NBFC-Navigating growth amidst regulatory changes

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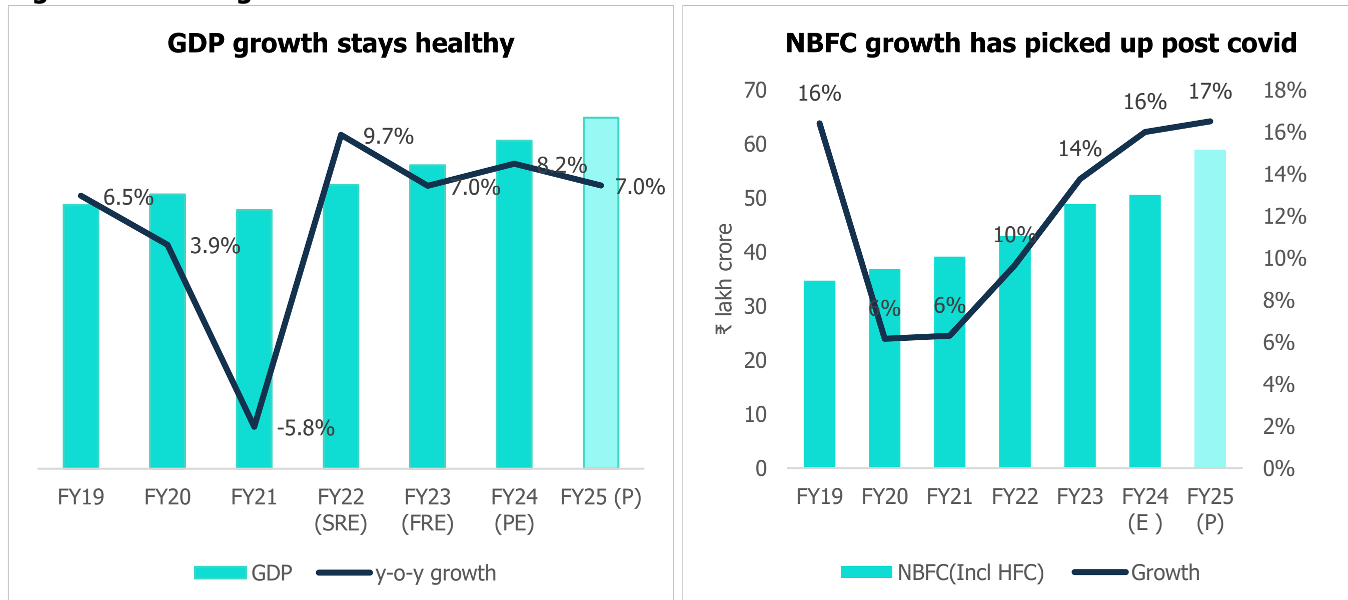
Overview

India, as the fastest-growing economy and the fifth-largest globally, offers a favourable environment for credit market expansion. The Non-Banking Financial Companies (NBFCs) maintain a significant 22% share - amongst banks, NBFC & AIFI in the credit market. NBFCs have stronger balance sheets with reduced leverage, and improved asset quality. We believe that credit costs are near bottom, if not already bottomed out. The growth of NBFCs is primarily driven by retail loans, with a high reliance on banks for funding. The rising interconnectedness of financial markets poses additional risks. A robust and proactive regulatory framework, coupled with swift penal actions by the Reserve Bank of India is crucial for balancing risk and growth. As competition intensifies, NBFCs' ability to mobilize resources, manage credit costs, and maintain Return on Equity (ROE) will be critical for sustaining their growth trajectory.

Economic Growth and Credit Demand

India's economy is on a robust growth trajectory, with healthy GDP growth rates despite geo-political challenges and growth concerns around the globe. The NBFCs sector has demonstrated significant resilience, with credit growth accelerating in the post-pandemic period. NBFCs play a crucial role in the financial ecosystem, growing at a CAGR of 14%. Amongst banks, NBFC and AIFIs (All India Financial Institutions), NBFCs have maintained 21-24% share of credit from FY17 to FY24. The banks account for approximately 70% and AIFIs make up remaining 5-7%. As India targets becoming a USD 5 trillion economy in the coming years, the demand for financing is set to increase, underscoring the vital role of NBFCs in supporting economic growth and development. The sector's ability to adapt and innovate will be crucial in addressing the evolving needs of the expanding economy. We expect NBFCs to grow at 17% in FY25.

Figure-1: Growing Economic



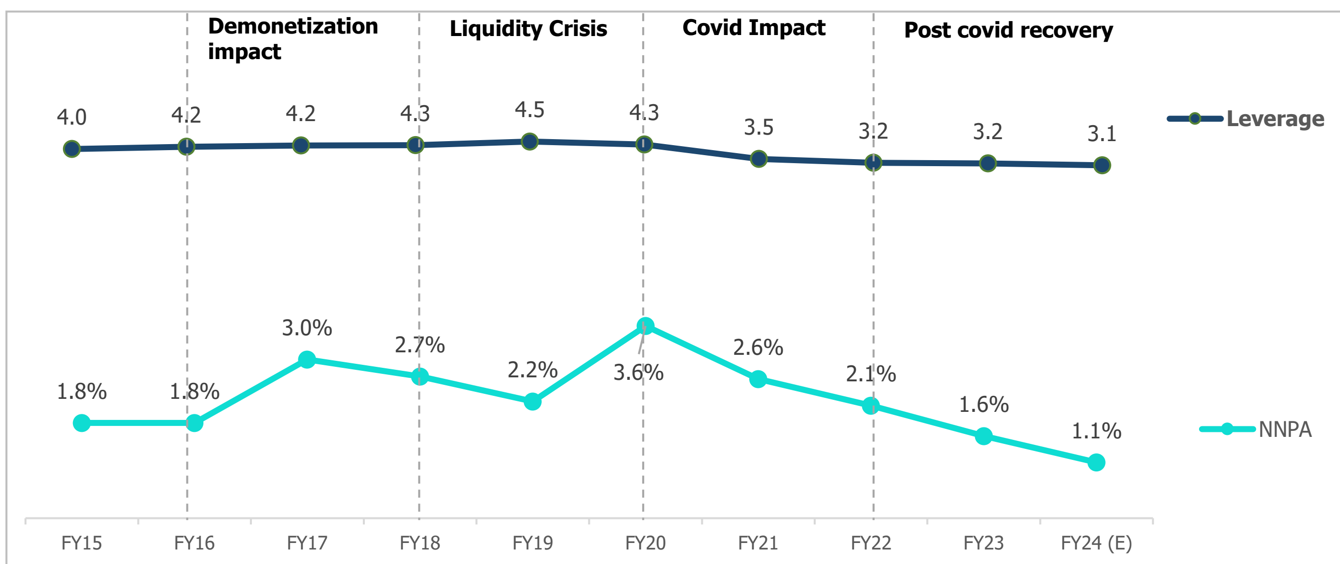
Source: MOSPI, CareEdge Estimates; SRE: Second Revised Estimate; FRE: First Revised Estimate; PE: Provisional Estimate

Strengthened Financial Metrics

Over the past decade, NBFCs have shown remarkable resilience, even amidst systemic shocks like the pandemic, thanks to crucial regulatory support and government initiatives. Currently, at aggregate level, NBFC balance sheets are stronger, with leverage ratios reduced to 3.1x from a peak of 4.5x. Asset quality has improved significantly, with the net non-performing asset (NNPA) ratio at an all-time low of 1.1%, despite the stricter Income Recognition, Asset Classification, and Provisioning (IRAC) norms introduced in November 2021. A similar trend is observed in credit costs (computed as provisioning & write off charged to P&L divided by average assets), which are near their bottom. However, an uptick in credit costs is anticipated over the medium term.

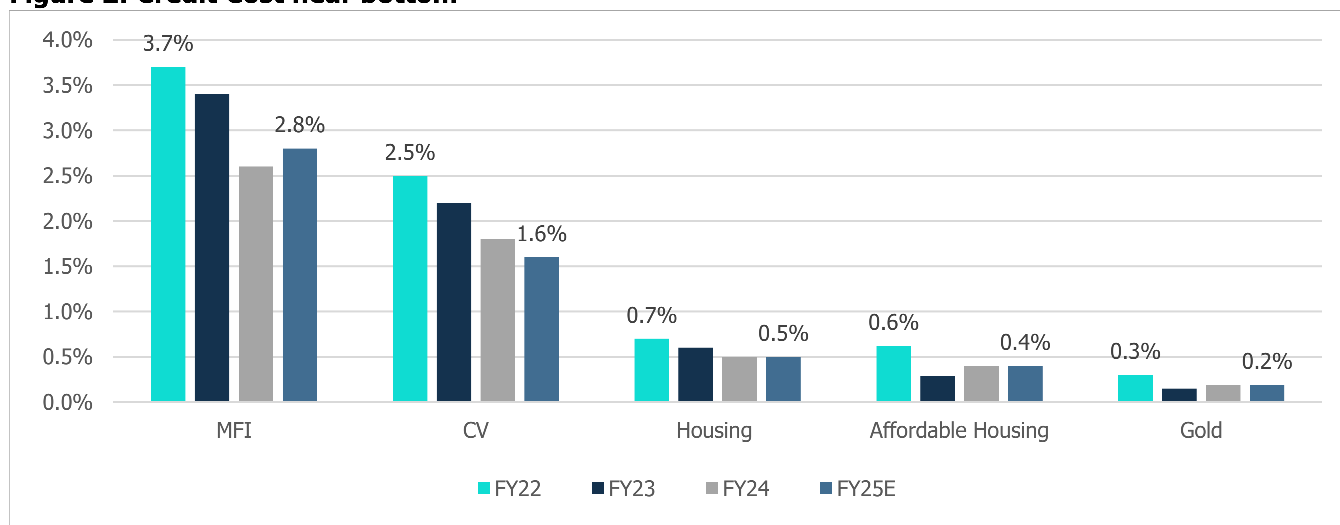
We also note that asset liability maturity pattern profile has strengthened with reliance on short-term funding, such as commercial papers, reducing from approximately 9% in FY17 to about 3% in FY24.

Figure 1: NBFCs – On Firm Footing



Source: RBI, CareEdge database

Figure 2: Credit Cost near bottom



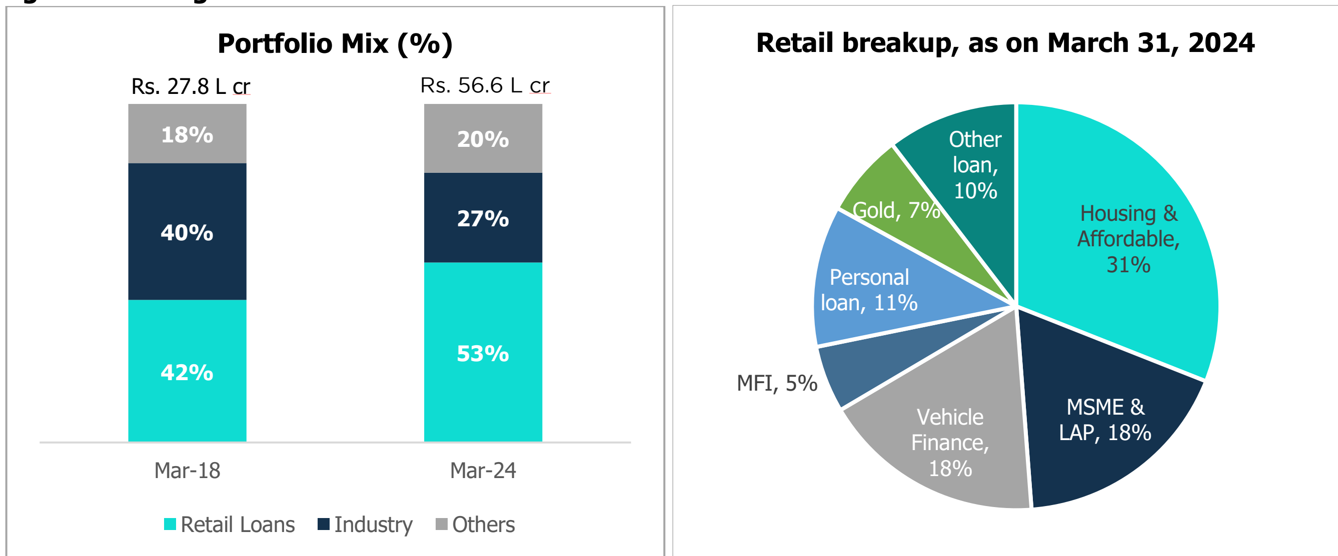
Source: Company data, CareEdge estimates

Shift Towards Retail Lending

The portfolio mix of NBFCs has significantly evolved, reflecting a shift from wholesale lending to a focus on retail loans. Retail loans now drive NBFC growth, with housing loans leading the share, followed by MSME loans, Loan Against Property (LAP), and vehicle loans. This transition has resulted in a more diversified and resilient loan portfolio. This transition was supported by emergence of new players like credit AIFs and private credit market. The preference of lenders and equity investor to support retail focused NBFCs also enabled this swift transition.

The wholesale lending within NBFC space is now predominantly handled by specialized entities registered Infrastructure Finance Companies (IFCs) or Infrastructure Debt Funds (IDFs). These entities are largely mandated to cater to this space and notable names include PFC, REC, IRFC, NaBFID, NIIF IDF, Aseem Infra.
Overall proportion of retail loans has gone up from 42% in FY2018 to 53% in FY24.

Figure 3: Rising Share of Retail in the NBFC Loan Mix

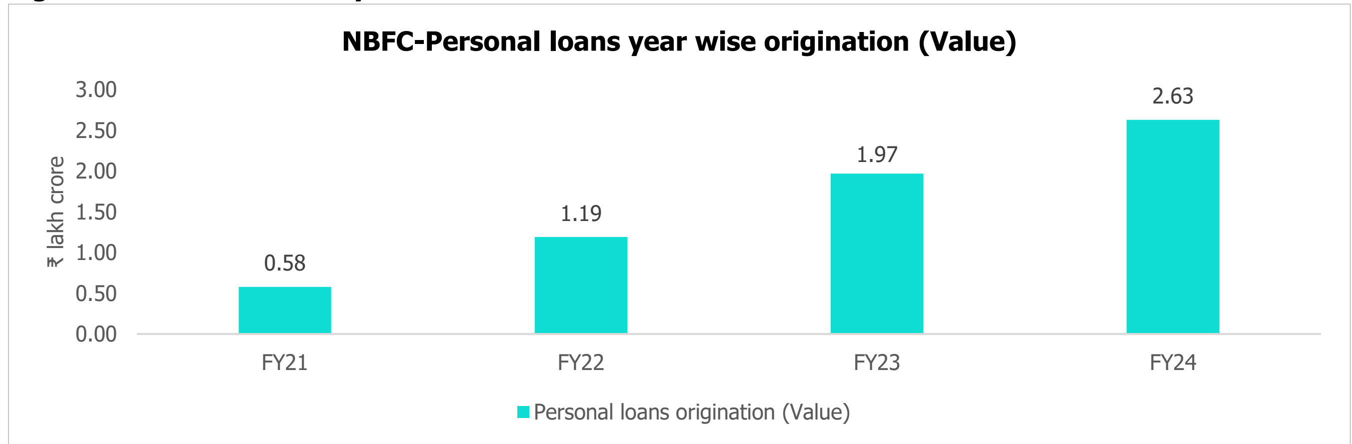


Source: RBI, NHB, CareEdge database

Unsecured Personal Loans and Digital Lending

The growth of unsecured personal loans within the NBFCs sector has been striking, driven by increased borrower penetration. The value of personal loans originated by NBFCs surged from INR 0.58 lakh crore in FY21 to INR 2.85 lakh crore in FY24. This expansion is accompanied by a substantial rise in the number of loans originated, increasing from 1.9 crore in FY21 to 10.4 crore in FY24. The average ticket size currently stands at INR 25,000. However, we also see shift towards higher ticket and longer tenure loans. This segment also shows higher delinquency trends, underscoring the need for vigilant risk management as NBFCs broaden their personal loan offerings.

Figure 4: Growth driven by Increased Borrower Penetration



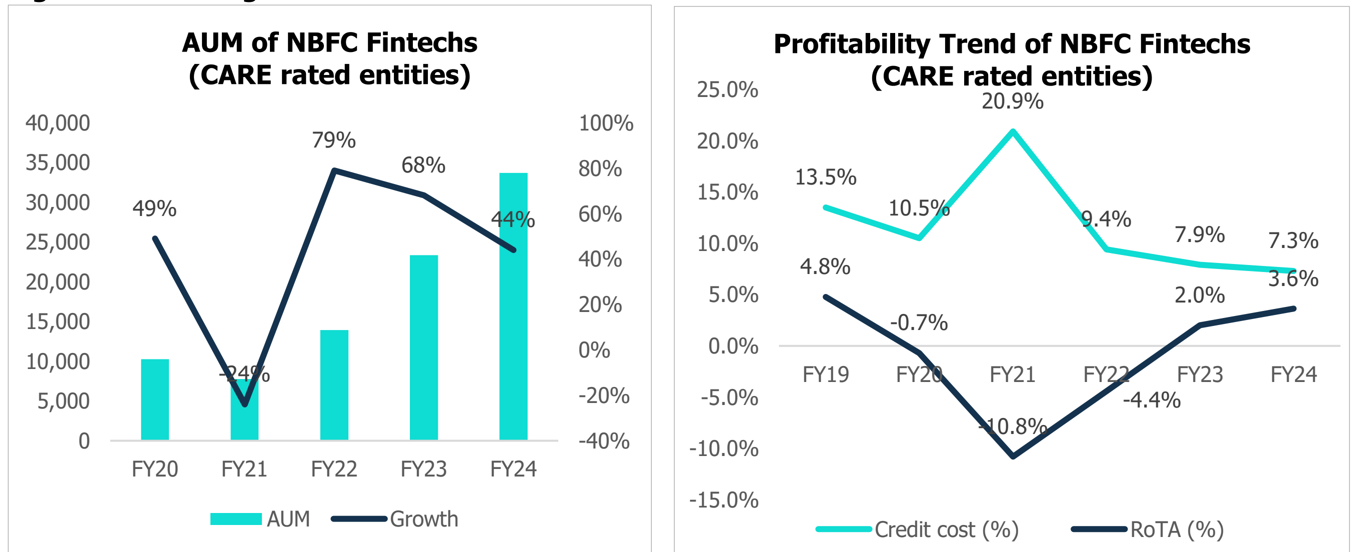
Source: CRIFHIGHMARK and CareEdge estimates

Top of Form Bottom of Form The Rise of Fintech NBFCs

Fintech Non-Banking Financial Companies (NBFCs) have experienced rapid growth in recent years, harnessing technology to boost efficiency and expand customer reach. The Assets Under Management (AUM) of CARE-rated fintech NBFCs have surged from ₹10,262 crore in FY20 to ₹33,676 crore in FY24, reflecting a notable year-on-year increase. However, growth rates are expected to moderate for the current fiscal year due to a higher base and potential funding constraints.

Fintech NBFCs have been able to maintain healthy Pre-Provision Operating Profit (PPOP) margins and reduction in credit costs has in turn improved the bottom-line, making them increasingly economically viable.

Figure 5: Fintech growth trend

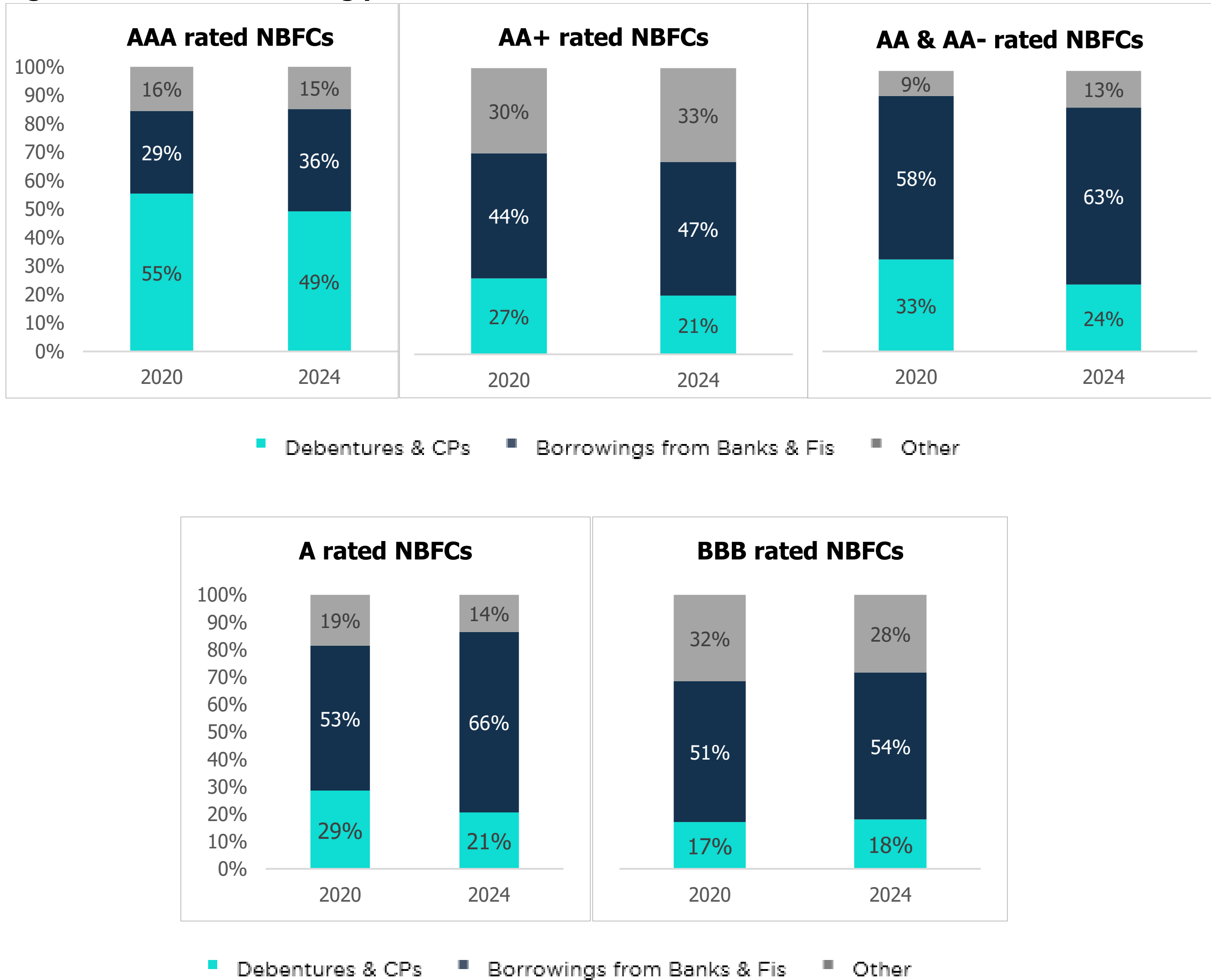


Source: Company data, CareEdge Estimates

Rising share of bank borrowings in the funding profile

The absolute exposure of all sets of debt providers have increased to NBFCs in line with book growth of NBFCs. However, in percentage terms, the funding patterns for NBFCs shows increased reliance on bank loans and a decline in bond market's share. This trend is visible across the rating categories. In terms of borrowing share, while market instruments dominate the borrowing mix of AAA rated entities, for entities rated AA and below, bank borrowings dominate the funding profile. We note that around 90% of bank debt to NBFCs is extended to entities rated in AA category or higher.

Figure 6: On book borrowing profile of CARE Rated entities

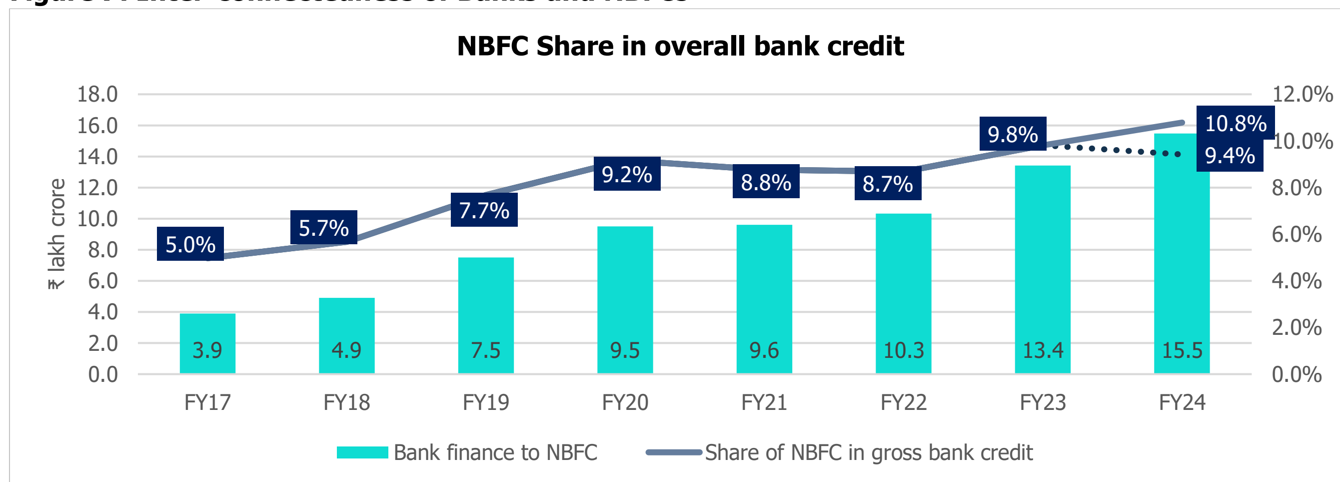


Source: Company data, CareEdge Estimates
Other includes Fixed deposits, Inter-corporate borrowings, Securitization

Rising Interconnectedness with Banks

The interconnectedness between banks and NBFCs has grown significantly, with bank finance to NBFCs increasing fourfold over the past seven years. Bank finance to NBFCs has risen from 5% to ~9.4% over the same period. If we ignore the likely impact of HDFC merger, bank finance to NBFCs would be near 10.8%. The Reserve Bank of India has raised concerns about the growing interconnectedness and are encouraging NBFCs to diversify their funding sources

Figure 7: Inter-connectedness of Banks and NBFCs



Source: RBI, CareEdge database

In addition to bank loans, banks also support NBFCs through their investment books (investment in NCDs, CPs, and PTCs) as well as through buyouts such as Direct Assignments (DA) and Co-lending Mechanisms (CLM).

Regulatory Framework balances Risk and Growth

The proactive regulatory framework, supported by swift penal actions, has been and will be instrumental in balancing risk and growth within the NBFC sector. A few notable regulations in recent history including scale-based norms, alignment of IRAC norms of NBFC to that of banks, capital treatment for exposure to Alternative Investment Funds (AIFs) etc. are contributing to a more robust sector.

Additionally, the Reserve Bank of India (RBI) has taken decisive penal measures against several prominent NBFCs in recent years for regulatory violations and exploitation of regulatory gaps, reinforcing the importance of adherence to regulatory standards and maintaining sector stability.

Strengths and Challenges

The NBFCs sector in India is currently experiencing several positive trends. Retail lending is increasing, with a focus on productive financing. NBFCs are effectively utilizing digital data to improve credit assessments and operational efficiency. Their balance sheets are stronger and credit costs are contained compared to previous years. The interest of equity investors remains robust and there is vast pool of debt capital overseas which is largely untapped.

However, challenges persist. Pressure on banks' credit-deposit ratios raises concerns about NBFCs' ability to secure funds. Enhanced regulatory supervision will lead to higher compliance costs, though necessary for stability. There is a growing discussion on need to monitor the end-use of funds by NBFC. Additionally, smaller NBFCs and smaller

fintechs are facing challenges on liability-side, underscoring the need for strategic solutions to address these challenges.

Conclusion

The NBFC sector in India is well-positioned for continued growth, bolstered by a thriving economy, robust balance sheets and a good portfolio mix. The sector's resilience and adaptability provide a strong foundation for future success. The last mile reach, understanding and focus on niche micro markets are expected to continue as their USP. As NBFCs continue to innovate and harness technology, their role in the financial ecosystem will become increasingly crucial, driving significant contributions to India's overall economic development, especially lower strata of the economy.

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