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CREDIT RATING AGENCY

Mr. Vipin Malik
(Chairman, Infomerics Ratings)

Dr. Manoranjan Sharma
(Chief Economist)

Mr. Athar Imam Raza
(Officer - Economic Analysis)

INDUSTRY OUTLOOK

NBFC SECTOR: GROWTH OUTLOOK AND CHALLENGES

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Introduction

The Non-Banking Financial Companies (NBFCs) sector in India plays a crucial role in the financial ecosystem of the country. Over the past decade, NBFCs have significantly increased their share in the credit portfolio, growing from one-sixth of the total bank credit in 2013 to more than one-fourth now. This steady growth reflects the sector's ability to reach underserved sectors, particularly small businesses, and households, offering customer-friendly credit solutions.

By leveraging technology, NBFCs have expedited and streamlined their credit delivery processes, positioning themselves as a preferred option for multiple individuals, groups and companies. However, this rapid expansion has also introduced systemic risks, prompting increased engagement and oversight from the Reserve Bank of India (RBI).

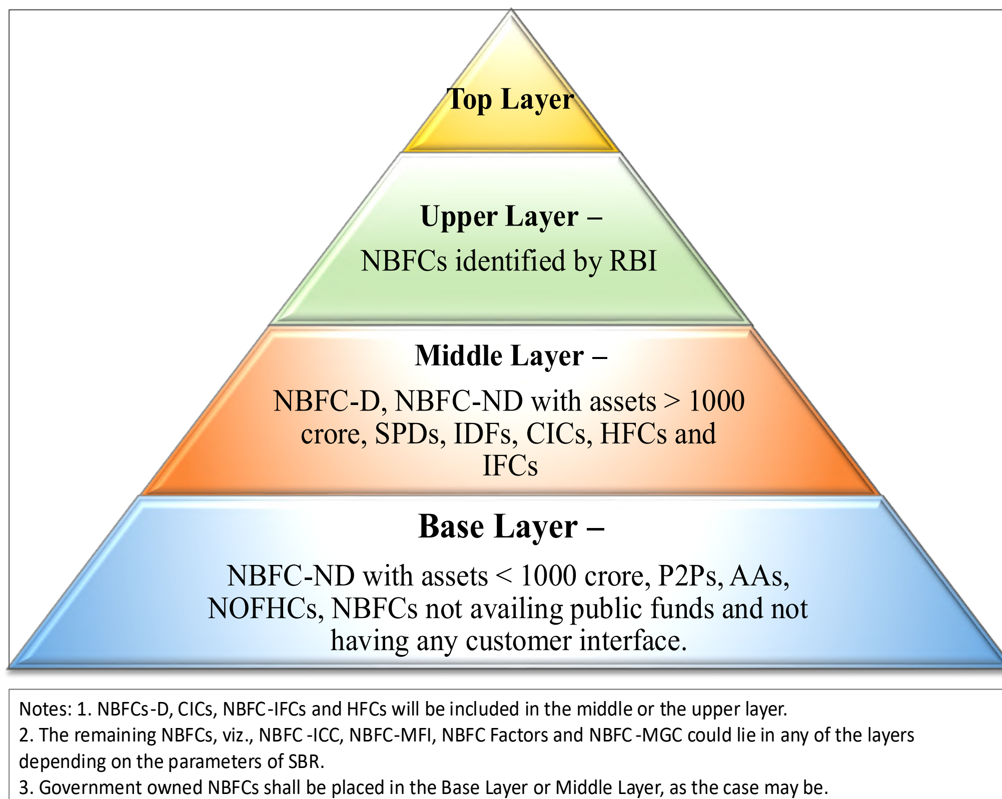
Structure of NBFIs under the Reserve Bank's Regulation

The RBI categorizes NBFCs based on their asset and liability structures into two main types: deposit-taking NBFCs (NBFCs-D) and non-deposit taking NBFCs (NBFCs-ND). Among the non-deposit taking NBFCs, those with an asset size of ₹500 crore or more are designated as systemically important (NBFCs ND-SI), while those with smaller asset sizes fall into a general category of other NBFCs-ND.

With the introduction of the scale-based regulation (SBR) framework, NBFCs are further classified into layers to reflect their systemic importance and complexity. Under this structure:

- NBFC-BL (Base Layer) includes NBFCs-ND that are not systemically important.
- NBFC-ML (Middle Layer) includes both systemically important NBFCs-ND (NBFCs ND-SI) and deposit-taking NBFCs (NBFCs-D).
- NBFC-UL (Upper Layer) includes larger and more complex NBFCs that are systemically significant (see Chart 1).

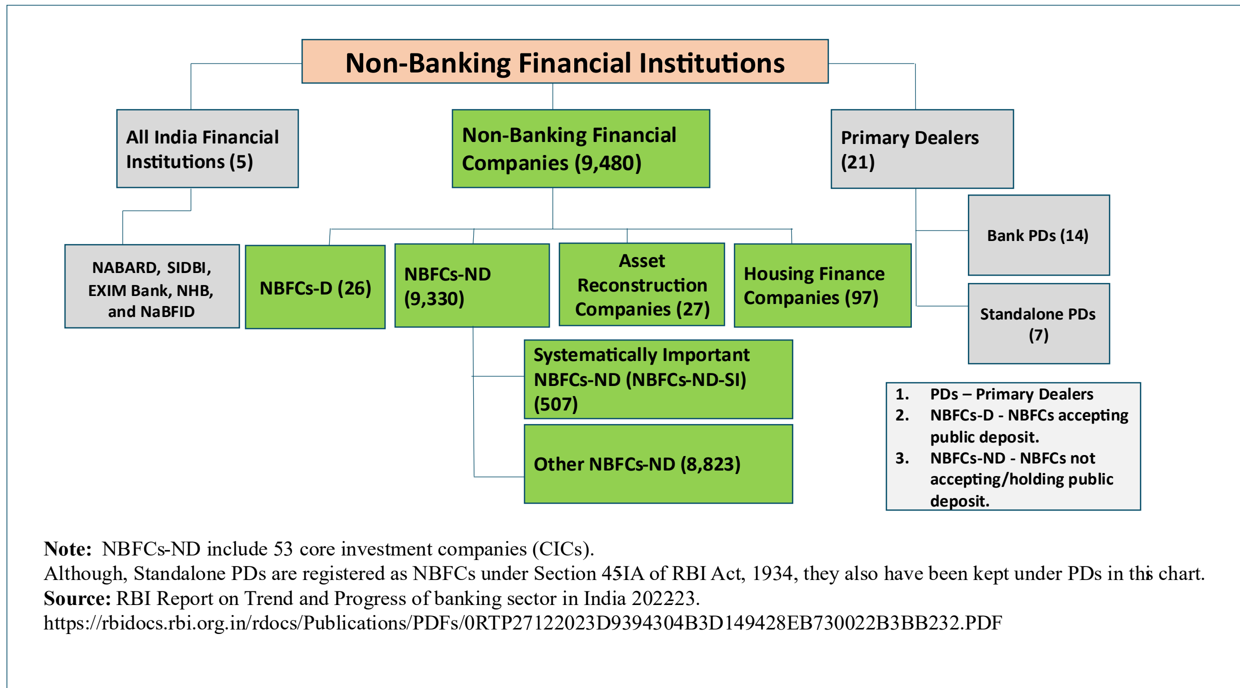
Chart 1: Scale-Based Regulation for NBFCs



Source: Report on Trend and Progress of Banking in India 2022-23, RBI

In this revised framework, traditional references to NBFC-ND, NBFC-ND-SI, and NBFC-D are now represented by NBFC-BL, NBFC-ML, and NBFC-UL, respectively. This layered regulatory approach is designed to align oversight with the scale and complexity of NBFC operations (see Chart 2).

Chart 2: Structure of NBFIs under the Reserve Bank's Regulation (as of Sept. end, 2023)



Note: NBFCs-ND include 53 core investment companies (CICs).
Although, Standalone PDs are registered as NBFCs under Section 45IA of RBI Act, 1934, they also have been kept under PDs in this chart.
Source: RBI Report on Trend and Progress of banking sector in India 2022-23.
https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0RTP27122023D9394304B3D149428EB730022B3BB232.PDF

Source: RBI

NBFC's Growth Outlook

The largest 20 NBFCs hold strong market positions and have long histories of providing specialized loans, such as housing finance and commercial vehicle loans. The robust economic growth, which the RBI Governor predicts will push India's growth rate to 7.2 percent in the current financial year, is expected to fuel strong credit demand and support the NBFC sector's profitability. This growth, coupled with current regulatory measures, will help mitigate the risk of rising credit costs on profitability.

NBFCs have demonstrated strong financial health, similar to the banking sector. As of the end of March 2024, the gross non-performing assets (GNPAs) of both scheduled commercial banks (SCBs) and NBFCs were below 3 per cent of total advances. Provisional data shows that the GNPA ratio for NBFCs stood at 2.5 per cent at the end of March 2024.

Capital adequacy for NBFCs remained comfortable, and asset quality improved as of the end of September 2023. Profitability indicators, such as Return on Assets (RoA) and net interest margin (NIM), remained strong, and the cost-to-income ratio improved. This sustained robust credit growth was supported by a strong demand for retail credit.

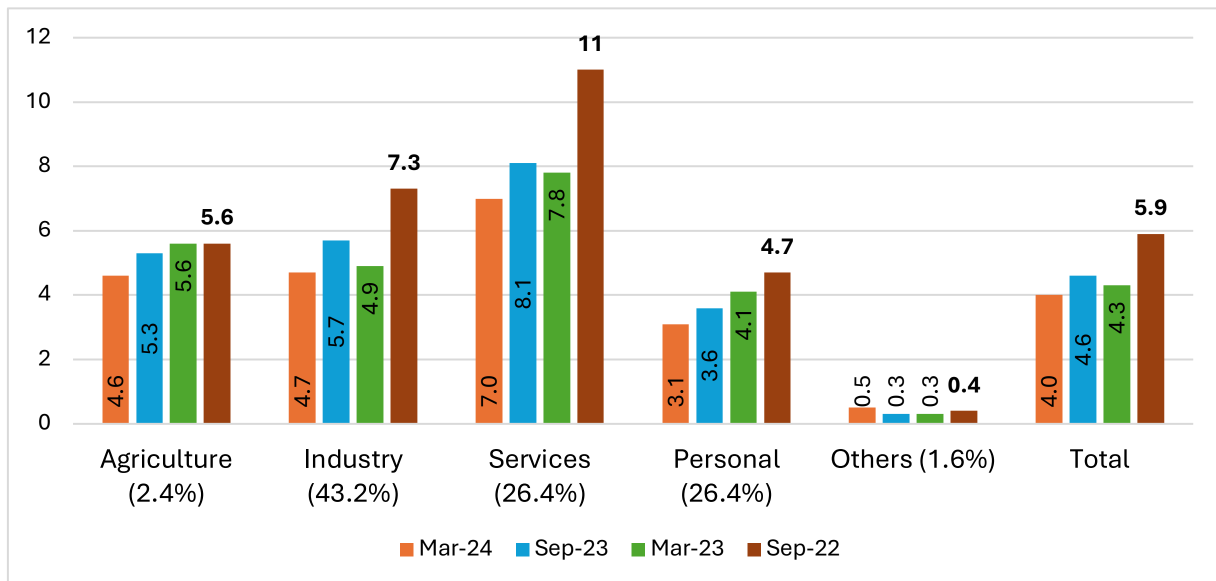
Snapshot of the NBFC Sector

- The NBFC sector saw a 20.8% increase in gross advances between September 2022 and September 2023, with significant growth in personal loans and lending to agriculture.
- The sector's GNPA ratio improved to 4.6% as of September 2023.
- Co-lending partnerships with banks and increased foreign direct investment have diversified funding sources for NBFCs.
- The share of corporate debt investment in NBFCs rose to ₹90,000 crore in April 2024.
- The capital position of NBFCs remains healthy - CRAR stood at 26.6 per cent in March 2024, well above the regulatory minimum requirement.
- The RoA ratio has been rising, the cost-to-income ratio has maintained a declining trend in the post-pandemic period and the NIM stood strong during 2023-24.
- Liquidity stock measures for NBFCs have remained stable – the ratio of short-term liability to total assets remained below 25 per cent; long-term assets constitute about two-thirds of assets; and CPs had less than two per cent asset share in total assets.
- Share capital, reserves and surplus of NBFCs declined during 2023-24 and constituted 28.3 per cent of their total liabilities in March 2024.

Sectoral GNP Ratio of NBFC

The GNPA ratio of NBFCs (including those under resolution) continued its downward trajectory in the post-pandemic period to reach 4.0 per cent in March 2024. Within the retail segment, vehicle/auto loans had the highest GNPA ratio (5.0 per cent), while other categories of loans had a ratio of below 3 per cent (see Chart 3).

Chart 3: Sectoral GNPA ratio of NBFCs



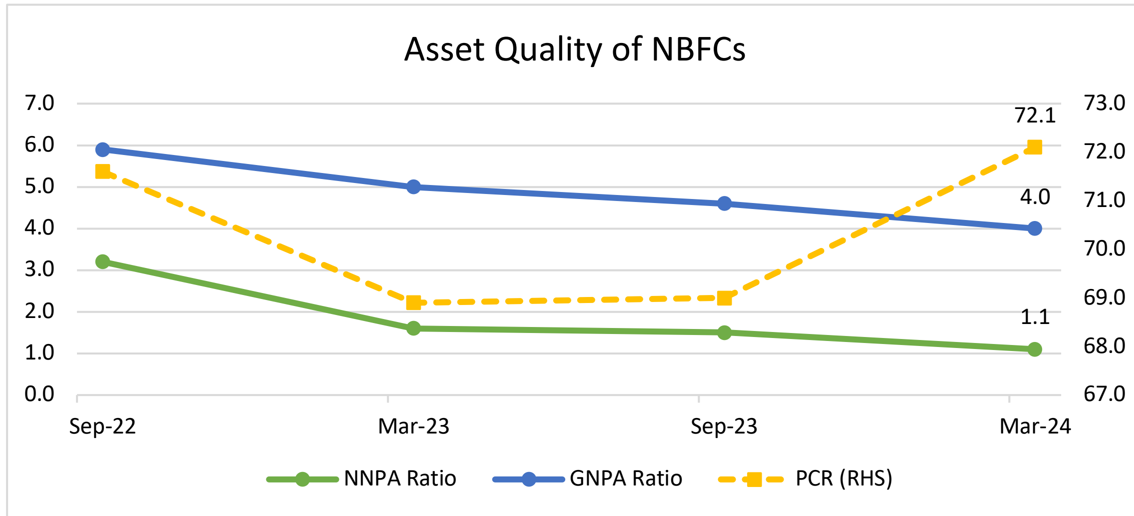
Note: Figures in bracket represent shares in outstanding loans in Mar-24

Source: Financial Stability Report June 2024, RBI

Asset Quality

Asset quality improved for both Government and private NBFCs. Private NBFCs' industrial advances, which account for one-fifth of the overall GNPA stock of the NBFC sector, further moderated as reflected in the GNPA ratio to 10.2 per cent in March 2024. The aggregate NNPA ratio of NBFCs improved further due to higher PCR and the fall in GNPAs.

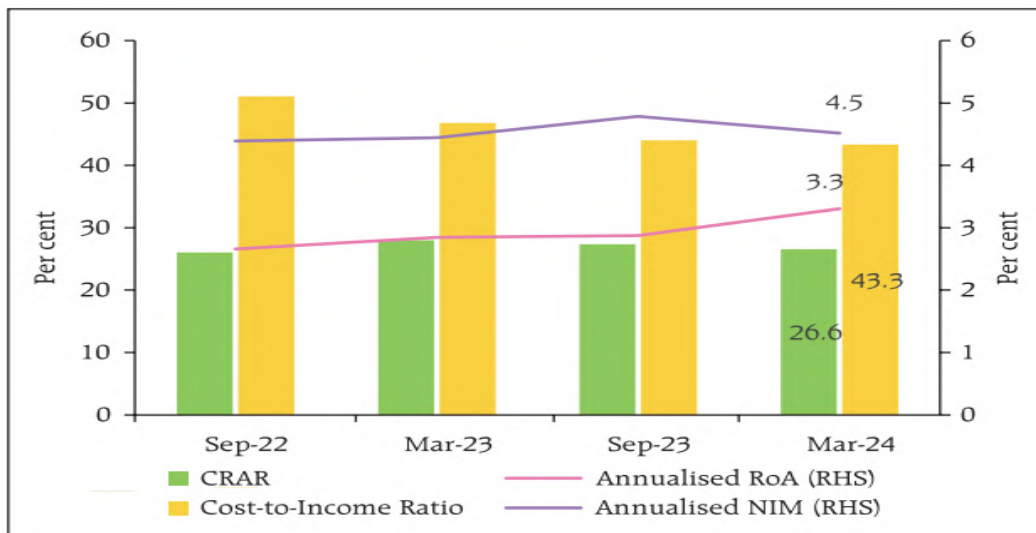
Chart 4: Asset Quality of NBFCs



Source: Financial Stability Report June 2024, RBI

The capital position of NBFCs remains healthy: their CRAR stood at 26.6 per cent in March 2024, well above the regulatory minimum requirement. The RoA ratio has been rising, the cost-to-income ratio has maintained a declining trend in the post-pandemic period and the NIM stood strong during 2023-24 (see Chart 5).

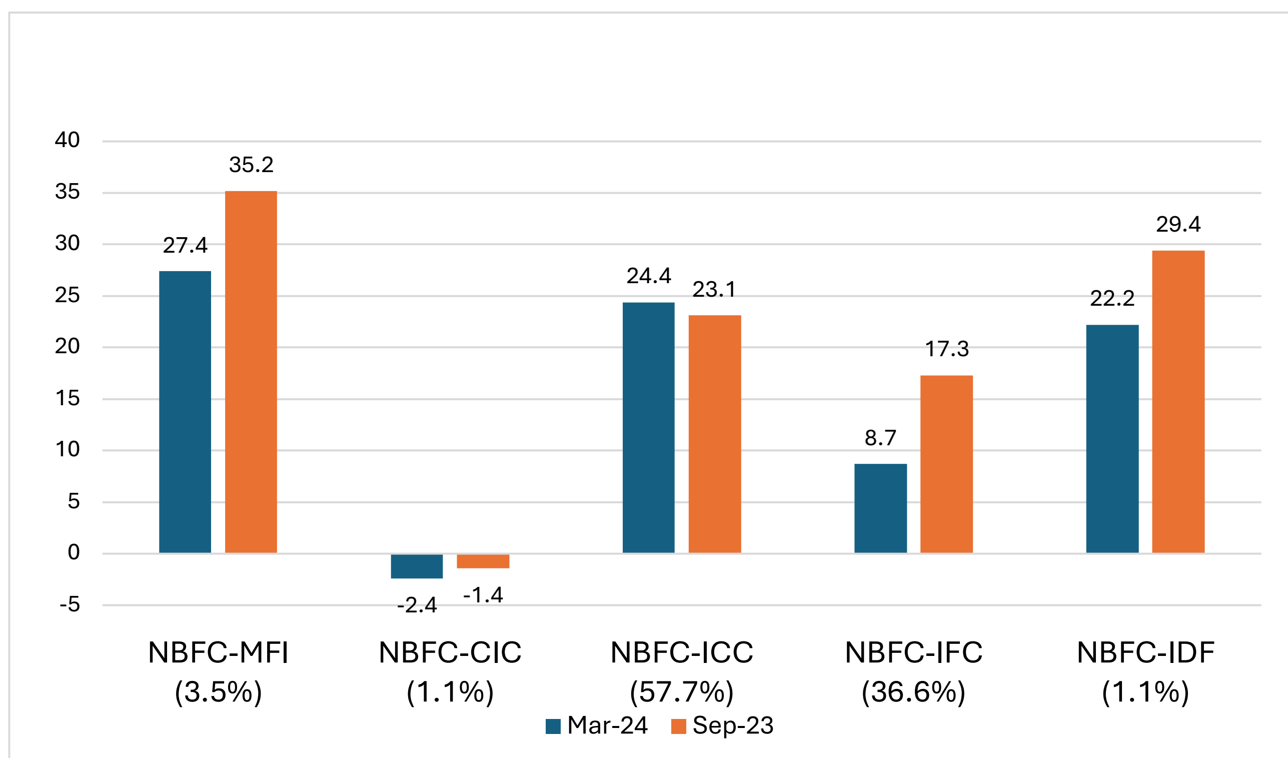
Chart 5: Capital Adequacy, Profitability and Efficiency



Source: Financial Stability Report June 2024, RBI

Credit growth in the largest category of NBFCs by activity, investment, and credit companies (NBFC-ICCs), has been accelerating in the post-pandemic period. In contrast, the second largest category, infrastructure finance companies (NBFC-IFCs), experienced a moderation in growth after four successive quarters of double-digit increases (see Chart 6).[1]

Chart 6: Activity-based Credit Growth of NBFCs (y-o-y)



Note: Figures in bracket represent shares in outstanding loans in Mar-24
Source: Financial Stability Report June 2024, RBI

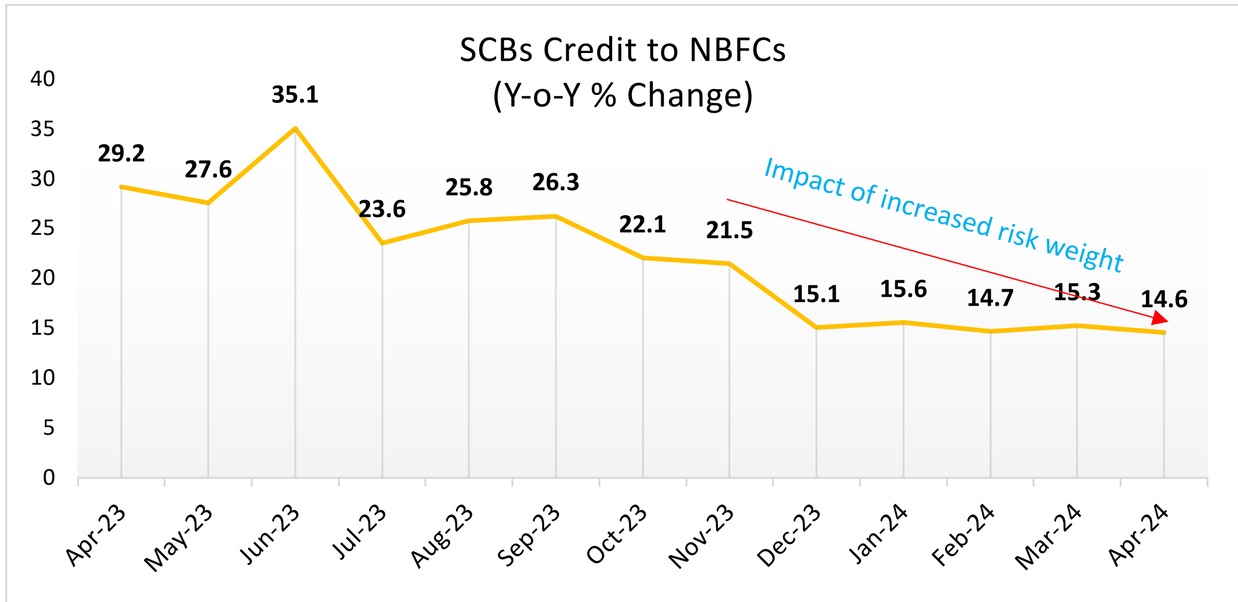
Status of Credit in NBFCs Sector

In the last quarter of FY24, Scheduled Commercial Banks (SCBs) in India saw a 19.3 per cent year-on-year growth in credit offtake, reaching ₹164.3 lakh crore, driven by increased personal loans, lending to NBFCs, and recent HDFC merger.

Credit to NBFCs

The outstanding bank credit to NBFCs stood at ₹15.54 trillion in April 2024. Bank funding to NBFCs grew by 14.6 per cent on a Y-o-Y basis in April 2024, compared to 29.2 per cent in April 2023, according to the RBI data. The RBI increased risk weights on unsecured consumer credit and bank credit to NBFCs on November 16, 2023, to pre-empt buildup of any potential risk in these segments. Consequently, credit growth in unsecured personal loans, such as, 'credit card outstanding' declined from 34.2 per cent in November 2023 to 23.0 per cent in April 2024, while bank credit growth to NBFCs declined from 21.5 per cent in November 2023 to 14.6 per cent in April 2024[2] (see Chart 7).

Chart 7: Outstanding Credit of SCBs to NBFCs

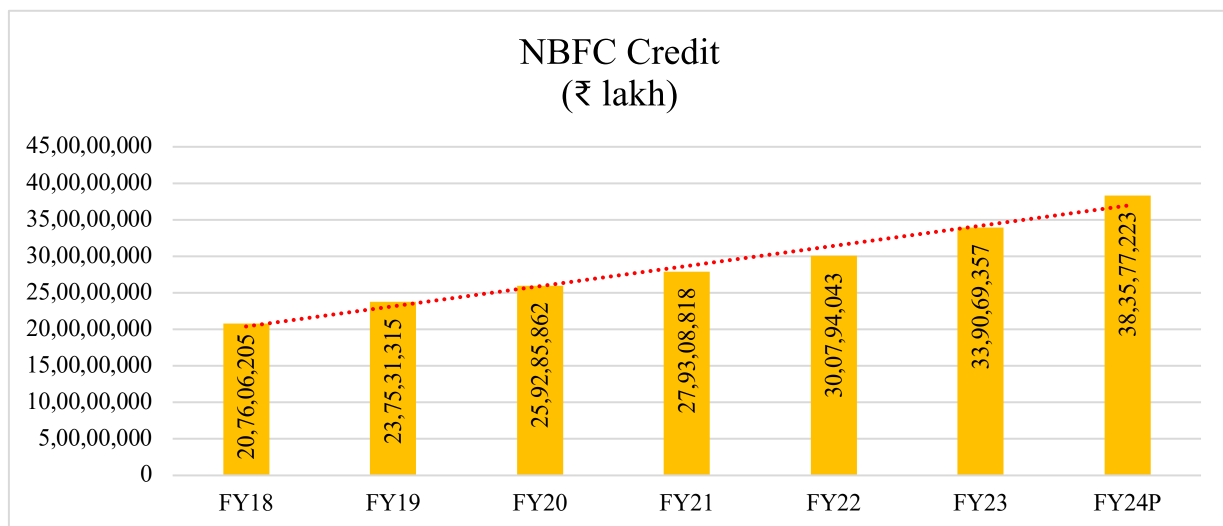


Sources: RBI | CMIE

NBFC-credit Growth

Between September 2022 and September 2023, the NBFC sector experienced a significant upward trend in credit growth, with gross advances increasing by 20.8 per cent compared to 10.8 per cent the previous year. This growth was predominantly driven by a substantial rise in personal loans, which grew by 32.5 per cent, and lending to the agriculture industry, which saw a 43.7 per cent increase. Over the past four years, the personal loans category surged by a compound annual growth rate (CAGR) of 33 per cent, significantly outpacing the overall credit growth of nearly 15 per cent CAGR.

Chart 8: NBFC-credit Growth Trend



Note: P – Provisional. Source: RBI

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Recent adjustments in risk weights for certain categories of retail loans are likely to impact the trajectory of credit growth within the sector, both at a general level and more specifically within certain sectors and sub-sectors. The total GNPA ratio of NBFCs improved to 4.6 percent in September 2023, down from 5.9 per cent in September 2022. Particularly, the personal loans segment, which experienced rapid growth in recent years, reported the lowest GNPA ratio at 3.6 per cent as of September 2023.

The increase in capital expenditure should compensate for the reduced growth in bank funding to NBFCs – a key driver of corporate credit – due to the 25 percentage points higher risk weight on lending to higher-rated NBFCs.

In the financial year 2023, the industrial sector was the largest recipient of credit from the NBFC sector, followed by the retail and services sectors. Among the subcategories, large-scale industries received the highest amount of credit (see Table 1).

Table 1: Sectoral Credit Deployment by NBFCs

S. No.	Items	At end-March 2022	At end-March 2023	At end-September 2023	Percentage Variation	
					2021-22	2022-23
	Gross Advances (Food + Non-Food Credit)	**2952442**	**34,26,970**	**36,93,921**	**9**	**16.1**
	Food Credit	**1739**	**-**	**-**	**-**	**-**
	Non-Food Credit (1 to 5)	**2950703**	**34,26,970**	**36,93,921**	**8.9**	**16.1**
1	**Agriculture and Allied Activities**	**53759**	**60,760**	**70,603**	**17**	**13**
2	**Industry**	**1131558**	**12,76,666**	**13,45,347**	**6.1**	**12.8**
	Micro and Small	44329	71,638	83,879	16.5	61.6
	Medium	17411	20,068	18,546	16.7	15.3
	Large	894541	10,20,441	10,98,821	4.6	14.1
	Others	175277	1,64,519	1,44,101	10.2	-6.1
3	**Services**	**407367**	**4,76,728**	**4,90,536**	**12.2**	**17**
	Of which					
	Retail Trade	41190	59,470	68,001	52.5	44.4
	Commercial Real Estate	87566	84,666	83,325	6.8	-3.3
4	**Retail Loans (4.1 to 4.10)**	**838528**	**10,54,530**	**11,96,757**	**12.5**	**25.8**
	Housing Loans (incl. priority sector Housing)	23280	32,425	39,223	8.9	39.3
	Consumer Durables	24789	31,543	38,484	33.9	27.2
	Credit Card Receivables	32710	44,007	49,231	25.8	34.5
	Vehicle/Auto Loans	335460	3,84,475	4,33,653	5.2	14.6
	Education Loans	14162	25,352	36,330	52.7	79

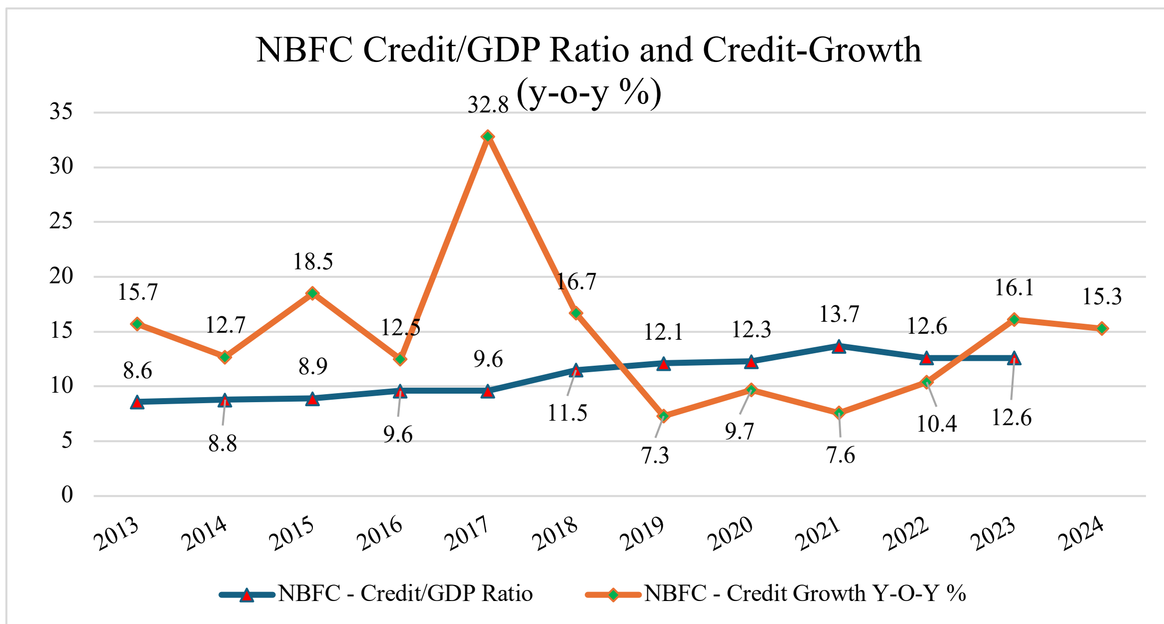
	Advances against Fixed Deposits (incl. FCNR(B), etc.)	43	215	247	37	406.9
	Advances to Individuals against Shares, Bonds, etc.	13023	14,053	18,532	56.8	7.9
	Advances to Individuals against Gold	119311	1,31,165	1,40,901	5.7	9.9
	Micro Finance Loan/SHG Loan	81599	1,18,752	1,16,908	22.6	45.5
	Other Retail Loans	194153	2,72,543	3,23,248	19	40.4
5	**Other Non-Food Credit**	**519491**	**5,58,287**	**5,90,677**	**6.4**	**7.5**

Source: RBI

NBFC's Credit to GDP Ratio

NBFCs have consolidated their position in recent years, as reflected in a gradual rise in their credit intensity (credit to Gross Domestic Product (GDP) ratio) as well as the relative importance in credit provision vis-à-vis scheduled commercial banks (SCBs). As of March 2023, NBFCs credit to GDP ratio stood at 12.6 per cent and the sector has grown to become 18.7 per cent of banking sector assets as of March 2023 as compared to 13 per cent ten years ago (March 2013) (see Chart 6).[3]

Chart 6: NBFC Credit/GDP Ratio and NBFC Growth



Source: RBI | Infomerics Economics Research

Exposure to NBFCs

NBFCs primarily rely on borrowings from markets and banks to finance their operations. Here is the pattern of NBFC's borrowing in terms of the secured and unsecured borrowings in the last 6 years (see Table 2).

Table 2: NBFC Borrowing Trend in the last 6 years.

(₹ crore)

	2019	2020	2021	2022	2023	End-September 2023
Secured Borrowings	1,106,917	1,305,214	13,30,259	14,87,621	17,64,649	18,44,331
Un-Secured Borrowings	895,891	930,122	10,20,750	10,96,879	12,37,590	13,25,627
Total Borrowings	**20,02,808**	**22,35,336**	**23,51,008**	**25,84,500**	**30,02,239**	**31,69,959**

Source: RBI

As of March 2024, NBFCs were the largest net borrowers of funds from the financial system, with gross payables amounting to ₹16.58 lakh crore and gross receivables at ₹1.61 lakh crore. The funding mix of NBFCs has shifted significantly with the banks' share increasing from 47.5 per cent in December 2018 to 55.1 per cent in March 2024. Similarly, long-term funds provided by banks and Alternative Investment Funds (AIFs) have risen from 40.7 per cent to 45.9 per cent in the same period.

Despite the potential systemic risks, the RBI has indicated that the hypothetical failure of the largest NBFC would impact only a small fraction of the banking system's Tier 1 capital, highlighting the sector's resilience and the effectiveness of regulatory measures in place.

A breakup of their gross payables reveals that the bulk of funds were sourced from SCBs, followed by AMC-MFs and insurance companies. The choice of instruments in the funding mix of NBFCs shows continued reliance on LT funds. The share of LT debt instruments (held by insurance companies and AMC-MFs) moderated in 2023-24 (Financial Stability Report, June 2024).

By the end of March 2023, bank borrowings surpassed debentures as the largest source of funds for NBFCs. Borrowings from banks continued to show high growth as of the end of September 2023. Approximately two-thirds of NBFCs' borrowings are payable in more than 12 months. At the end of March 2023, there was a slight increase in short-term borrowings, which are payable within three months or less (see Table 3).

Table 3: Sources of Borrowings of NBFCs

(in ₹ crore)

Items	At end-March 2022	At end-March 2023	At end-September 2023	Percentage Variation	
				2021-22	2022-23
1. Debentures	10,14,611	11,10,234	11,45,536	3.30	9.40
	(39.3)	(37.0)	(36.1)		
2. Bank Borrowings	9,20,555	11,33,221	11,97,626	18.80	23.10
	(35.6)	(37.7)	(37.8)		
3. Borrowings from FIs	69,078	89,982	99,844	21.30	30.30
	(2.7)	(3.0)	(3.1)		
4. Inter-corporate borrowings	89,896	1,05,184	1,04,148	15.50	17.00
	(3.5)	(3.5)	(3.3)		
5. Commercial papers	70,266	84,366	1,14,109	-3.20	20.10
	(2.7)	(2.8)	(3.6)		
6. Borrowings from Government	18562.00	18750.00	18758.00	-3.00	1.00
	(0.7)	(0.6)	(0.6)		
7. Subordinated debts	72,349	72,510	68,285	4.50	0.20
	(2.8)	(2.4)	(2.2)		
8. Other borrowings	3,29,182	3,87,991	4,21,653	10.60	17.90
	(12.7)	(12.9)	(13.3)		
9. Total borrowings	25,84,500	30,02,239	31,69,959	9.90	16.20

Notes: 1. Data are provisional. 2. Figures in parentheses indicate share in total borrowings.
Source: RBI

Table 4: Sources of Funds

(in %)

Item Description	Mar-21	Mar-22	Mar-23	Mar-24
Share Capital, Reserves and Surplus	26.7	29.4	29.4	28.3
Total Borrowings	63	60.6	61.1	62.4
Of which				
Borrowing from banks	19.8	20.6	21.7	22.6
CPs subscribed by banks	0.4	0.4	0.3	0.3
Debentures subscribed by banks	3	2.9	2.7	2.1
Total from banks	**23.2**	**23.8**	**24.8**	**25**
CPs excluding CPs subscribed by banks	1.6	1.4	1.5	1.6
Debentures excluding debentures subscribed by banks	22.8	20.4	19.4	19.7
Others	10.2	10	9.6	9.2
Total	**100**	**100**	**100**	**100**

Source: Financial Stability Report, June 2024, RBI.

The funds raised by non-banking financial companies (NBFCs) from mutual funds increased by 30 per cent y-o-y to ₹2.1 trillion in April 2024.[4] The MF debt exposure to NBFCs had risen by just 0.2 per cent Y-o-Y to ₹1.6 trillion in April 2023. Analysts and NBFC executives said this increase in funding signals MFs' comfort in taking exposure to better-rated finance firms. The MF debt exposure to NBFCs, including their commercial papers (CPs) and corporate debt, crossed the ₹2 trillion mark after 55 months (see Table 5).

Table 5: Deployment of Debt Funds by All Mutual Funds: Assets under Management

(in ₹ million)

Months	Money Market Instruments (other than corporates)	Corporate Debts	Securitised Debts
	Commercial Papers		Single sell downs/single loans
Jan-23	812,597.90	673,125.60	837.1
Feb-23	773,021.50	644,656.90	762
Mar-23	785,474.80	674,408.10	691.2
Apr-23	876,222.80	726,364.60	621.9
May-23	924,130.00	788,352.80	556.6
Jun-23	896,006.50	725,072.80	492.5
Jul-23	1,046,506.30	762,400.90	429.1
Aug-23	1,012,256.50	753,645.60	366.3
Sep-23	989,911.10	781,287.30	306.8
Oct-23	924,028.30	660,433.70	0
Nov-23	924,638.80	634,333.90	0
Dec-23	1,040,071.00	828,624.60	147.5
Jan-24	1,023,432.70	821,431.80	101.1
Feb-24	1,030,964.40	823,829.60	57.4
Mar-24	1,033,663.40	862,426.60	21
Apr-24	1,183,182.80	896,716.60	0

Source: CMIE

In August 2019, the exposure to NBFCs was above ₹2 trillion. The CP outstanding stood at ₹1.18 trillion. Such a level was witnessed five years ago in May 2019. The investment in corporate debt of NBFCs increased by 23.5 per cent Y-o-Y and 4 per cent month-on-month to ₹ 90,000 crore in April 2024. Meanwhile, the share of total corporate debt to NBFCs inched up to 4.4 per cent in April 2024 from 4.2 per cent in April 2023.

As per the recent data published by RBI in its Bulletin, across the term market segment, yields on 3-month treasury bills (T-bills) and rates on certificates of deposit (CDs) eased while rates on commercial paper (CP) for non-banking financial companies (NBFCs) hardened during May 16 to June 12, 2024. The reason of softening yield on the 3-month T-bill after the announcement of reduced supply of shorter-dated T-bills for Q1:2024-25 on May 17, 2024. Reflecting this, the average risk premia in the money market (3-month CP minus 91-day T-bill) increased to 92 bps during May 16 – June 12, 2024, from 79 bps during April 16 – May 15, 2024. Financial conditions, however, remained congenial, with the term spread (10-year G-sec minus 91-day T-bills) narrowing to 14 bps from 18 bps during April 16 - May 15, 2024.

The regulatory nudge from the RBI to banks to moderate the pace of funding to NBFCs and the narrowing gap in the cost of funds between money taken from asset management companies and banks also contributed to the increase in funding.

Institutional and Regulatory Initiatives for NBFCs

The RBI has warned micro-lenders and non-bank financiers against usurious lending practices, particularly targeting small-ticket borrowers. Despite general compliance with guidelines on Key Facts Statements (KFS), some regulated entities still impose undisclosed fees and high-interest rates. The RBI Governor Shaktikanta Das emphasised that customer protection remains a top priority for the Reserve Bank, highlighting the need for transparent and fair lending practices in the microfinance sector and among non-banking financial companies (NBFCs).[5]

The Finance Industry Development Council (FIDC), representing non-banking financial companies (NBFCs), has urged the Reserve Bank of India (RBI) to review its recent draft circular on infrastructure provisioning. NBFCs demand flexibility in supporting the sector, particularly regarding standard asset provisions during the construction phase. The draft proposes maintaining a general provision of 5 per cent of the funded outstanding for all existing and stressed exposures on a portfolio basis, a measure FIDC seeks to amend.

The Council suggests retaining the standard provision rate of 0.4 per cent, with enhanced provisions reserved for projects extending their Date of Commencement of Commercial Operations (DCCO). Clarity on applicability and minimum financing limits is also sought by FIDC.[6]

Recently, NBFCs have explored new avenues to access funding, diversifying their sources beyond traditional channels. Co-lending partnerships with banks, facilitated by the RBI's regulatory framework, have emerged as a significant source of funds for NBFCs. These collaborations enable NBFCs to leverage the low-cost funds available with banks to deliver credit to the underserved segments.

The foreign direct investment inflows into the NBFC sector have surged in recent years, driven by favourable regulatory policies and India's robust economic growth prospects. Venture capital and private equity firms have also shown keen interest in investing in NBFCs, recognising their potential to tap into underserved markets and drive financial inclusion.

The RBI has asked NBFCs to restrict cash loans to ₹20,000, according to media reports. This comes after the regulator took action against IIFL Finance for several violations including disbursal and collection of loans in cash over the statutory limit.

The RBI has adopted a hybrid regulatory approach for NBFCs, combining activity-based and entity-based regulations to safeguard financial stability and protect customers. This method leverages the strengths of both approaches to achieve a comprehensive and flexible regulatory framework, suitable for the evolving NBFC sector.

Entity-Based Regulations: Entity-based regulations offer a holistic view of overall risk exposure for specific financial institutions, addressing systemic risks arising from various activities within a single entity. These regulations are generally easier to implement and enforce, as they apply uniformly to a set of entities. But they may be less precise in targeting specific activities and slower to adapt to changes.

Activity-Based Regulations: Activity-based regulations allow for precise targeting of risky financial activities, regardless of the type of institution involved. This approach can result in a fragmented regulatory landscape, making oversight more complex, and systemic risks from multiple activities may remain undetected. To avoid regulatory arbitrage, the principle of "same risk, same activity, same regulation" is advocated but needs to be calibrated for effective yet non-stifling regulations.

Regulatory Approach: The RBI has developed a nuanced approach, recognizing the specialized activities of NBFCs, each carrying unique risks. This approach balances prudential regulations, focusing on solvency and financial stability, with conduct of business regulations, ensuring fair practices towards customers. The current regulatory landscape combines entity and activity-based approaches under these two pillars.

Key Initiatives

Peer to Peer Lending Platforms (NBFC-P2Ps):

- Prudential regulations for NBFC-P2Ps are kept minimal since they do not undertake credit risk themselves, focusing on basic entry-level requirements.
- Conduct norms are stringent, comparable to other regulated financial entities, due to the trust placed by lenders on these platforms for services like KYC authentication and credit scoring.

Microfinance Sector:

- The regulatory framework for microfinance loans is entity-agnostic and activity-based, targeting customer protection for vulnerable borrowers.
- The framework ensures comprehensive regulation across all regulated entities providing microfinance loans.

Infrastructure Debt Fund-NBFCs (IDF-NBFCs):

- The regulatory framework for IDF-NBFCs has been harmonized with other NBFCs engaged in infrastructure financing.
- Requirements like a sponsor have been withdrawn, and regulatory capital requirements and exposure norms aligned with NBFC-IFCs and NBFC-ICCs.

Regulatory Calibrations:

- Despite some harmonization, significant differences remain between regulations for banks and NBFCs, especially those in the upper layer. For instance, the minimum initial capital requirement for a universal bank is ₹1000 crore, compared to ₹10 crore for an NBFC. Banks face stricter scrutiny for licensing and have restrictions on activities, priority sector lending requirements, and detailed branch authorization policies, unlike NBFCs. Additionally, while the regulatory capital requirement for NBFCs is higher at 15 percent compared to 9 percent for banks, it only covers credit risk, not market and operational risks as it does for banks.

Deposit-Taking Activity:

- The RBI has been cautious about allowing NBFCs to accept public deposits. The non-acceptance of public deposits by NBFCs provides regulatory comfort, allowing for lower entry barriers, specialization in specific sectors, and lower exit barriers. Since 1997, the RBI has not issued new certificates for NBFCs to accept public deposits, and the number of deposit-taking NBFCs has decreased from 241 in March 2014 to 26 in September 2023.

These initiatives and regulations aim to ensure the sustainable growth and stability of the NBFC sector in India, addressing unique risks while fostering a robust financial system.

NBFCs and its CO-LENDING MODEL: *A BOON OR A BANE? :*
https://www.infomerics.com/publication-detail/nbfcs-and-colending-model-a-boon-or-a-bane

Risks and Challenges

NBFCs have grown increasingly interconnected with banks, which can amplify systemic risks, particularly during periods of financial stress. This interconnectedness manifests both directly (e.g., through debt instruments, shares, or other contractual relationships) and indirectly (e.g., through common exposures to sectors, markets, or instruments). One major issue is the concentration and contagion risks associated with being large net borrowers, particularly with high exposure to banks.

Many NBFCs maintain multiple borrowing relationships with banks, which can create contagion risks within the financial system due to high leverage. Over-reliance on bank credit and concentrated funding sources may also result in funding challenges during stress events, highlighting the need for NBFCs to diversify their funding sources.

In response to these risks, NBFCs in the middle and upper layers are required to make internal capital assessments similar to the Internal Capital Adequacy Assessment Process (ICAAP) for commercial banks. This involves factoring in various risks, including credit risk, market risk, operational risk, and other residual risks. The PCA framework in the upper and middle layers operational for NBFCs with effect from October 2022 will extend to the government NBFCs (excluding those in the base layer) from October 2024. This framework is designed to address financial weaknesses in NBFCs proactively.

The implementation of Scale Based Regulation (SBR) has introduced a layer-wise regulatory structure based on the size, activity, and perceived riskiness of NBFCs, ensuring a more tailored and effective oversight mechanism. Despite the increase in the share of public deposits in the total borrowings of NBFCs-D (deposit-taking NBFCs) due to competitive interest rates and robust credit ratings, the number of NBFCs permitted to accept deposits has been declining, which might affect their funding stability in the long run.

NBFCs have shown significant credit growth, with their credit intensity (credit to GDP ratio) rising steadily. The spreads on bonds issued by NBFCs have remained below pre-pandemic levels, reflecting improved market confidence and increased activity in the sector. In their pursuit of high growth, NBFCs may oversimplify underwriting processes, which can compromise the quality of their loan portfolios. It is crucial for NBFCs to balance ease of lending with stringent underwriting standards.

Another concern involves the practices of NBFC-P2Ps, where some have been found to engage in non-compliant activities. Individual lenders on these platforms might not fully understand the risks involved in providing credit, and misleading practices such as promising high returns and structuring transactions irresponsibly have been observed.

The increasing reliance on digital mediums and partnerships with FinTechs has heightened technology-related risks, including cybersecurity threats and operational disruptions. To manage these risks effectively, NBFCs need to implement robust risk mitigation measures that go beyond regulatory minimum requirements. Addressing these concerns is essential for the sustainable growth and stability of the NBFC sector in India.

Road Ahead

The future of Non-Banking Financial Companies (NBFCs) in India is poised for significant growth and transformation. To capitalize on emerging opportunities, NBFCs need to focus on enhancing financial literacy and fostering responsible borrowing and saving behaviours. With technology becoming more integral to daily life, the risk of cyber fraud and unscrupulous activities increases. By empowering individuals with financial knowledge, NBFCs can drive sustainable and responsible economic growth, ensuring that all segments of society benefit from financial advancements.

To thrive in the evolving financial landscape, NBFCs must address the credit needs of underserved segments, leverage new sources of funds, and embrace technological advancements. Promoting financial literacy will be crucial in protecting consumers and promoting informed financial decisions. By integrating these strategies, NBFCs can play a pivotal role in driving universal and sustainable economic growth, ensuring that the benefits of financial inclusion and technological innovation are widely shared across the nation.

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