# NBFCs & IBC: RSTV – Big Picture

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**What's the Issue?**

- In a move to help address the woes of the NBFC sector (Non-Banking Financial Companies), the Reserve Bank of India (RBI) can now seek the resolution of non-banking financial companies, whose assets are worth at least 500 crores under the Insolvency Law.
- The Corporate Affairs ministry issued a notification specifying the categories of financial service providers (FSPs) that can be taken up for resolution under the "generic framework" of the Insolvency and Bankruptcy Code (IBC).
- The ministry had notified the framework to work specifically with the FSPs (while excluding the banks) which are systematically important, as per the Code wherein sectoral regulators can seek resolution of stressed entities.
- Section 227 of the Code enables the central government to notify, after consultation with the financial sector regulators, FSPs or categories of FSPs for the purpose of insolvency and liquidation proceedings.
- The generic framework is being introduced during the time of liquidity crisis in the non-banking financial companies (NBFCs).

**What's the role of RBI?**

- It gives an opportunity for the market mechanism to work.
- It helps the financial system and reduces the **domino effect** on the NBFCs.
    - Domino effect refers to the cumulative effect of a chain reaction of similar events.
- Gives RBI another option to resolve bankruptcy and insolvency issues by assigning it to the IBC.

**What's the Liquidity Crisis?**

- The liquidity crisis is a result of three main reasons:
    - The institutions providing developmental funding for big infrastructure projects were dismantled after the 1990s. Thereby that responsibility was taken up by the NBFCs and banks.
    - NBFCs take short term loans and lend for long term projects, causing them to roll over loans.
    - The banks after being hit by the NPA crisis are reluctant to renew the loans.

**Should banks be included under the IBC?**

- Systemically important institutions are being brought under the IBC.
    - Systemically important financial institutions refer to financial institutions, banks, and non-banking companies that are too big to fail.
- The NBFCs are being given priority now to be brought under the IBC, as these companies do not have a clear regulatory mechanism, which is essentially why they are called the shadow banking sector.
- The NBFC creditors fall into 3 categories:
    - Banks
    - Depositors
    - Bond Holders

- The attempt with NBFCs, if successful, can be extended to the banks.
- Under the NCLT framework, while negotiating, the stakeholders and investors get the comfort of no post-resolution questions. Without this framework, the negotiation would be subject to questions and criticism.

**Factors for the inclusion of NBFC under IBC:**

  - **Transparency:** Transparency with respect to internal functioning is an issue in NBFCs.
    - The NBFCs have been unable to fix the issue and tend to pass around the blame. This has to be stopped and the focus should be redirected to finding a solution for the problems faced.
  - **Mismanagement:** Increased instances of mismanagement and lack of corporate governance.
  - **Stress:** The stress in NBFC stems from the stress in their clients' assets, which isn't in the NBFCs' control.

- **Maturity mismatch:** NBFCs take short term loans and give loans for long term projects. This is a case of maturity mismatch.
  - The dismantling of the developmental banks had pushed the commercial banks and the NBFCs to lend for long term projects.

- **Regulation:** There is a need for proactive and technology-enabled regulation.

**Inclusion of NBFCs under IBC:**

- The financial sector crisis will tend to carry a lot of associated political risks and this should be avoided when NBFCs are brought under the IBC.
- IBC provides a rule-based environment for the resolution of problems in financial companies:
  - It will help in the management of market emotions, if under a situation of crisis.
  - It is quite essential for a developing country.
  - As in the case of the Punjab National Bank, it was solely due to the resolution of Insolvency and Bankruptcy Code (IBC), that the bank was able to recover the maximum amount in a short duration of five months, which had improved the bank's chances of returning to a situation of profitability.
  - Provides confidence in the prevalence of established process to handle any situation.
- The IBC should further ensure that:
  - The other sectors of finances do not experience a domino effect upon the liquidation of a particular NBFC.
  - The core service or the business of the institution brought under the IBC must continue. The notification takes care of that by ensuring that license and registration of the financial institution will not be canceled even under the IBC.
  - The interest of depositors and creditors of the company has to be considered, which requires a much stronger and clearer framework and guidelines for the same.
    - The confusion here is that the regulation of the banks and non-banks cannot be separated. It is difficult to differentiate between different units of the financial sector as they perform overlapping functions.
    - Hence there has to be a unified approach for regulation of the whole financial sector.

## Financial Sector and Risks:

- There will be more processes and systems to follow under the IBC and as the NBFCs are being brought under the IBC. This will enable the financial sectors to take more risks.

- The risks are measurable due to the clear risk to reward ratio.
- NBFCs performs an extremely important function in the economy of providing credit by creating a balance between those who have and those who don’t.

Way Forward:

- **Developing the market:** The market has to be developed for long term bonds in the country. The country has to develop in terms of financial capability to fund long term projects.

- New Regulations: New and clearer regulation systems have to be formulated, which are unified and considers all aspects of the market and company needs.