NBFC to hide its true financial position was to move around loans within its own key subsidiaries, maintaining a disguise of a sound financial health of the company. Further, a 2019 RBI report revealed that the company was able to hide four years of bad loans from it. What all this essentially points to is that instead of focussing on the ambit of regulations and revising it from time-to-time, the actual focus should be compliance, monitoring and supervision mechanisms to prevent further banking crisis.

Conclusion and Recommendation

The NBFC sector in India has experienced a robust growth, as the credit growth in the traditional banking sector has been moderately slow owing to the rising crisis of stressed assets or non-performing assets for banks. Non-banking financial companies (NBFCs), emerged as alternative intermediaries of finance, as due to the bank's balance sheet crisis, there was a credit vacuum which paved the way for the rise of such institutions. Currently, the NBFCs and other shadow banking entities account for about 17% of total credit in the country. [25] The relevance as primary providers of commercial credit has not only significantly increased in the past decade, but is also more likely to increase in post-COVID times, as they have become the crucial lenders for certain niche sectors of the economy.

Given their exposure to high-risk niche segments, and no direct contact with the general public in forms of their deposits, they primarily rely on funding from banks, and short term loans such as commercial papers. This poses a unique risk which causes an inherent structural problem,

[24] Arvind Subramaniam, Excerpt from 'Of Counsel: The Challenges of the Modi-Jaitley Economy,', Penguin Viking (2018).
[25] Reserve Bank of India, Report on Trend and Progress of Banking in India 2017-2018.

that of liquidity. From a regulatory standpoint, NBFCs are not as stringently supervised and regulated by the RBI as traditional banks. This partly stems from the factor of feasibility, of supervising close to 10,000 NBFCs as compared to 90 scheduled commercial banks, but also the fact NBFCs serve those sectors that are underserved by traditional commercial banks due to reasons such as high operating costs, already stressed balance sheets, etc[26]. Even the RBI recognised that NBFCs serve particular sectors/ regions and that "their uniqueness must be preserved to ensure sustained flexibility of their operations in the last mile of credit distribution", when developing new scale-based regulations for the industry.

However, in the past few years, the shadow banking sector seems to be in trouble with the default of some of the most prominent NBFCs, such as the IL&FS and the DHFL . As investors started pulling out, from both the securities of the NBFCs as well as mutual fund companies which had the maximum exposure to the sector, the entire sector began to experience a crisis of confidence. The shadow banking sector faced a serious liquidity crisis, as multiple companies found it difficult to roll-over their debts or raise loans altogether. Though IL&FS was saved by the grace of government intervention, and DHFL has since merged with the Primal Group, the confidence crisis in shadow banking has exposed the hidden faults of the sector.

NBFCs in India, and globally too, have an inherently risky and flawed business model-the use of short term borrowings to raise long term assets. This leads to an amplified problem of an asset-liability mismatch. In good market conditions, the companies roll-over the existing loan. However, when the market is volatile, it becomes difficult for the NBFC to raise funds. To alleviate this problem to some extent, it becomes important that India develops and deepens its bond market, so that NBFCs can reduce their excessive reliance on banks, which themselves are in a frail condition.

Or more specifically, the market for covered bonds-a class of securities that is secured by a pool of assets. Investors have recourse to those set of assets that act as collateral if the issuer of the bond defaults or becomes insolvent, essentially acting as a double safety valve as there exists double recourse. These type of bonds are especially common in overseas market, like in Europe. [27]

[26] Rajeswari Sengupta, Lei Lei Song, and Harsh Vardhan, A Study of Nonbanking Financial Companies in India No. 83, Asian Development Bank South Asia Working Paper Series (October 2021)
[27] Ridhima Saxena, Covered Bonds: A Liquidity Fix for NBFCs Amid the Pandemic, Bloomberg Quint (Jun 2021) <https://www.bloombergquint.com/business/covered-bonds-a-liquidity-fix-for-nbfcs-amid-the-pandemic> Accessed 23/03/22 at 12:00 P.M.

In India, covered bonds are slowly gaining traction as it helps investors/lenders to overcome their liquidity problem, as these bonds would be traded in an open market, and further, they reduce the funding cost as covered bonds are highly rated. Another legal advantage of covered bonds is that assets held in trust for a third party would be excluded from the liquidation estate. and would not be used for recovery, under the IBC.[28]

From a practical standpoint, as long as NBFCs turn to banks for primary funding, they will continue to be tightly regulated as in the aftermath of the IL&FS default and the already beleaguered state of banking in India, any default committed by a shadow bank on public money would be detrimental to the entire financial system, triggering another major crisis. While NBFCs need to be tightly gripped, their excessive reliance on banks would prevent them from fulfilling its purpose of serving nice and un-served areas.

However, bond markets may not always work well and be dependable as there is a chance that it may squeeze liquidity out of the market, spilling over the financial costs of high interest rated to end consumers, in terms of availing loans. Thus, a more practical solution rooted in reality is the proposed increase of NBFCs on long-term debts, as the market for commercial papers and mutual funds is reducing their exposure to the sector. Long-term bonds are safer because of the better asset-liability management options they offer. But companies also have to offer higher interest rates on these than on CPs, making the funds costlier. However, the risk of frequent repayment on short-term borrowings gets eliminated as the industry is facing a crisis of confidence. Further, it diversifies their loan portfolio and lessens immediate repayment obligations.

[28] Insolvency and Bankruptcy Code, 2016, Section 36(4)(a).