NBFC stress may lead to system liquidity due to interconnectedness: IMF

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An International Monetary Fund report found that 63% of the power sector loans were from the three largest Infrastructure Financing Companies. Representative image | Photo Credit: Getty Images

Stress in the Non Banking Finance Companies (NBFCs) may pose risk in the financial system due to their overexposure to power and infrastructure sector and interconnectedness with other markets, said IMF in a report.

The International Monetary Fund report titled "India Financial System Stability Assessment" found that 63% of the power sector loans were from the three largest Infrastructure Financing Companies, a type of an NBFC in fiscal 2024. This increased from 55% in 2019-20. Moreover, 56% of their lending was financed by market instruments and only rest by bank borrowings in second quarter of fiscal 2024. The dependence on bank borrowings for financing their lending nevertheless increased since fiscal 2019. State-owned NBFCs like IREDA are at a higher risk, the international institution found.

Besides, spillover of NBFC stress, the IMF also studied banks'resilience ifa stagflation were to occur, a situation when growth slows and inflation soars. In the stress test, IMF found that in the event of a stagflation, public sector banks (PSBs) may have difficulties maintaining a capital adequacy ratio (CAR)of barely 9%. CAR is the ratio of capital to riskweighted assets, used to measure the bank's ability to absorb losses. RBI mandates a 12% and 9% CAR for PSB and Scheduled commercial banks respectively. IMF said that though the likelihood of stagflation had receded in 2024 there were"geopolitical risks and monetary policy miscalibration of major central banks could result in an increase in interest rates," which could slow economic growth.

"Assuming zero growth to their loan portfolio, PSBs can maintain barely the 9% CAR in the recession scenarios. This means that PSBs should strengthen their capital base, including by retaining their earnings instead of paying dividends to the government as they have been doing in the past few years, to ensure they can support economic recovery in a potential future downturn. PSBs are relatively more vulnerable because they have lower initial CARs and are more sensitive to credit risk," the report found.

The international institution also gave recommendations to mitigate the risks. State-owned NBFCs should have the same regulatory burden as private sector NBFCs to create a level playing field, the report found. Further, it also underlined the importance of enhanced data sharing regarding to NBFC credit and exposure. Apart from these, IMF recommended measures like prioritising financial stability over development motives of banks among others.

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