Reviving the Financial Sector

Recommendations

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Confederation of Indian Industry

RESEARCH

BACKGROUND

The Financial Sector in India over the last few years has become an integrated system with players like NBFCs, Banks, HFCs, Mutual Funds amongst others becoming symbiotically inter-connected and these no longer exist in isolation. Any significant impact on one segment is bound to have a ripple effect in the entire system. The sector has become much more broad-based compared to even five years back.

While the fundamentals of the Indian economy remain robust, the financial sector in the country is undergoing a phase of challenge, which can become a big hurdle to the growth story of India. Besides the liquidity crunch, there also is the risk of investor sentiments getting affected, which eventually will find a reflection in foreign capital outflows, thus weakening the rupee further.

The statement of the problem, plaguing the sector can be analysed by understanding some of the systemic imbalances as below:

- Currently, Mutual Funds have sectoral limit on investment in NBFCs upto 25% of the AUM of the particular scheme and HFCs can be additional 15%. Considering the inherent risk profile of NBFCs and HFCs, such investment norms are increasing the risk exposure of mutual funds.
- NBFCs and Housing Finance Companies (HFCs) are suffering from Asset-Liability Mismatches (ALM) as they had borrowed short but are having to lend long. This could set off a chain of problems, since NBFCs have borrowed from MFs and Banks. In a worst-case scenario, this could lead to a run on mutual funds and defaults in the NBFC sector.
- In the current scenario of lack of liquidity, particularly of short term Commercial Papers, it is leading to a contagion effect. Redemption pressure on Mutual Funds has increased and credit to NBFCs is drying out. The MFs may not opt for roll-over of the papers because of the risk perceived in NBFCs. Also, if the roll over happens it will be at a higher yield for NBFCs.

Some other critical issues facing the sector are:

- 11 public sector banks have been put under prompt corrective action (PCA) which has further reduced the credit flow to the real sector. While there is a curb on lending, these banks have been receiving deposits which is getting routed only to repo market and not to the real sector further adding to the liquidity crunch in the market.
- Under-developed Corporate Bond Market is also adding to the funding gap.

The immediate concern is to alleviate investor and depositor's concerns and such steps need to be taken with the intention to provide stability and certainty, as well as tackling the liquidity shortages.

Some of the measures recommended in this note may be considered by the Government and the Regulators to maintain financial stability and keep systemic risks at bay.

MEASURES TO BE TAKEN IN THE SHORT TERM

1. SEBI and RBI should come out with a road-map to reduce the exposure of Mutual funds to NBFCs and HFCs from 40% to 25% in graded tranches.
2. RBI must encourage NBFCs to securitize its assets which can be purchased by Banks.
3. Backstop facility by the RBI - Reserve Bank of India (RBI) must provide backstop facility to Housing Finance Companies (HFCs) through the National Housing Bank (NHB). Additionally, RBI may also consider providing the same facility directly to the systemically important deposit taking NBFCs (NBFCs-D).
4. Regulators like RBI, SEBI, IRDAI, PFRDA and Government of India need to present a coordinated front while addressing the current issues.
5. The RBI should ensure the market feels comfortable that the financial sector is well-regulated and will be provided liquidity, if required. This will lead to markets becoming more normal. Communicating to the markets and providing comfort is essential at this point in time or else the situation can deteriorate.
6. Provide sufficient system liquidity - The Reserve Bank of India (RBI) must work out further credit lines to provide sufficient liquidity as otherwise a severe credit crunch will dent consumer demand and growth of Indian economy.
7. The RBI may also revisit the lending restrictions of PCA banks and consider allowing them lending to NHB which in turn can use it to finance housing projects.
8. Reserve Bank of India needs to open limited special liquidity window (open direct lines of credit as RBI had opened liquidity window for mutual funds for a short-period in 2008 and 2013) to meet emergencies of Financial Institutions including Mutual Funds which have been significantly impacted.
9. The RBI should open a window for Mutual Funds, (say for 6 months), to get refinance directly / indirectly from RBI against quality collateral, so that desperate sales by mutual funds (on account of redemptions owing to deteriorating investor confidence) can be avoided. Desperate actions by mutual funds may distort the whole yield curve resulting in mark-to-market losses across the industry. Also, RBI may open a liquidity window for banks to obtain cheap refinance for specific on-lending to NBFCs. The level of liquidity

crunch at which such a special window needs to be opened by RBI should be based on regulatory and policy judgement.

10. The RBI should keep itself in readiness, should there be a situation of further volatility of this nature which necessitates an intervention like a NRI bond issuance.

11. RBI intervention should be there in the Rupee Market in such a manner, so that bond yields do not go out of control.

12. Enforcement and Recovery Rights for NBFCs - The Ministry of Finance vide its notification dated 5th August 2016, allowed NBFCs registered with RBI and having an asset size of over INR 500 crores to exercise powers under the SARFAESI act. However, the NBFCs were allowed to enforce security interest of only those cases which involves principal amount of at least Rs.1 crore or above. While the monetary limit prescribed for other classes of secured creditors under the SARFAESI Act is Rs.1 lakh. Also, NBFCs do not have recourse to Debt Recovery Tribunal (DRT). It is recommended that NBFCs may be allowed to exercise the right of recovery of dues under the provisions of SARFAESI Act for a sum of INR 1 lakh & above and NBFCs should be permitted access to the Debt Recovery Tribunals for speedy recovery of their debts.

MEASURES TO BE UNDERTAKEN OVER MEDIUM TERM

1. Relax cap and conditionalities on FDI in banking and non-banking financial services sector-

   Measures could be taken to ease the cap and conditionalities to attract foreign investors. Current caps and conditionalities are:

   - FDI for private sector banking is capped at 74% with any foreign investments beyond 49% only permitted through the government approval route.
   - At least 26% of the paid-up capital will have to be held by residents, except in case of wholly owned subsidiary of a foreign bank.
   - FDI in public sector banking is capped at 20% under the government approval route subject to Banking Companies (Acquisition & Transfer of Undertakings) Acts 1970/80.
   - Security Receipts (SRs) issued by Asset Reconstruction Companies are subject to the following:
     - Foreign Portfolio Investors can invest up to 100 per cent of each tranche in Security Receipts issued by Asset Reconstruction Companies, subject to provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (“SARFAESI”).
     - Such investment should be within the FPI limits on corporate bonds prescribed by the Reserve Bank.
     - Investment by Foreign Portfolio Investors in the unlisted corporate debt securities and securitised debt instruments should not exceed investment limits prescribed for corporate bonds

   At present, the regulations do not permit 100% FDI under automatic route and conditionalities are specified, as stated above, for such investment, in banking and some categories of non-banking financial companies. Some relaxation in this will attract foreign investors. As a safeguard, a monetary limit may be provided within which FDI will be considered under automatic route or will be considered without any conditionalities.

2. One-time restructuring of underlying projects -

A separate framework may be developed to allow one-time restructuring of underlying projects of Banks and NBFCs. The current framework for restructuring have stringent conditions and are primarily contained in RBI Circular of 12 February 2018 on Resolution of Stressed Assets, such as:

- In case of infrastructure projects under implementation, change in date of commencement of commercial operations ("DCCO") need not be treated as 'restructuring', subject to following conditions:
  - The project is an infrastructure project under public private partnership model awarded by a public authority;
  - The loan disbursement is yet to begin;
  - The revised date of commencement of commercial operations is documented by way of a supplementary agreement between the borrower and lender and;
  - Project viability has been reassessed and sanction from appropriate authority has been obtained at the time of supplementary agreement.
- In cases where change in ownership and extension of DCCO takes place before the original DCCO, and if the project fails to commence commercial operations by the extended DCCO, the project will be eligible for further extension of DCCO subject to conditions such as:
  - Banks should establish that implementation of the project is stalled/affected primarily due to inadequacies of the current promoters/management and with a change in ownership there is a very high probability of commencement of commercial operations by the project within the extended period;
  - The project in consideration should be taken-over/acquired by a new promoter/promoter group with sufficient expertise in the field of operation. If the acquisition is being carried out by a special purpose vehicle (domestic or overseas), the bank should be able to clearly demonstrate that the acquiring entity is part of a new promoter group with sufficient expertise in the field of operation;
  - The new promoters should own at least 51 per cent of the paid-up equity capital of stake in the acquired project. If the new promoter is a non-resident, and in sectors where the ceiling on foreign investment is less than 51 per cent, the new promoter should own atleast 26 per cent of the paid-up equity capital or up to applicable foreign investment limit, whichever is higher, provided banks are satisfied that with this equity stake the new non-resident promoter controls the management of the project;

- Viability of the project should be established to the satisfaction of the banks.
- Intra-group business restructuring / mergers / acquisitions and / or takeover/ acquisition of the project by other entities/subsidiaries/associates etc. (domestic as well as overseas), belonging to the existing promoter/promoter group will not qualify for this facility. The banks should clearly establish that the acquirer does not belong to the existing promoter group;
- The new owners/promoters are expected to demonstrate their commitment by bringing in substantial portion of additional monies required to complete the project within the extended time period. As such, treatment of financing of cost overruns for the project shall be subject to the guidelines prescribed in paragraph 13 of this circular. Financing of cost overrun beyond the ceiling prescribed in paragraph 13 of this circular would be treated as an event of restructuring even if the extension of DCCO is within the limits prescribed above;
- This facility would be available to a project only once and will not be available during subsequent change in ownership, if any.

Such one-time restructuring opportunity could be provided upon certain eligibility conditions being fulfilled, such as, promoters should not have siphoned funds or be wilful defaulter and forensic audit of the project be clean. In essence, if the project has not performed well due to market conditions and the issues are of a particular sector / project type, then such project should be considered for one-time restructuring. Clear provisions should be made for recompense prior to any money flowing to shareholders.

3. There is a need to revisit the ownership structure of Public Sector Banks.

Confederation of Indian Industry

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