IL&FS crisis: NBFCs need a paradigm shift in their business model to survive

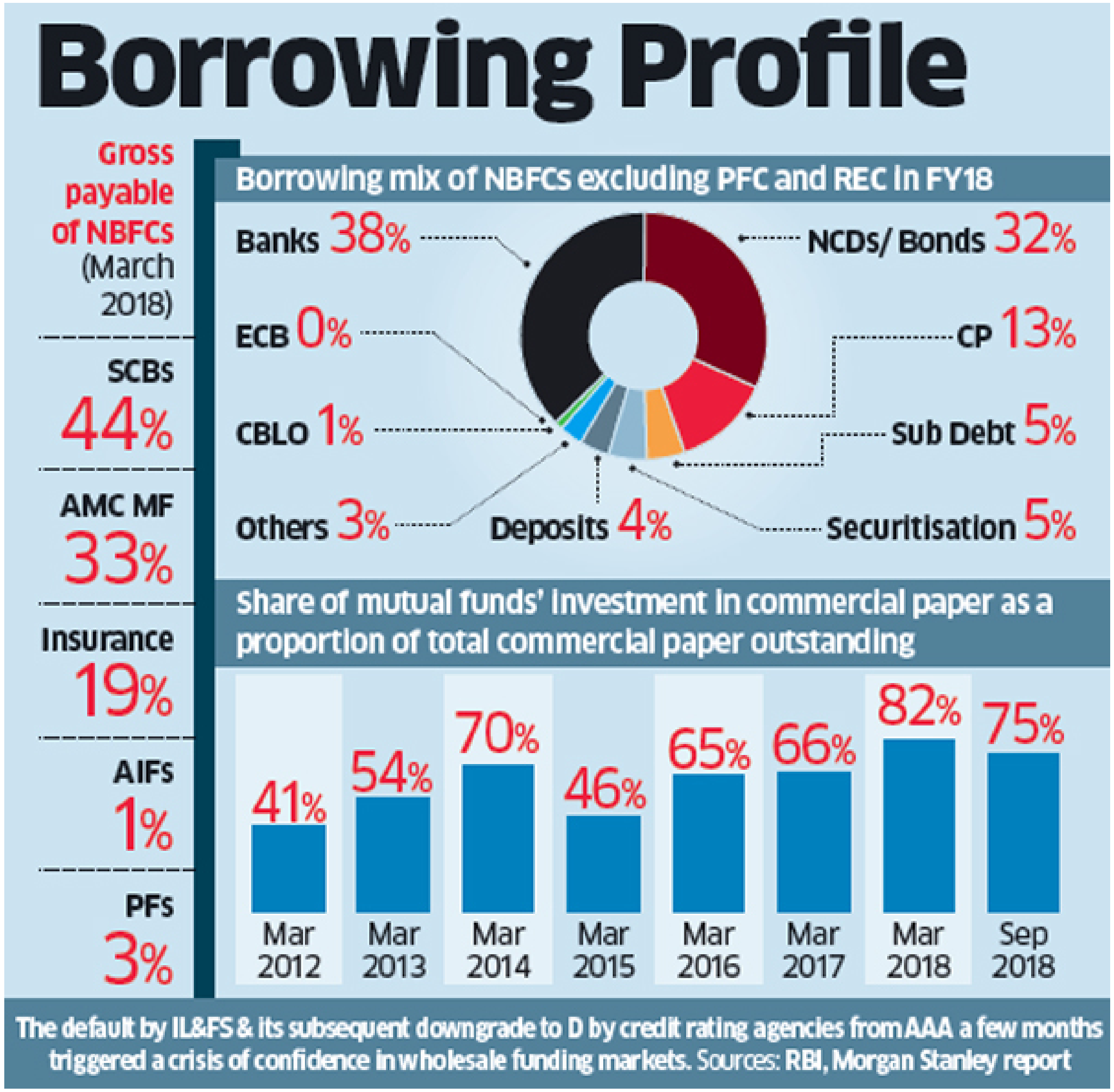
BY SHILPY SINHA, ET BUREAU | UPDATED: NOV 28, 2018, 06.27 AM IST

When India crafted its first National Housing Policy in 1988, suggesting the government change its role from a provider of homes to a facilitator of private financing in the industry, there were a handful of para banks giving borrowers the cash to secure a roof above their heads. Three decades later, about 90 housing finance companies are in the business, accounting for half the funds disbursed for building homes with at least 12 such entities accepting public deposits. The share of para banks in India's broader lifestyle sectors – automobiles, appliances, or luxury vacations – is even more dominant, and non-banking finance companies (NBFCs) could be rightfully credited with driving consumption for businesses – and in geographies, untouched by highstreet lenders.

But is that dominance now about to end? NBFCs had harnessed increased demand, banking stress, digital disruption, credit bureaus, and distribution reach to expand. But they must now reinvent their financing models – align asset and liability tenures – to survive. So, NBFCs need to generate the business but either securitise the liabilities or hive them off their books quickly to always align their outbound cash flows with the inbound.

"Some NBFCs funded short and lent long… the best days for NBFCs are behind them, let's put it politely," said Aditya Puri, MD and CEO of HDFC Bank, the country's most valued lender. "Now, we have to see how the regulations evolve. Do we need more regulations on finance companies and mutual funds? My answer is: yes. They should be subjected to the same liquidity cover, audit, operational procedures. We must understand that we do not have a deep enough corporate bond market in the country."

Of course, any crisis separates the winner from the also-ran. Large NBFCs with strong asset books have liquidity to fund growth, and could sustain expansion at 15-19%. But the days of 30-40% growth could be over.



THE WRIT AND THE ROLES

NBFCs have sailed in the so-called blue oceans where traditional banks didn't drop anchor. But will new regulations disrupt growth?

Over the years, the central bank has formed several committees to strengthen regulations amid rising importance of NBFCs in the Indian financial system. From the AC Shah Committee on sectoral reforms in 1992 to the Nachiket Mor Committee on financial inclusion in 2013, the regulator has tried to address asset-liability mismatch, regulatory arbitrage, and liquidity risks.

As of March 2018, there were 11,402 NBFCs registered with the Reserve Bank of India, of which 156 were deposit-accepting. There were 249 systemically important nondeposit accepting NBFCs. They face prudential regulations such as capital adequacy requirements and provisioning norms, besides reporting requirements. Housing finance companies (HFCs) have capital requirement of 12% versus 15% for NBFCs and 9% for banks.

“The regulator and government should support these entities while monitoring them in a reasonably stringent manner rather than clubbing them with over 11,000 NBFCs in the country,” said Sanjiv Bajaj, MD of Bajaj Finserv. “There can be an individual supervision criterion for very large NBFCs. Banks lend to these NBFCs because NBFCs can gather consumer assets in a profitable manner, which banks are either not interested in or cannot. One must understand that these large NBFCs are helping the economy.”

So far, NBFCs have made use of digital disruptions. The e-KYC helps on-board customers. As India is the second largest smartphone market with more than 300 million users, NBFCs use digital data to finalise credit decisions to segments lacking traditional proofs of income.

BORROW SHORT, LEND LONG

About half the incremental credit in the past five years came from NBFCs and HFCs, and top 10 para banks contributed about 30%. Most NBFCs have short-term loans, which fund long-term borrowings.

Recent funding restraints have led the industry to seek a special window from the central bank. The proportion of short-term borrowings has been increasing over the past couple of years since NBFCs were hesitant to lock in long-term funding, expecting a fall in interest rates. The central bank recognised the need to strengthen asset-liability guidelines given NBFCs’ reliance on bank funding and short-term borrowings.

HFCs are selling assets to banks to free-up funds. State Bank of India, HDFC Bank and other large banks have been buying portfolios from NBFCs. The healthy appetite for securitisation among banks is expected to lead to an increase in transaction volumes.

“Funding from mutual funds to NBFCs/ HFCs will depend on confidence and inflows and it is unlikely to go up soon,” said Morgan Stanley in a report. “Banks will also be constrained by internal sectoral caps.”

But what is in favour of NBFCs still is their ability to reach the customers where banks can’t. So more NBFCs and mortgage lenders may shift in favour of originate and distribute model from owning those assets.

“They lack origination and collection machinery; hence, aggressive buyout of retail loans from NBFCs and HFCs via pass through certificates (PTCs) is easier to implement and more capitalefficient,” said Morgan Stanley.

THE REINVENTED PARA BANK

Business models will evolve around the nature of business and target customers. Bank assets and liabilities are regulated by Reserve Bank of India (RBI). NBFCs borrow from banks. According to the Financial Stability Report, 2018, banks have 44% exposure to NBFCs, followed by asset management companies managing mutual funds at 33%, and insurance companies at 19%.

“Gone are the days when finance, business and risk could work in silos,” said Kuntal Sur, partner, PwC. “There is need to integrate finance and risk departments. Everyone will have to look at niche areas like Bajaj Finance. NBFCs will need to follow global norms.”

The average maturity of loans for HFCs is 7-8 years, but financing is short term. Wholesale-lending NBFCs have registered a 35% growth in the past four years. According to a Morgan Stanley report, real estate exposures of NBFCs/ HFCs have risen at a 30% CAGR, to 3.5% of system credit. These are not large numbers, but any major asset quality issue could cause the current crisis of confidence to linger.

“NBFCs will have to borrow longer tenors to minimise the risk asset liability mismatches,” said Karthik Srinivasan, senior VP, Icra. “Today NBFCs have 15-20% of borrowings through commercial papers. Most home loans are repaid in 7-8 yrs. If you are not able to pass it on to the borrowers, it will eat into your return on equity and profitability.”

HORSES FOR COURSES

Bajaj Finance has demonstrated its dominance in the consumer durables segment, while Shriram Transport has built a niche in the used vehicles space. NBFCs will have to be ahead of banks in innovating and reaching out to new target customers. In the auto industry, new car financing is not done by NBFCs, but they have created new markets in used-car financing.

“NBFCs will find new innovations and opportunities and they will also get their asset liability sorted out,” said PS Jayakumar, MD and CEO, Bank of Baroda. “In the short term, there may be some challenges… but these things will get rebalanced in a proper way. I assume they will continue to remain creative in terms of new ideas and warehousing until banks come and do it. Certain things earlier predominantly done by NBFCs are no longer done by them as banks stepped in.”

Will HFCs now focus on high yielding commercial property and developer financing to maintain the RoEs?

“As Darwin says, it’s not the strongest that survives: the most adaptable will survive,” said Jayakumar. “There will be NBFCs that adapt and ones that don’t.’’

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