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BORROWING TROUBLES

Expand the liability pools for NBFCs

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SAFETY NETS. Diversifying funding sources and creating a more resilient financial framework are crucial for the sustained growth of NBFCs ISTOCK.COM

Over the past decade, non-banking financial companies (NBFCs) have evolved from being perceived as a 'shadow' of traditional banks to becoming a significant contributor to India's economy, contributing over 12.5 per cent of the country's GDP. The sector's credit share has grown substantially from 15 per cent of the total Scheduled Commercial Bank credit in 2014 to 22.5 per cent in 2024, driven by its pivotal role in making formal credit accessible to MSMEs, the retail sector and underserved populations.

With its expanding scale, stability and innovation, NBFCs have become integral to the financial ecosystem. This growth has been supported by diverse funding sources like bank loans, debentures, commercial papers and other debt instruments — with term loans and debentures alone constituting for over 75 per cent of borrowings. In the financial services industry, liabilities actually serve as assets. Hence, diversifying and deepening funding sources, along with establishing a more resilient financial framework, have become crucial for the sustained growth of NBFCs, reducing dependence on banks and enhancing overall financial stability.

REIMAGINING BONDS

The Indian bond market accounts for a substantial share of nearly 36 per cent of the debt capital used by the NBFCs but its investor base remains narrow. Presently, large corporate treasuries, family offices, insurance companies and retirement funds dominate the space, with a notable preference for Central and State government securities, PSUs and a handful of AAA rated entities. This concentration limits NBFCs' access to a broader investor pool and restricts the depth of corporate bond markets, further exacerbated by the removal of indexation benefits on debt mutual funds from April 1, 2023, which significantly reduced long-term liquidity provided by the mutual funds.

To address these limitations, industry stakeholders have proposed several recommendations. The first one involves creating an on-tap issuance facility for non-convertible debentures (NCDs). This would include a pre-approved umbrella document with 6-12 months' validity, allowing weekly issuance and monthly listing, thereby streamlining access. Secondly, issuers could be allowed to buy back a portion of the NCDs periodically, increasing market liquidity and encouraging retail participation.

SEBI's recent Liquidity Window Facility (LWF) is a step in this direction, introducing a framework that aims to improve the liquidity of corporate bonds. By providing investors with an exit option on predetermined dates, LWF can bridge the gap between public deposits and bond investments. This initiative has the potential to significantly expand retail participation in the corporate bond market — an essential shift for creating a resilient financing structure for NBFCs. However, to fully leverage this opportunity, the industry must actively engage in investor education to help retail investors understand the potential of the bond market and the value of diversified debt investments.

BROADEN FUNDING

Investment regulations for insurance and pension funds rightfully focus on stability but leave limited flexibility. Insurers must allocate 50 per cent of their funds to G-Secs with 25 per cent to Central government securities and 15 per cent to infrastructure and housing. Investments in the BFSI sector are capped at 30 per cent and exposure to other sectors is 15 per cent, with a maximum of 15 per cent per corporate group and 5 per cent for promoter-linked groups. Moreover, 75 per cent of the corporate bond portfolio must be in AAA rated or sovereign assets, with only 5 per cent allowed in A-rated and below investments. Similar restrictions apply to pension funds, which can invest in India's Top 200 companies or AA-rated and above corporate bonds but are capped at 15 per cent per industry and 10 per cent for lower rated or short tenor bonds.

Developing a robust market for securitised products, bond insurance and credit default swaps is essential to enhance flexibility and returns. These tools may allow insurers and pension funds to diversify portfolios while managing risks effectively. Relaxing some of these caps and expanding investment opportunities in corporate bonds and infrastructure will support broader economic growth while maintaining financial stability.

For long-term sources of funding, foreign currency borrowing in the form of ECBs and bonds is a large pool. With international interest rates softening, lower hedging costs and demand for better-rated Indian Paper, there is a compelling case to pursue and expand this market. FY24 saw the resurgence of the ECB market, with total borrowings touching almost $50 billion after several years of subdued activity. However, major action was in capital goods, modernisation projects and infra development. In the first quarter of FY25, the total foreign currency borrowings touched $11 billion across 336 deals, with NBFCs accounting for over 40 per cent at $4.6 billion. There is a further case to expand the liability mobilisation by NBFCs using foreign currency borrowings as the landed and fully hedged cost of ECBs is at par with domestic borrowings, and it opens up new avenues for long-term sources of funds.

THE SUSTAINABLE ROAD

NBFCs are pivotal to India's financial inclusion and growth agenda. To scale sustainably, they require diversified funding supported by broader bond market participation, optimised frameworks for insurance and pension funds, and expanded foreign borrowing options. A robust funding base will fuel and support the growth prospects of NBFCs, enabling them to become key drivers of inclusive and long-term economic progress.

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