NBFC SECTOR – TRENDS, REGULATORY FRAMEWORK AND WAY FORWARD

Overview

The NBFC sector has been gaining systemic importance in the recent years and the share of NBFC has steadily grown from 10.7% of banking assets in 2009 to 14.3% of banking assets in 2014.

NBFCs typically have several advantages over banks due to their focus on niche segment, expertise in the specific asset classes, deeper penetration in the rural and unbanked markets. However, on the flip side, they depend to a large extent on bank borrowings, leading to high cost of borrowings and face competition from banks which have lower cost of funds.

The growing asset size of the NBFC sector has increased the need for risk management in the sector due to growing interconnectedness of NBFCs with other financial sector intermediaries. The Reserve Bank of India (RBI) has been in the recent past trying to strengthen the risk management framework in the sector, simplify the regulations and plug regulatory gaps so as to prevent regulatory arbitrage between banks and NBFCs.

The Reserve Bank of India released the 'Revised Regulatory Framework for NBFCs' on November 10, 2014 which broadly focuses on strengthening the structural profile of NBFC sector, wherein focus is more on safeguarding of the depositors money and regulating NBFCs which have increased their asset-size over time and gained systemic importance.

Due to subdued economic growth, last two years, have been challenging period for the NBFCs with moderation in rate of asset growth, rising delinquencies resulting in higher provisioning thereby impacting profitability. However, comfortable capitalisation levels and conservative liquidity management, continues to provide comfort to the credit profile of NBFCs in spite of impact on profitability.

I. Business profile of NBFCs

Historically, NBFCs have been financing various asset classes ranging from retail, corporate and infrastructure segment. Based upon the business profile, NBFCs are classified in eight broad categories. Out of the eight categories, seven are under the regulatory purview of RBI while the Housing Finance Companies (HFCs) are regulated by the National Housing Bank (NHB).

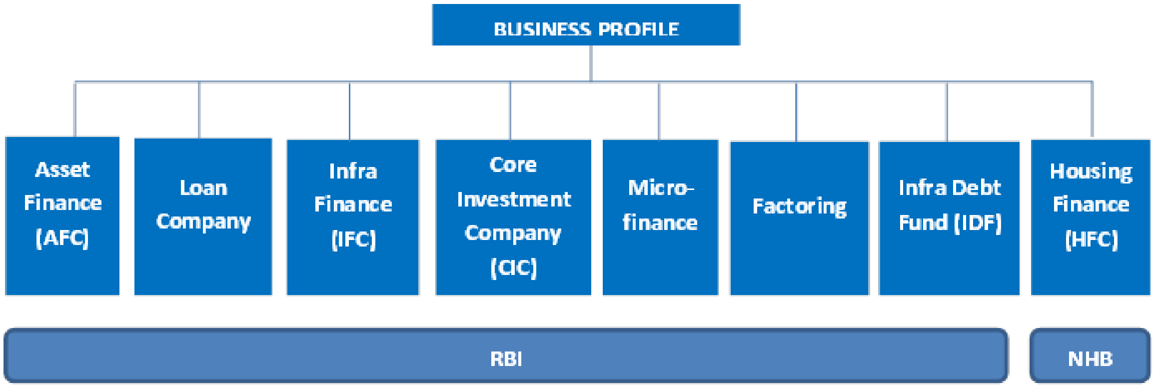
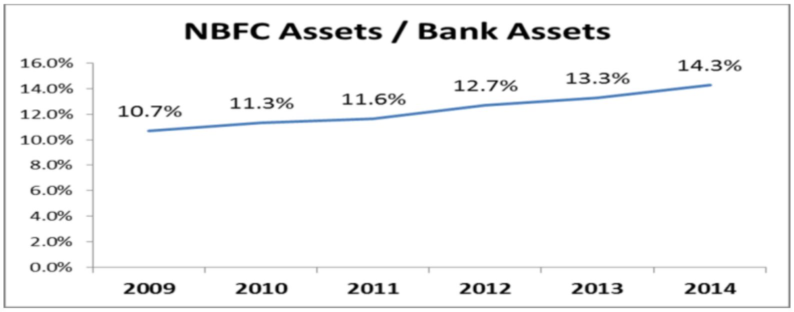


Diagram 1: Profile of NBFCs

II. Structural Profile of the NBFC sector

1. Increasing size and systemic importance

Over the years, the NBFC sector has been gaining systemic importance. The same can be seen with the rise in share of NBFC assets as a percentage of bank assets. The share of NBFC assets have steadily grown from 10.7% of banking assets in 2009 to 14.3% of bank assets.



Source RBI Reports

2. Stronger Regulatory Environment leading to higher capital cover and Better Risk Management

With increase in systemic importance, RBI has been tightening the regulations to manage the risk in the sector and has been prescribing higher capital and provisioning requirement. RBI also has been emphasizing on higher disclosures by large size NBFCs as well as deposit taking NBFCs to safeguard public money and avert any systemic shocks. In addition, the RBI has taken prompt preventive actions in addressing specific issues to manage systemic risk.

3. Move towards Secured Lending

During the credit crisis of 2008-2009, NBFCs saw a surge in Non Performing Assets (NPAs) in the unsecured lending products like short term personal loans. As a result, NBFCs which had high exposure to unsecured loans faced severe losses on account of higher provisioning. Post 2009, most NBFCs have reduced the proportion of unsecured lending in their portfolio and moved towards secured lending products.

4. Lower Liquidity Risk

Another lesson learnt by NBFCs from the credit crisis of 2008-2009 was conservative liquidity management. Over the years, NBFCs have shifted towards maintaining conservative Asset Liability Maturity (ALM) profile by increasing the proportion of long term funding and generally maintaining liquidity buffers in terms of liquid investments and committed lines from banks.

5. Stronger Lending Infrastructure

In the last 5 years, the sector has grown stronger in terms of lending infrastructure. NBFCs have seen increase in scale of operations which has necessitated up-gradation in technology and IT systems. The establishment of Credit Bureaus has helped improvement in credit culture which has helped the NBFCs in the retail financing business. Over the period, the credit bureaus have built sizeable database which will help in strengthening the lending infrastructure in the long run. High growth in scale of business requires better management capability as a result most

NBFCs have now put in professional management teams to manage business and credit operations.

6. Rising number of large players – backed by strong promoters

Over the last few years, the sector has seen rise in the number of large players which are backed by corporate houses / private equity investors who wish to participate in the credit growth of the country but faced stringent regulations and high entry barriers in Indian banking sector. Many of the large corporate houses and banks have also diversified into lending and lending related businesses focusing into niche segments. However, with a rise in number of players, the competition in sector has intensified and impact of stiff competition in the long needs to be observed.

7. Diversification and Mortgage Based lending

During last couple of years most of the large sized NBFCs have diversified in various product segments in order to mitigate product concentration risk. In the recent past, mortgage finance has emerge as one of the better performing asset class resulting in most of the large NBFCs diversifying in mortgage finance including housing loans and loan against property. Also many NBFCs have set up their housing finance companies in order to focus on this asset class.

III. Key Performance Trends observed in the NBFC Sector

CARE has analyzed 40 large sized NBFCs comprising of deposit accepting NBFC as well as non-deposit accepting NBFCs with presence across various asset classes. These 40 large size NBFCs account for or around 40% - 45%of the total NBFC sector assets.

1. Capital Adequacy remains comfortable

At present the Capital Adequacy Ratio(CAR) for the NBFC sector is comfortable both on Total CAR as well as Tier I CAR basis. The Total CAR for the sector was around 20% with Tier I CAR of around 15.5% as on March 31, 2014 which was comfortably higher than the minimum regulatory requirement of 15% for Total CAR and 7.5% for Tier I CAR except for gold loan NBFCs which is required higher minimum Tier I CAR of 12%.

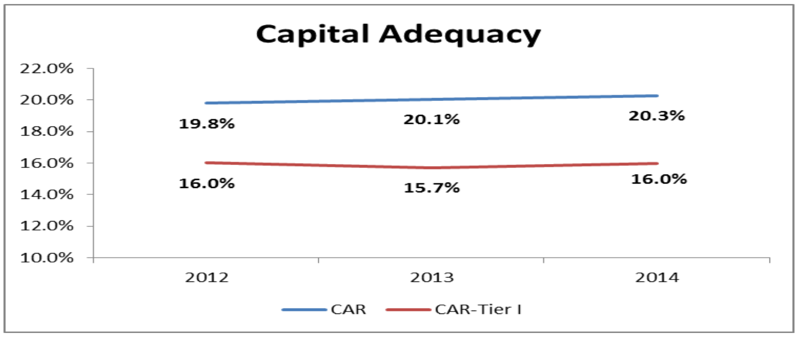


Chart 1: Trend in Capital Adequacy of NBFCs Source: CARE Study

Overall capital adequacy ratio has remained stable over last couple of years with entry of new large players with strong capital back-up. However, due to higher issuance of Tier II capital primarily in the form of subordinated debt followed by preference capital and perpetual debt, the share of Tier II capital has increased over a period. However, at the current level of Tier I CAR, the sector seems comfortable with respect to revised guidelines of 10% of Tier I CAR by March, 2018.

2. Asset quality under pressure due to economic stress

NBFCs have witnessed a stress in asset quality during the last two-three years due to weak operating environment and economic downturn. Sectors which are directly linked to economic activities like commercial vehicle, construction equipment and infrastructure financing have witnessed sharp deterioration in asset quality. Gold loan NBFCs have also witnessed asset quality concerns on account of regulatory uncertainties, correction in gold prices and funding constraints.

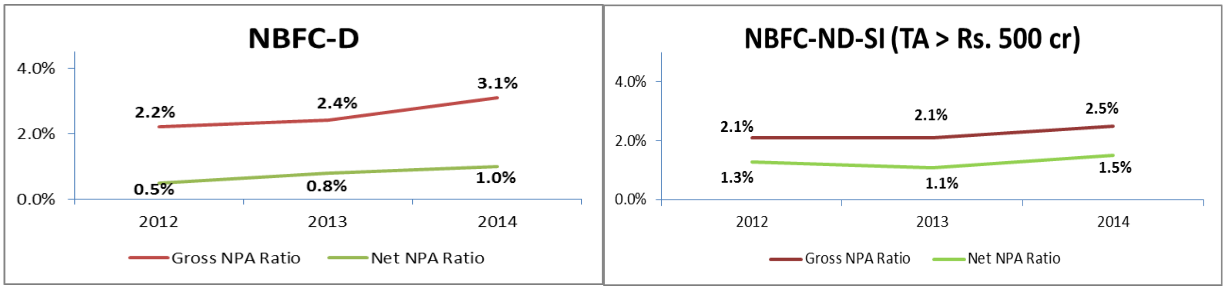


Chart 2: Trend in Asset Qualityof NBFCs Source: RBI

Deposit accepting NBFCs have seen higher deterioration in asset quality as compared to non-deposit accepting NBFCs as major deposit accepting NBFCs are operating in commercial vehicle financing. However, deposit accepting NBFCs have better provision coverage of around 60%.

During current financial year i.e. FY15 (refers to period April 01, 2014 to March 31, 2015), delinquencies for NBFCs remained at elevated levels due to no pick-up in industrial activity. However, the industrial activity is expected to see recovery during later part of the year.

3. *Profitability impacted on account of slowdown in growth and asset quality pressure*

During FY13, overall profitability remained stable as compared to FY12 levels. The Return on Total Assets (ROTA) for FY13 was at 2.57% as compared to 2.58% for FY12.

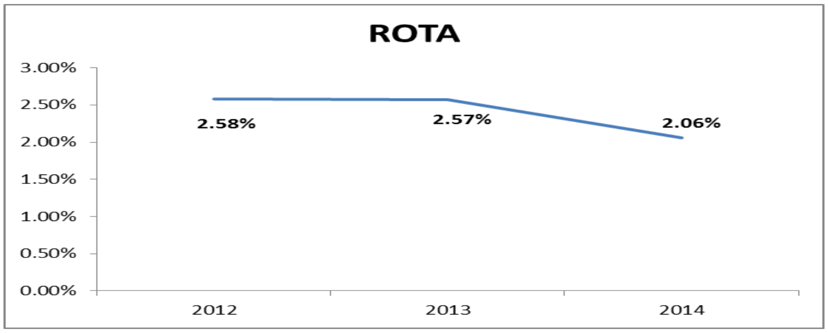


Chart 3: Trend in Capital Adequacy Source: CARE study

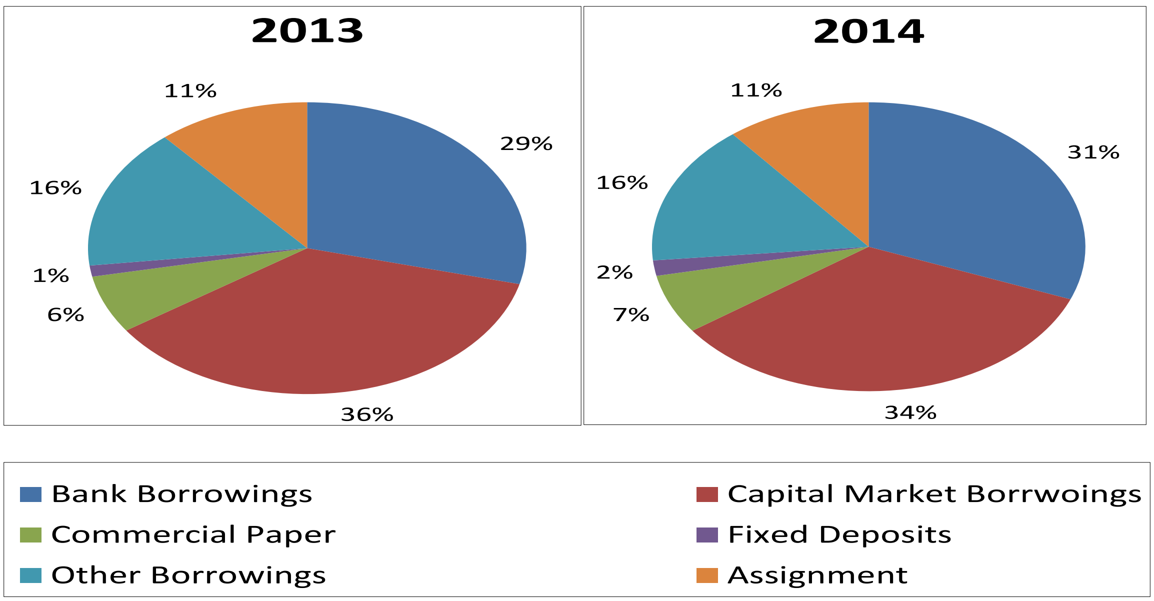
During FY14, due to hardening of interest rates and rising delinquencies, the NBFC sector has seen pressure on net interest margins and increase in credit cost.Increase in NPAs has dual effect – (1) not earning of interest and (2) reversal of interest income which was booked in earlier period.Due to which the profitability has taken a hit which is visible from ROTA declined from 2.57% for FY13 to 2.06% for FY14.

4. *Resource profile continues to be stable*

Borrowings through capital market including NCDs, subordinated debt, preference shares, perpetual debt continued to be the major source of funding for NBFCs as it accounted for 34% of total borrowings in FY14 followed by banks funding which accounted for 31% of their total borrowings. Overall borrowing mix in FY14 has remained in-line with FY13. Dependency on short term borrowings like commercial paper is less at around 7% which helps them to manage their asset liability mismatches.

Revised guidelines on securitization and priority sector lending made NBFCs to re-look at their business model. Direct loans given to NBFCs are now not classifying as priority sector lending except for NBFC-MFIs. Lending via securitization route through direct assignment without credit enhancement or through Pass Through Certificates (PTCs) can be classified as priority sector lending criteria.

Change in above guidelines has made NBFCs to explore channel business tie-ups and direct assignment i.e. securitization without credit enhancement with banks to save their capital cost and overcome fund raising constraints.



IV. Recent Regulatory Changes

1. *Loan Against Shares*

In the current year RBI issued guidelines on lending against shares, wherein RBI perceived that the asset class posed a systemic risk wherein an event of default by borrowermay lead to offloading of shares by the lending NBFC in the market leading to very high volatility and impacting NBFC ability to recover its loan.The regulation has prescribed the following changes:

- Lending restricted to 50% Loan To Value (LTV) of the security

- Only A category as described by the Securities and Exchange Board of India (SEBI) shares can be pledged as collateral to avail loan from NBFCs
- Online reporting of pledge of equity shares by NBFCs to the stock exchanges

2. ***Lending Against Gold***

In case of lending against gold, RBI harmonized the LTV ratio and valuation methodology as different NBFCs were using different valuation methods and thereby leading to differences in the loan amount by different players against the same collateral, both for banks as well as NBFC. Additionally due the high risk perceived by the RBI in the segment RBI mandated Gold loan Also, NBFCs lending against gold are required to maintain high Tier I CAR of 12%.

3. ***Restructuring of Advances***

With regard to restructuring by NBFC, RBI has allowed only Infrastructure and Non-infrastructure project loans restructured to enjoy standard classification. In terms of provisioning RBI has again harmonized regulation for banks and NBFCs.

4. ***Sharing of Special Mention Accounts (SMA) data***

RBI has laid down framework for recognizing Special Mention Accounts (SMA) wherein there are early warning signals at par with banks.Thus, NBFC need to classify early warning accounts into

(i) SMA-0 (based on certain parameters,

(ii) SMA-1 (30-60 days overdue) and

(iii) SMA2 (60-180 overdue).

These SMA accounts need to be reported to Central Repository of Information on Large Credits

SMA-2 to trigger Joint lender forum and formulation of corrective action plan together with banks, thus to help bank and NBFC to take corrective actions to address the stress before it turns into NPA

5. ***Restriction on raising retail NCD by way of Private placement***

Over the years, many NBFCs have been raising NCDs by way of private placement from retail investors, the same posed a high risk as this effectively meant that these were in a way retail deposits as there was no guideline to restrict the same.

Accordingly, RBI issued a circular to address this regulatory Gap which addresses the issue

a) By raising minimum investment to Rs.25 lakh in case of private placement
b) Restricting maximum investors at 49

Also now NBFC can't give loan against security of its own NCDs

V. RBI's Revised Regulatory Framework – Impact Analysis

Table 1 – Impact analysis of key changes

Change in Norm	Impact
NBFCs registered prior to April, 1999 to raise their Net Owned Funds NOF to Rs.2 crore by March, 2017	• Brings in parity for NBFCs formed prior to and after April, 1999 • Ensures only serious and competitive players with minimum NOF remain in the market
Limit on deposit acceptance reduced to 1.5 times of Owned Funds from 4 times of Owned Funds for Deposit taking AFCs and mandatory investment grade credit rating for accepting public deposits	• Mandatory investment grade credit rating helps to safeguard depositors • Limit on deposits improves safety for public depositors • However, majority of deposit taking NBFCs are already compliant
Revision in threshold for defining systemically important NBFC to asset size of Rs.500 crore from Rs.100 crore	• Larger NBFCs subjected to more stringent norms • However, regulatory compliance requirement reduced for NBFCs having assets size between 100 crore to 500 crore
Multiple NBFC that are part of a corporate group or floated by common set of promoters will not be viewed on standalone basis	• To help regulate groups having multiple small NBFCs and bring them under more regulatory supervision
Introduction of leverage ratio (total outside liabilities / owned funds) of 7 for NBFC-ND having assets less than Rs.500 crore	• Restricts leverage of non systemically importantNBFCs
Increase in Tier I CAR (core CAR) to 10% from current 7.5% for NBFC-D and NBFC-ND-SI	• In line with RBI's move to improve loss absorbing capacity of systemically important financial institutions • Will increase capital requirement in the long run. • However, currently most of the large NBFCs have Tier I CAR of more than 10%, so there would be no immediate impact

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Introduction of leverage ratio (total outside liabilities / owned funds) of 7 for NBFC-ND having assets less than Rs.500 crore	• Restricts leverage of non systemically importantNBFCs
Change in NPA recognition to 90 days overdue from 180 days overdue for loans and 360 days for hire purchase assets	• Removes regulatory arbitrage for NBFCsvis-à-vis banks • Will lead to jump in NPAs for the NBFCs over the short term • Will impact the profitability due to higher provisioning requirement with increase in NPAs and interest reversals
Provision on standard assets increased from 0.25% to 0.40%	• Strengthen the balance sheet of NBFCs by increasing the loss absorption capacity of NBFCs in long run • Will have higher impact on profitability in short run
Credit concentration norms for AFCs to be in line with other NBFCs	• Unlikely to have much impact as AFCs typically have retail loans
Corporate governance and disclosure norms	• Will improve corporate governance and accountability of systemically important NBFCs and improve transparency • Ensures availability of important information to investors

Impact on Key financial parameters of NBFCs

CARE's analysis is based on 40 large NBFCs.

1. ***Profitability***

On the profitability front, as per CARE's estimates ROTA will see an impact in the range of 35-45 bps due to rise in standard asset and NPA provisioning upon complete implementation of the revised framework.

2. ***Asset Quality***

On the Asset Quality front the transition phase will help in reducing the impact, however the Asset Quality parameters are likely to deteriorate during transition phase with the addition of one bucket each year. If the guidelines were to be implemented immediately, Gross NPA levels as on March 31, 2014 would have doubled based on 90 DPD level from the current level of 3.4% based on 180 DPD.

However, the transition phase will help reduce the impact due to following factors:

a) CARE expects that over the period of next three years there will be economic recovery and credit growth will pick up for NBFC sector as well. As a result and over the period of three years, outstanding advances book will increase thereby lowering the NPA %.
b) Secondly it is expected that with the economic recovery fresh slippages would reduce drastically thereby helping in reducing the impact. As past two years have seen very high slippages.
c) Also, over the transition phase NBFC's will fine tune there systems and processes and try to align their borrowers to new reporting systems.

All these measures together will reduce the impact. Accordingly, as per CARE's estimates, Gross NPA level may be in the range of 5.8%-6.1% by 2018 from around 3.4%* as on 2014

3. ***Capital Adequacy***

Higher Tier I Capital adequacy requirement Is likely to have Impact in the long run as NBFCs will need to maintain higher Tier I capital on a consistent basis. However, Current capital adequacy level is comfortable, thus there will be no impact in short term.

VI. Way Forward

The cyclical stress on asset quality and profitability of NBFCs is covered by strong capital adequacy, secured lending and lower ALM risk. With increased importance of NBFC sector Structural support expected from regulator is higher.

RBI regulations are in line with its desire to strengthen financial system and reduce the regulatory arbitrage between banks and NBFCs. Accordingly, the new regulatory framework will lead to strengthening of NBFCs balance sheet, with increase in loss absorbing Tier I capital requirement for systemically important NBFCs and deposit accepting NBFCs and restricting leverage for smaller NBFCs in line with higher core Tier I requirement for Banks under Basel III guidelines. On NPA recognition norms and provisioning on standard assets also, banks and NBFC will be at par. The increase in disclosure requirement and corporate governance norms will improve the transparency and increase the accountability of management and the board and improve the investor awareness.

Overall, CARE perceives revised regulations to be Positive for the NBFC sector. CARE believes that current profitability levels can absorb impact of additional provisioning requirements. The regulations will make the NBFC sector structurally stronger, increase transparency and improve their ability to withstand asset quality shocks in the long run.

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