Face-Off

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Should NBFCs Lose Priority Sector Tag?

No, It will Raise Cost of Funds

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The RBI's move to exclude loans given to the non-banking finance companies (NBFCs) from the priority list is wrong and unjustified. The central bank had recognised the role of NBFCs in 2003-04, saying their relative organisational flexibility enabled them to provide tailor-made services relatively faster than banks.

The contribution of the sector was also acknowledged by a parliamentary standing committee. NBFCs have been instrumental in the development of various sectors ranging from agriculture, automobile and transportation to small enterprises. The drastic measure has dealt a blow to the complementary and supplementary relationship that has emerged over a period of time, courtesy the RBI's policy to channelise credit flow to the priority sector from banks through NBFCs. All rural and semi-urban areas where banks do not operate are likely to suffer. Priority sector borrowers — artisans, craftsmen, retail traders, farmers and tiny enterprises — will be hurt. The move will also impact the operations of NBFCs. Fund flow to these entities of hitherto priority sector loans will dry up. The cost of funds would go up for borrowers (even those falling within the definition of priority sector borrower) and business volumes will shrink.

An articulated view needs to be taken on the decision that affects both the borrowers and the systemically important intermediary. Competent intermediaries play a very important role in financial distribution. To have an efficient credit delivery system, controlling and creating an enabling situation is the right approach rather than eliminating intermediaries altogether. It is ironical that, on the one hand, we are struggling to reach to the millions of financially excluded citizens and on the other, we are putting an end to an already existing credit delivery system developed by NBFCs.

Even on grounds of equality, why should NBFCs be singled out and denied participation in the national agenda of financial inclusion by choking the line of credit to them? The infrastructure and manpower deployed by NBFCs should not be rendered redundant by a single stroke without drawing a future course of action for smooth transition.

Right Move; RBI can't Verify Fund Use

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Five years ago, a 78-year-old educated person wanted to know how she could retrieve an overdue deposit of ₹75,000 from a non-banking finance company (NBFC) that was in a mess. She has now turned 83 and is yet to get back her deposit. Such incidents of default notwithstanding, the NBFC sector in India has grown. Now, they have become large enough to pose systemic risks to the financial sector.

Figures published by the RBI at the end of March 2010 show that the total assets of the NBFC sector, at ₹6,57,185 crore, forms 10.9% of the assets of the commercial banking system. NBFCs had borrowings of ₹1,70,746 crore, mainly from the banking system. They had also issued debentures of ₹1,38,722 crore and the investors include banks. Thus, a sizeable portion of the deposits of the banking system is lent by banks to NBFCs. Banks have been willing to lend to NBFCs at lower rate of interest against loans granted by the latter to agriculturists, with jewellery as security. The provision to classify such loans as priority sector credit was withdrawn by the RBI in February, 2011. The move by RBI is appropriate as reliable verification of the end use of funds by NBFCs for agricultural lending is not possible.

Now banks will be forced to charge appropriate risk premium by way of higher rate of interest on loans to NBFCs. It is not only the pricing aspect that has to be addressed by the regulator. There are allegations of notice of jewellery auction not being actually sent to defaulters, benamis taking part in the auction, nexus between NBFCs and jewellery shops and amount realised in excess of loan outstanding being credited to a suspense account and later on taken into the income account of NBFCs.

The practice of NBFCs raising debentures as if they are deposits from retail investors on a continuous basis also needs to be regulated. Regulation of the NBFC sector must be strengthened to avoid not only systemic risk but also to save depositors and investors from undergoing the plight of the 83-year old lady who is still struggling to get back her investment from a failed NBFC.