Nova Dhruva

Re-fueling NBFCs

Way Forward

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The Problem at Hand

A brief glance at the liability profile of the NBFCs (as given below) tells us the importance of Commercial Papers (CPs) in providing liquidity while maintaining low interest costs. CPs have contributed ~10-11% to the overall NBFC borrowings of INR 16.1 tn (as per Sep-18). Prior to the IL&FS crisis, in a market with substantial liquidity, the supply of CPs was matched by a strong demand from various market participants such as Banks and Mutual Funds (MFs). This was in addition to short term debentures which are a major source of funding for NBFCs. From the table below, we can observe that a significant fund mobilization has been done from channels other than the conventional Bank borrowings.

NBFCs - Sources of Funds (in INR bn)	Mar-16	Mar-17	Mar-18	Sep-18
Deposits	271	306	319	326
Debentures	5,394	6,480	7,155	7,551
Bank Borrowings	3,376	3,134	4,039	4,937
CPs	854	1,291	1,406	1,816
Others	1,092	1,152	1,353	1,511
Total	**10,987**	**12,363**	**14,272**	**16,141**

Source: RBI Trends and Progress of Banking in India

In the backdrop of tight liquidity and domino effect of multiple corporate defaults (IL&FS, DHFL etc.), there have been few takers for the CPs issued by NBFCs. As such, they are now finding it difficult to roll over their CPs which has further snowballed into a pan NBFC Asset Liability Mismatch (ALM) crisis.

Even well placed players with robust asset quality and strong corporate governance practices are finding it challenging to raise growth capital. As fear grips the wider markets, lenders hoard liquidity and not lend even though fundamentals may be strong. As Banks and NBFCs retract from active lending, the contagion has spread to other sectors such as manufacturing, auto, real estate etc. which are capital intensive in nature.

For the NBFC sector, an immediate capital infusion complemented by regulatory changes are the need of the hour to kickstart credit growth and propel economic growth to other industries as mentioned above.

Potential Solutions

Solution 1: Renewal of short-term credit to NBFCs

Considering the importance of CPs and other short term borrowings, it is extremely crucial to address the market pessimism surrounding the same by re-encouraging participation from Banks and MFs for such instruments issued by high rated NBFCs. This will enable them to diversify the sources of funding while maintaining low interest costs and spur the overall credit growth.

Needless to say, the extent of reliance on CPs and other short term sources of funding needs to be closely monitored so as to avoid any ALM crisis.

Solution 2: Lower risk weights – A step in the right direction

In February 2019, RBI revised the risk weights applicable to Banks for exposures to NBFCs. We believe this is a step in the right direction as it would encourage lending to higher rated NBFCs. The changes suggested are:

- Exposure to all NBFCs excluding Core Investment Companies (CIC) will be risk weighted as per the ratings assigned by the credit rating agencies
  - Earlier, this was extended only to Asset Finance Companies (AFCs), NBFCs – IFC and NBFCs – IDFs

Risk weights - Long-term claims on NBFCs (excluding CICs) and Corporates

Domestic rating agencies	**AAA**	**AA**	**A**	**BBB**	**BB & Below**	**Unrated**
Risk weights	20%	30%	50%	100%	150%	100%

Solution 3: Extending the co-origination of loans by banks and NBFCs for non-PSL lending

In September 2018, RBI introduced a scheme of co-origination of loans by banks and NBFCs to provide competitive credit to priority sector.

Under this scheme,

- Loans would be originated by NBFC with a minimum exposure of 20% and banks would fund the rest of the loan with pre-agreed rates of lending by the two players
- Both the lenders will have the flexibility to price their part of the credit exposure

Since the launch of the scheme last year, around INR 5,000 crores – INR 10,000 crore of such loans have been sanctioned.

An extension of such scheme to non-PSL lending would help the wider NBFC segment boost its profitability while diversifying exposure across larger asset base and minimizing portfolio risks.

Solution 4: Recapitalization of NBFCs with private capital

In Oct-17, Government of India announced recapitalization of the beleaguered Public Sector Banks (PSBs) to the tune of INR 2.1 lakh crores. Under the same, over the last three Financial Years, PSBs have been recapitalized to the extent of Rs. 2.9 lakh crore, with infusion of Rs. 2.2 lakh crores by the Government and mobilization of over Rs. 0.7 lakh crore by PSBs themselves.

This has helped some of the banks to come out of RBI's PCA framework by enhancing their capital position.

Recently, in budget 2019-20, a first loss guarantee scheme was announced for acquisition of high rated pooled assets of NBFCs by PSBs to the extent of INR 1 lakh crore. While this may be a nudge in the right direction, we believe there is a need to embark on a concerted recapitalization of NBFCs with private capital to facilitate immediate fund infusion and to address liquidity problems and enable stronger credit offtake.

Solution 5: Turning around the key stressed sectors such as auto and real estate

The overall economic slowdown has wreaked havoc on some of the key sectors to which NBFCs have significant exposure to – e.g. auto, real estate and MSMEs.

The NBFCs are caught in the vicious circle as the credit extension to these sectors are drying up with the rising NPA levels. A sluggish end-user demand (on account of slowing economy) along with rising credit costs or lower availability of credit is further aggravating the challenges faced by the industry.

We believe a revival in the overall economy and a rise in the consumption levels would drive the end-user demand and help facilitate the turnaround of these ailing sectors. This is also expected to have a positive effect on the overall performance and profitability of NBFCs.

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