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Role and Importance of NBFCs in Financial Stability in the Indian Economy

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Abstract:

A sound and vibrant financial system is a prerequisite for the growth and economic development of a nation. The growth of the financial structure has a positive effect on economic development of an economy. In India, banking penetration aggressively increased through programs like the Pradhan Mantri Ja n Dhan Yojana, however the quality of coverage and ability to access comprehensive financial services for households as well as small businesses is not satisfactory. In this scenario, the role of non-banking finance companies (NBFCs) sector is remarkable. Over time, the sector has evolved from being fragmented and informally governed to being well regulated and in many instances, adopted the best practices in technology, innovation and risk management as well as governance. This paper makes an attempt to study the importance and financial performance of non-banking financial companies (NBFCs), the entities of NBFIs. This paper comprises the performance and assessment of NBFCs in 2023-24 and the first part of 2024–2025 over the previous years.

Keywords: Non-banking financial companies (NBFCs), non-banking financial institutions (NBFIs), financial system, prudential regulations, capital adequacy, asset quality, non-performing asset (NPA).

Objectives:

1. To examine the role of Non-Banking Financial Companies (NBFCs) in promoting financial inclusion and enhancing financial accessibility for the underserved and unbanked sectors in India.
2. To analyze the financial performance of NBFCs during the financial year 2023-24 and the first half of 2024-25 with respect to balance sheet growth, sectoral credit distribution, profitability, and funding patterns.
3. To understand the sectoral diversification and credit allocation by NBFCs to various industries such as retail, infrastructure, agriculture, MSMEs, and microfinance.
4. To assess the capital adequacy, asset quality, and overall soundness indicators of NBFCs as a measure of their contribution to financial system stability.

Introduction:

The financial sector in any economy consists of several intermediaries. Apart from banking entities, there are non-banking financial institutions (NBFIs) that are an important constituent of India's financial system.

Non-banking financial institutions (NBFIs) are entities regulated by the Reserve Bank include non-banking financial companies (NBFCs), housing finance companies (HFCs), all India financial institutions (AIFIs), and standalone primary dealers (SPDs). NBFCs are registered companies, both government and non-government, which engage in credit intermediation and facilitate last-mile credit delivery to unbanked and underbanked sectors. They are also at the forefront of the digital transformation of the lending space, leveraging technology to offer tailor- made credit offerings to customers. HFCs provide housing credit to individuals, co-operative societies and corporates. The five AIFIs, namely, the National Bank for Agriculture and Rural Development (NABARD), the Export-Import Bank of India (EXIM Bank), the Small Industries Development Bank of India (SIDBI), the National Housing Bank (NHB) and the National Bank for Financing Infrastructure and Development (NaBFID) are apex financial institutions providing long-term funding to important sectors like agriculture, foreign trade, small businesses and infrastructure. Primary dealers (PDs) underwrite issuances of government securities (G-secs) and act as market makers in the G-sec market This paper comprises the performance of only Non-Banking Finance Companies in 2023-24 and the first half of 2024-25.

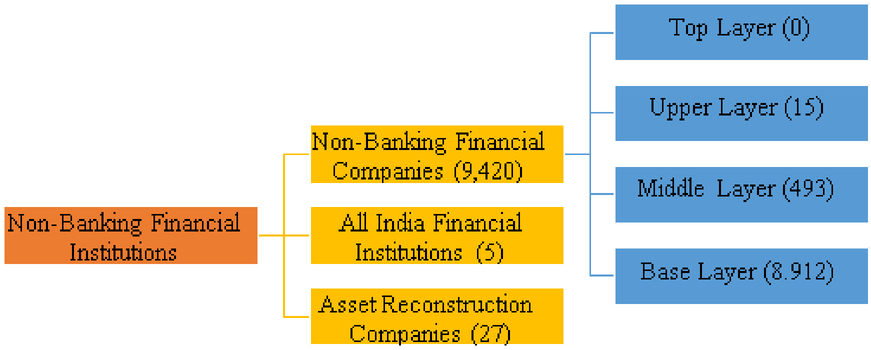
Historical Context:

The banking system forms the core of the Indian financial system after the nationalisation of banks. Driven largely by the public sector initiative and policy activism, commercial banks have a dominant share in total financial assets and are the main source of financing for the private corporate sector. Apart from the financial institutions, rapid expansion of NBFCs have taken place in the eighties and provided avenues for depositors to hold assets and for borrowers to enhance the scale of funding of their activities.

Since late 1980s up to the mid-1990s, the number of NBFCs increased substantially on the back of easy access of funds from capital market IPOs and deposits from the public. In 1981, there were 7,063 NBFCs. The number went up to 24,009 in 1990 and there were as many as 55,995 NBFCs by 1995. The high deposit rates offered by NBFCs led investors to invest their funds in NBFCs. The deposit base of the NBFCs grew at an average rate of 88.6% per annum between the period Apr-91 to Mar-97. However, rapid growth in NBFCs could not be sustained as in the late 1990s several loans granted by the NBFCs turned sticky, leading some of the large NBFCs to default in repayment to their depositors. This led the RBI to introduce stringent guidelines in 1997-98 which hampered the ability of NBFCs to raise deposits. The proliferation of NBFCs in the decade of 1990s left a regulatory gap, which was bridged with the amendment of the Reserve Bank of India Act, 1934 in January 1997. This has been followed by issuance of several regulations aimed at alignment of the regulatory environment of the NBFCs with that of the banks and ensuring protection to depositors. Subsequent regulatory initiatives covered areas of compulsory registration, prudential regulations, investment norms, disclosure standards, strengthening of supervisory oversight, etc. The tightening of regulatory and supervisory framework for NBFCs has also been coterminous with the rapid product development and diversification, sweeping changes in technology along with trends indicating consolidation in the financial sector. NBFCs recovered from various phases and witnessed rapid growth in recent years. NBFCs, regulated by RBI and registered under the Companies Act, emerged to fill the void for sectors and people excluded from banking.

Structure and categories of Non-Banking Financial Companies (NBFCs):

Fig 1: Structure of NBFIs under the Reserve Bank's Regulation (As on March 31, 2024)



Notes: 1. Figures in parentheses indicate the number of institutions (provisional). 2. NBFCs, viz., NBFC-ICC, NBFC- MFI, NBFC Factors, and NBFC-MGC could lie in any of the layers depending on the parameters of SBR. NBFC- CICs, HFCs, and IFCs could lie either in the upper or middle layer. 3. Government-owned NBFCs are placed in the base or middle layer.

Sources - RBI and NHB.

NBFCs regulated by the Reserve Bank are a group of heterogeneous financial entities operating with diverse business strategies. The Reserve Bank's scale-based regulation (SBR) framework categorises NBFCs into top, upper, middle and base layers, based on their size, activity, and perceived riskiness. The SBR framework is progressive in that it is built on the principle of proportionality, with regulations commensurate with the size and interconnectedness of the NBFCs (Table 1). Smaller and/or less complex NBFCs are relatively lightly regulated, while larger and more systemically important NBFCs are subjected to enhanced regulatory scrutiny. Given the inherently diverse and dynamic nature of these entities, the Reserve Bank invited applications to recognise self-regulatory organisations (SROs) for the NBFC sector in June 2024. This establishes principles for self-regulation, which complement the extant regulatory/statutory framework and incentivise enhanced professionalism, compliance, innovation and ethical conduct. NBFC-UL and ML dominate the NBFC sector in terms of assets. In terms of number, NBFCs in the base layer (NBFC-BL) constituted 96.2 per cent of the total, while accounting for only six per cent of total assets (Table 1). Credit extended by NBFCs was 13.6 per cent of gross domestic product (GDP) during 2023-24. At the end of March 2024, it accounted for 24.5 per cent of the outstanding credit of SCBs (Chart 1)

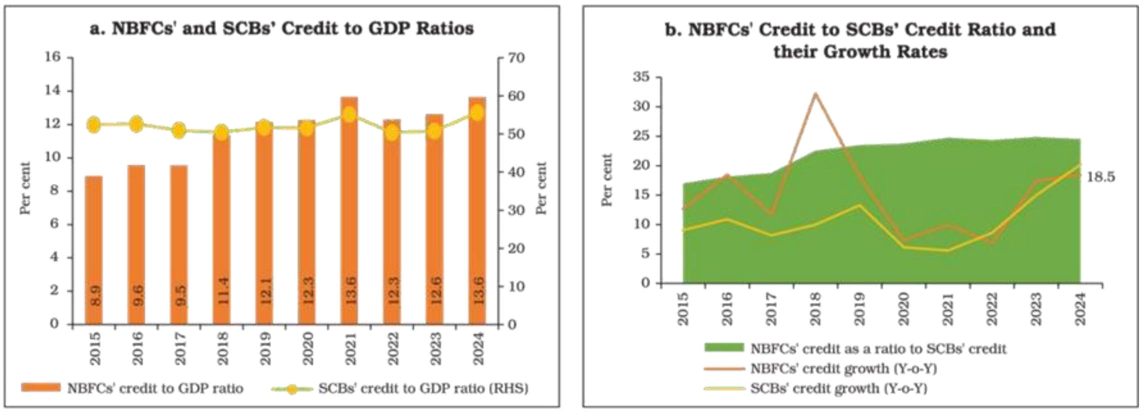
Table 1: Composition of NBFCs (At end- March 2024)

(Share in per cent)

Layer	Number	Assets
1	2	3
NBFC-UL	0.1	25.2
NBFC-ML	3.7	68.8
NBFC-BL	96.2	6.0
Total	**100.0**	**100.0**

Note: Data excludes HFCs, CICs and SPDs. Source – RBI

Chart 1: NBFCs' Credit vis-à-vis SCBs' Credit and GDP (At end-March)



Source - Report on Trend and Progress of Banking in India, various issues; Handbook of Statistics on the Indian Economy, various issues.

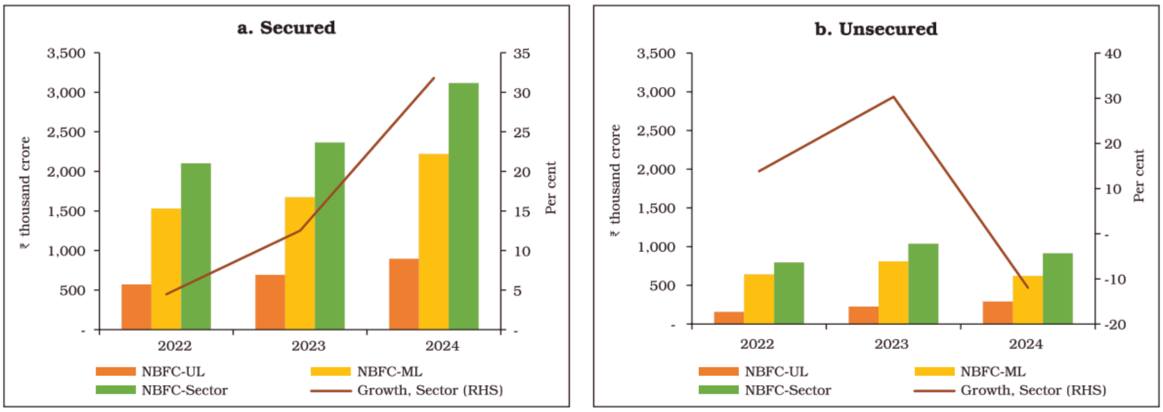
Ownership Pattern of NBFCs:

The NBFC sector is dominated by non-government companies, with a share of 93.1 per cent by numbers at end-March 2024. Government companies, albeit much less in number, had a substantial share in total assets of the NBFC sector. Owing to their generous size and concentration of funding towards the infrastructure sector, the prompt corrective action (PCA) framework was extended to the government companies (except those in the base layer) from October 1, 2024. Out of nine NBFC-UL, three are deposit taking while the rest are non-deposit taking. Post identification as NBFC-UL, NBFCs must get listed within three years. In terms of assets, NBFCs-ML dominate the NBFC sector, with a share of 73.2 per cent in the total assets. Most of these companies are private limited companies in contrast to NBFCs-UL.

Assets and Liabilities of NBFCs:

During 2023-24, the balance sheet of the NBFC sector expanded in double digits (16.3 per cent as compared with 17.2 per cent in the preceding year). On the liability side, NBFCs' borrowings from banks decelerated, while funds raised through debentures picked up, reflecting inter alia the impact of the increase in risk weights on banks' lending to NBFCs, effective November 2023. On the asset side, growth in loans and advances accelerated to 18.5 per cent in 2023-24 from 17.4 per cent in 2022-23, driven by upper layer NBFCs. NBFC-MLs' credit growth was relatively muted on account of contraction in unsecured loans (Chart 2). Aggregate credit continued to expand in double digits even though unsecured lending contracted at end-September 2024. At end-March 2024, NBFC-ICCs and IFCs together accounted for 95.6 per cent of the assets of the sector (Chart 3a). Upper layer NBFCs are primarily NBFC-ICCs, which mainly cater to the retail segment. Most of the NBFC-IFCs are government-owned, mainly providing credit to the infrastructure sector. NBFC-MFIs, which are crucial for last mile credit delivery, have been growing their share in aggregate assets of the sector. Growth in the assets of the NBFC-Factors outperformed the sectoral average (Chart 3b). High growth in loans and advances of NBFC-ICCs, the largest category, was sustained in 2023-24. The pace of expansion of NBFC-IFCs, the second largest category, decelerated as lending by a major entity in the category, which lends to railway infrastructure projects, recorded a marginal contraction. Two NBFC-IFCs engaged in lending to the power sector, on the other hand, recorded higher disbursements in 2023-24 than a year ago. NBFCs maintained comparable maturity profiles on both sides of their balance sheets during 2023-24. At end-March 2024, more than two-thirds of the aggregate credit exposures and total borrowings were long-term i.e., more than 12 months.

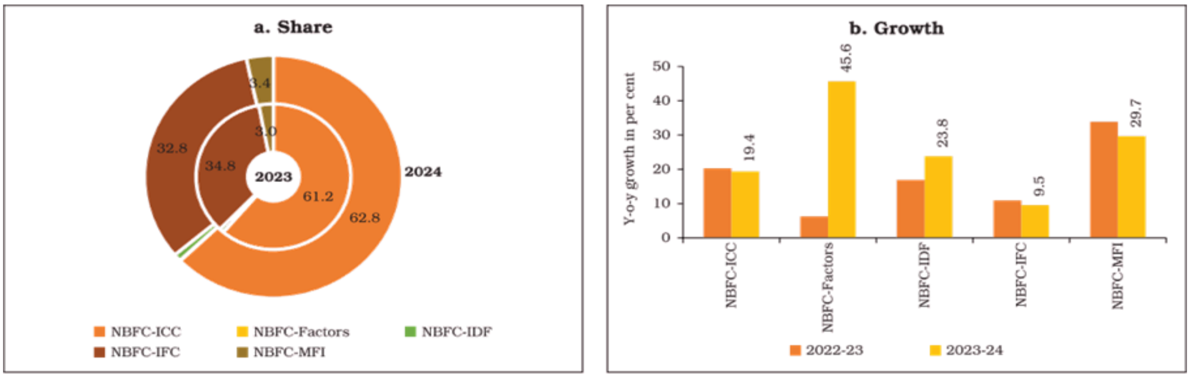
Chart 2: Nature of NBFCs' Loans and Advances (At end-March)



Note: Data are provisional.

Source - Supervisory Returns, RBI

Chart 3: Total Assets of NBFCs, by Classification (At end-March)

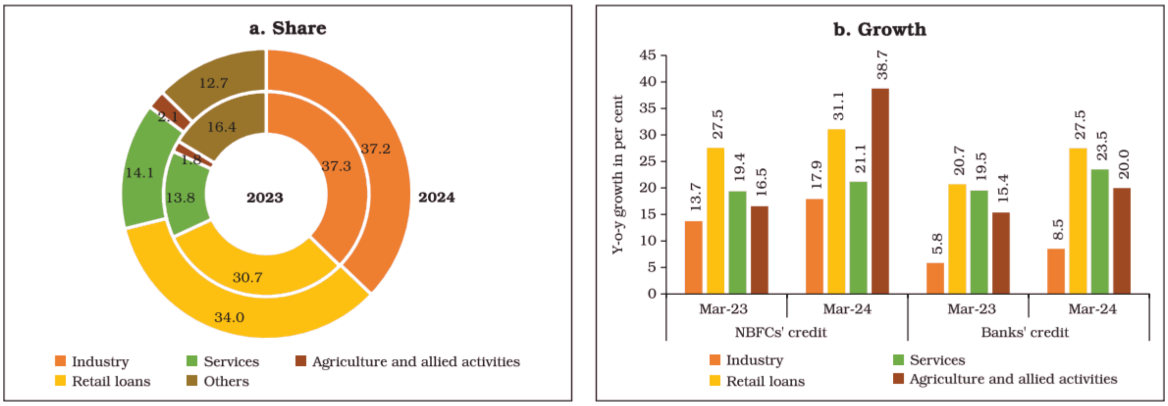


Note: Data are provisional
Source - Supervisory Returns, RBI

Sectoral Credit of NBFCs:

NBFC-ICCs have a relatively diversified lending portfolio, dominated by retail loans. IFCs lend mainly to industries (mostly power and railways). MFIs primarily cater to the credit needs of retail customers through collateral-free small ticket loans. At end-March2024, NBFC-ICCs, IFCs and MFIs together provided 99 per cent of the total credit disbursed by the sector. Industry and retail sectors receive a dominant share of NBFCs' credit (71.2 percent of the total loan portfolio at end-March 2024). During 2023-24, NBFCs recorded higher growth of credit to all sectors (except services) relative to banks. NBFCs' credit to agriculture and allied activities has also grown at a robust pace in the past two years, resulting in a rise in its share in total lending (Chart 4). Credit growth to major sectors remained robust on a year-on year basis at end- September 2024.NBFCs have steadily expanded their share in total credit extended by banks and NBFCs to MSMEs (11.7 per cent of total credit at end-March 2024), with those engaged in services cornering a larger share than their industry counterparts. NBFCs' 'digital first' approach, e.g., utilisation of account aggregation framework, is helping in flow of credit to MSMEs. This is expected to get a boost from the proposed unified lending interface (ULI). Vehicle loans, loans against gold and microfinance loans have been the stronghold of NBFCs, together accounting for 56.7 per cent of their retail portfolio at end-March 2024. The growth of unsecured retail credit by NBFCs moderated after the tightening of macroprudential measures in November 2023. NBFC-MFIs– dominant players in the Indian microfinance space – ease credit constraints on traditionally underserved communities by giving them access to a host of financial services. The share of micro-credit in the total retail lending portfolios of NBFCs stood at 10.8 per cent at end- March 2024. NBFCs (including MFIs) have maintained their share in total micro-credit loans (Chart 5). SROs for MFIs have put in place safeguards like limiting the number of microfinance lenders to a borrower to four and capping total indebtedness to ensure market discipline and borrowers' welfare. NBFCs mobilise funds from a wide range of sources led by borrowing from banks and issuance of debentures. For NBFCs-D, public deposits remain an important source of funds. More recently, asset sales and securitisation have emerged as important funding sources, particularly because of their role in facilitating liquidity management.

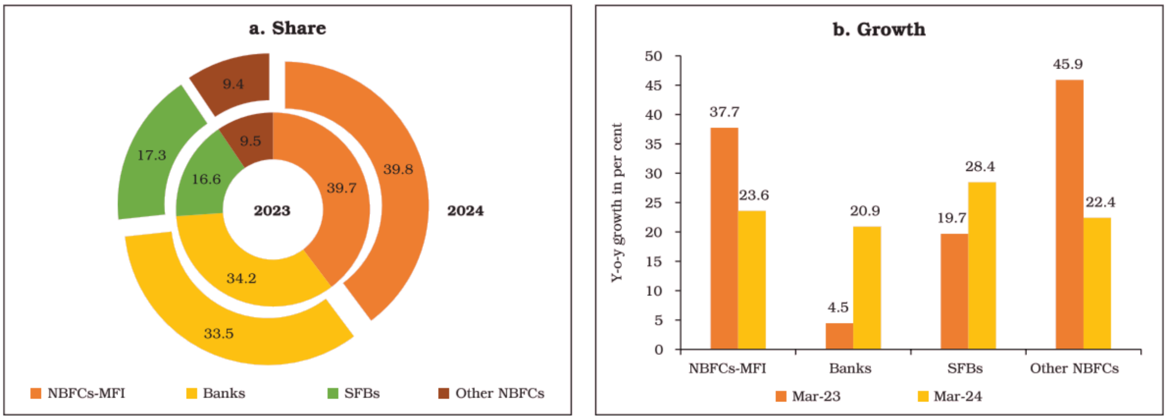
Chart 4: Distribution of NBFCs' Credit (At end-March)



Note: Data are provisional.

Source - Supervisory Returns, RBI

Chart 5: Micro-credit Outstanding across Regulated Entities (At end-March)



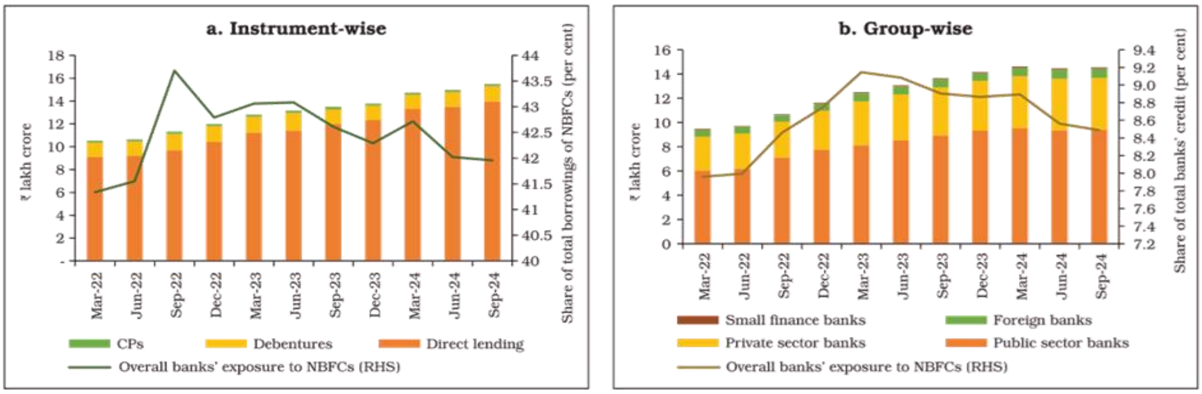
Source - Microfinance Institutions Network (MFIN)

Borrowings:

In the immediate aftermath of the IL&FS episode in 2018, NBFCs encountered significant challenges, including an erosion of confidence, rating downgrades, and liquidity constraints that limited their ability to borrow from the market. Exacerbated by the COVID-19 pandemic, this led to increased dependence of NBFCs on banks for funding. In 2023-24, the growth of borrowings from banks moderated due, inter alia, to higher risk weights on bank credit to NBFCs. The moderation in borrowings from banks continued at end-September 2024.

Bank borrowings remain the primary source of funds for NBFCs. In fact, the reliance of NBFCs on market borrowings has declined in recent years. Overall bank exposure to NBFCs as a share of total bank credit also declined in 2023-24 (Chart 6). The reduction in NBFCs' reliance on banks for funds bodes well for overall financial stability.

Chart 6: Banks' Exposure to NBFCs



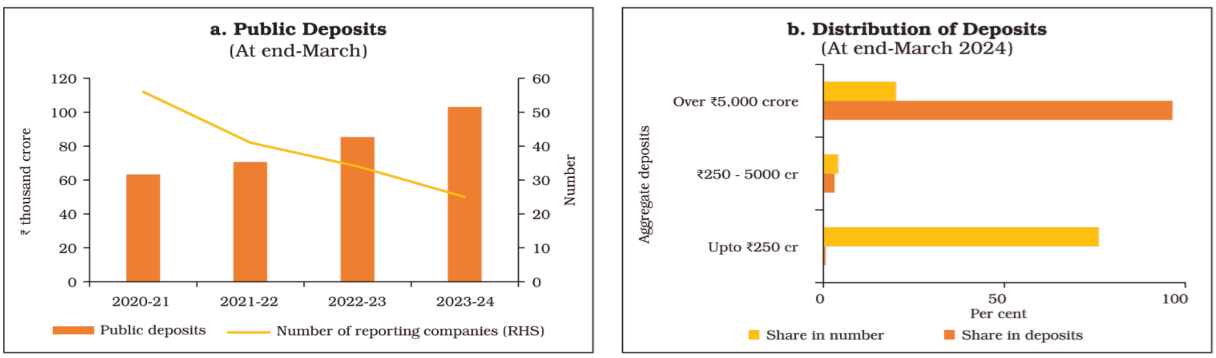
Note: Data are provisional.

Source - Supervisory Returns, RBI

Public Deposits:

The balance sheet of NBFCs-D expanded by 21.6 per cent in 2023-24, with robust growth in both deposits and credit. Notwithstanding a reduction in the number of NBFCs-D to 25 at end-March 2024 from 36 a year ago, their deposits recorded double digit growth (20.8 per cent) in 2023-24. Five NBFCs accounted for 96.4 per cent of total deposits (Chart 7). The Reserve Bank has undertaken a cautious approach towards deposits mobilised by NBFCs-D, as they are not insured by the Deposit Insurance and Credit Guarantee Corporation (DICGC). As per the extant regulatory requirements for acceptance of deposits, these NBFCs should have at least an investment-grade rating of 'BBB–' on their fixed deposits from any SEBI-registered credit rating agency. Furthermore, the quantum of deposits should not exceed 1.5 times their net owned funds (NOF) for terms ranging from 12 to 60 months and interest rates capped at 12.5 per cent.

Chart 7: Public Deposits with NBFCs-D



Notes: 1. NBFCs-D have been grouped into different buckets based on the size of their aggregate public deposits. No NBFCs-D had deposits in the bucket of ₹ 250-500 crore and ₹ 500-1,000 crore. 2. Data are provisional. Source: Supervisory Returns, RBI.

Financial Performance:

About 90 per cent of NBFCs' income accrues from fund-based sources, via interest and investment earnings, while fee-based income contributes the rest. During 2023-24, the aggregate income growth of

NBFCs accelerated to 25.8 per cent from 23.2 per cent in 2022-23, with both fee and fund-based income growing in double digits. Aggregate expenditure grew in 2023-24, albeit at a slower rate than total earnings. Interest expense was the largest expenditure component (59.0 per cent of the total at end-March 2024). Other financing costs along with operating expenditure constituted the rest of gross expenditure. Cost-to-income ratios fell across both layers, boosting profitability. Growth of net profit remained robust in H1:2024-25.

Key indicators of financial performance, viz., return on assets (RoA) and return on equity (RoE), improved during 2023-24 across all layers and classifications of NBFCs, benefitting from operational efficiency gains and effective risk management.

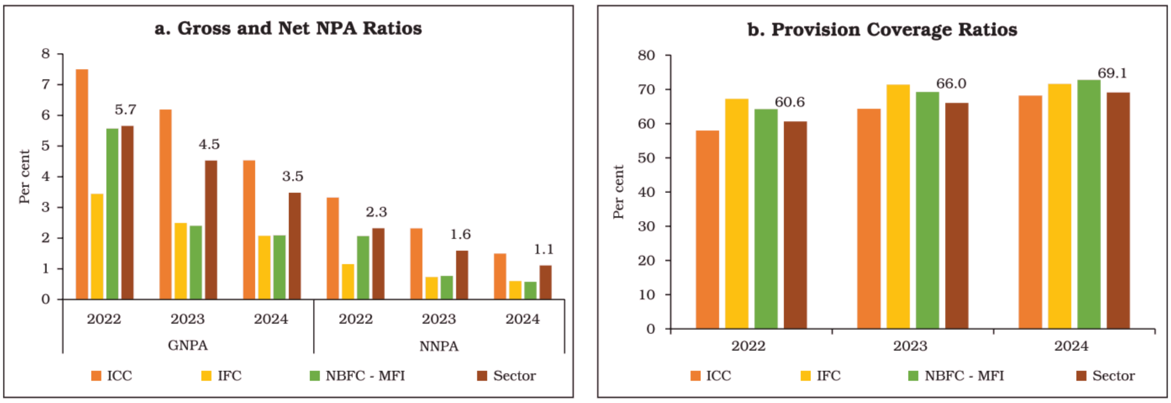
Soundness Indicators:

The Reserve Bank's prompt corrective action (PCA) framework assesses the health and resilience of an NBFC with focus on asset quality and capital adequacy as the key monitorable metrics. At an aggregate level, the NBFC sector achieved an improvement in both asset quality and capital adequacy during 2023-24.

Asset Quality:

The asset quality of NBFCs across different classifications improved further in 2023-24, indicating effective resolution of bad assets. NBFCs have also maintained adequate provisions against outstanding non-performing assets (NPAs) (Chart 8). This trend continued in H1: 2024- 25, with gross and net NPA ratios declining to 3.4 per cent and 1.1 per cent, respectively, as at end-September 2024. Sector-wise, asset quality improved for vehicle loans, transport operators and agriculture and allied activities, while it deteriorated marginally for credit card receivables and loans against gold. Gross advances under larger borrowal accounts (exposure of ₹5 crore and above) grew by 14.1 per cent during 2023-24 (13.5 per cent in the previous year). Asset quality of these accounts exhibited significant improvement during the year, bringing down their share in total NPAs. The GNPA ratio of large borrowal accounts, however, stood higher than that of the overall NBFC sector.

Chart 8: Asset Quality of NBFCs, by Classification (At end-March)



Note: Data are provisional.

Source - Supervisory Returns, RBI.

Capital Adequacy:

At end-March 2024, the NBFC sector-maintained capital to risk-weighted assets ratio (CRAR) of 26.9 per cent, well above the regulatory requirement. Under the SBR, NBFCs [except core investment companies 14 (CICs)] in the upper layer are required to maintain common equity tier 1 capital (CET 1) of a minimum of nine per cent of risk-weighted assets, within the overall CRAR of 15 per cent. At end-September 2024, CRAR of the sector stood at a comfortable level of 26.1 per cent.

Exposure to Sensitive Sectors:

Lending and investments in capital markets and commercial real estate are susceptible to fluctuations, with implications for financial stability and are, therefore, classified as sensitive sectors. NBFCs' exposure to sensitive sectors increased to 23.8 per cent of their total assets at end-March 2024 from 21.2 per cent at end-March 2023, driven by lending to the capital market.

Conclusion:

India's financial infrastructure still relies on the NBFC industry, particularly when it comes to providing last-mile loans and serving markets that conventional banks have historically ignored. The transformation of non-bank financial companies (NBFCs) from loosely regulated organizations to tech-enabled, well-regulated financial intermediaries underscores their increasing importance in attaining equitable growth. NBFCs (Non-Banking Financial Companies) in India have become a significant part of the financial landscape, contributing to financial stability by filling gaps in the traditional banking system. NBFCs had double-digit balance sheet expansion, increased profitability, better asset quality, and excellent capital adequacy throughout the fiscal year 2023–2024 and the first part of 2024–2025. They continue to play an essential role in assisting important industries including microfinance, infrastructure, agriculture, and MSMEs.

Through regulatory support, careful risk management, and financing source diversification, the industry showed resilience in the face of financial challenges during the COVID-19 and IL&FS crises. The Scale-Based Regulation (SBR), which the RBI implemented, has enhanced monitoring and distinguished risk governance. With improved return ratios, strengthened financial metrics, and a digital-first approach to lending, NBFCs are well-positioned to contribute meaningfully to India's financial stability and economic growth. Their continued relevance will depend on robust governance, innovation, and alignment with regulatory expectations.

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