Liquidity in the Market-Impact on NBFCs, HFCs, Outlook for Financial Sector, Economy

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Developments in the Market – Genesis of the Liquidity Crunch

- High NPAs and capital constraints in PSUs – 11 banks under PCA – low growth of bank lending - they found it easier to lend in bulk to NBFCs and sit back. This was incentivised by the lower risk weight on exposures to NBFC with high ratings.
- Demonetisation in November 2016- public invested their cash balances majorly in MFs/Insurance. These entities deployed the liquidity inflow on NBFC paper.
- Growing demand for retail credit and residential and commercial real estate. NBFCs filled in the slack.
- NBFCs funded this faster credit growth via increasing access to market borrowings
- NBFCs, esp HFCs were growing by borrowing partly on short term at low interest rates and rolling over these liabilities.
- Mutual fund exposure to NBFC debt reached 30% of their debt funds AUM was unlikely to sustain. And, 55% of this was short tenor (Credit Suisse).
- Further, by September 2018, MFs had reached their regulatory sectoral exposure norms of 25 % of NAV of scheme for NBFCs/HFCs.

Developments in the Market – Genesis of the Liquidity Crunch

- Environment changed in Sept 2018 with rising interest rates:
- Adverse signals were building up over August-September 2018:
  - Oil prices were rising
  - Indian Rupee was depreciating against USD.
  - Agitations by farmers, poor growth in jobs.
  - At the same time stock market was rising.
  - Fed Reserve action – in tightening mode.
  - US sanctions on China.
  - Merger of Bank of Baroda – Vijaya and Dena bank.
  - Supervisory action on CEOs of three important private banks.
- System was poised for correction.
  - Problem created by default by IL&FS
  - Started Default on Commercial paper Obligations from September 14, 2018.
  - Abrupt downgrade in the ratings of bonds sold by IL&FS and related entities after they defaulted on payment obligations in September. Credit rating agencies (CRAs) had downgraded the bonds from high investment grade (AA+ in some cases) to default or junk (downgrades to a lesser extent were going on since August but went below the radar).
  - Stock market began correcting – steep downtrend

Developments in the Market – Genesis of the Liquidity Crunch

LOGO

- Correction in stockmarkets led to rapid fall in overall market sentiment
- Redemption pressures on MFs – which in turn had to liquidate holdings of NBFC/HFC papers to keep within regulatory sectoral limits.
- Risk aversion – exposures to NBFCs – MFs not willing to roll over CPs due for redemption-banks were declining to honour committed lines of credit.
- The Media dubs it as India's "Lehman Brothers" moment.
  - However, this is basically a scenario that hit "Northern Rock" in Britain during the sub-prime crisis of Sept 2017 – overstretched liquidity.
- In the absence of a 'Lender of Last Resort' facility – NBFCs faced a crisis of confidence in the markets.

Measures to Alleviate the Stressed Conditions

- **RBI - Immediate measures to ease flow of liquidity to the system (Oct to Dec 2018):**
- SBI and three other PSBs have announced intention to buy up portfolios from NBFCs. SBI has in fact stated its intention to buy up loans to the extent of Rs 450 bn.
- **Oct 19, 2018**
  - RBI has permitted banks to treat incremental lending to NBFCs (from Oct 19 to Dec 31, 2018, extended upto March 2019)) as part of Liquidity Coverage Ratio (for Basle III). G-Secs give returns of, say, 7.5% to 8%. NBFCs will easily offer 9.5%+ right now.
  - Granted relaxation for single borrower exposure norms from 10% to 15%- upto Dec 2018 (extended till March 2019).
- **Nov 2, 2018- Announced a Partial Credit Enhancement Facility to banks -** shall only be utilized for refinancing the existing debt of the NBFC-ND-SIs/HFCs. Tenor 3 years or more.
- (in the form of an irrevocable contingent line of credit which will be drawn in case of shortfall in cash flows for servicing the bonds and thereby improve the credit rating of the bond issue.)
- **Nov 19, 2018** – **Capital Conservation Buffer** - transition period to implement the last tranche of 0.625 per cent under CCB has been extended by one year — up to March 31, 2020. Banks can achieve CCB of 2.5 per cent of their risk-weighted assets by March-end 2020. Estimated to release Rs 35,000 crore.
- **Nov 29, 2018 - Relaxation on the guidelines to NBFCs on securitisation transactions -** In order to encourage NBFCs to securitise/assign their eligible assets, it has been decided to relax the Minimum Holding Period (MHP) requirement for originating NBFCs, in respect of loans of original maturity above 5 years, to six months (earlier 12 months)
- **Dec 18, 2018 – To infuse liquidity,** RBI announced it will purchase more government securities under open market operations for a total amount of Rs 50,000 crore in January 2019, which also improved sentiment. (Oct – 36 K cr, Sept – 20K cr, Aug and July – Nil).
- **Jan 1, 2019 – Restructuring package for MSMEs**- To be implemented by March 31, 2019 – units with borrowings upto Rs 25 lakhs (from banks and NBFCs)- provision of 5% for these acct – as against 15% for sub standard accounts.

Regulatory Interventions

- Credit Rating Agencies – From November 14, 2018 – SEBI has tightened disclosure norms for credit rating agencies
  - The rating agencies will now need to disclose
    - The liquidity position of the company being rated.
      - A company’s liquidity position would include parameters such as liquid investments or cash balances, access to unutilized credit lines, liquidity coverage ratio, and adequacy of cash flows for servicing maturing debt obligation.
    - If the company is expecting additional funds to pare its debt along with the name of the entity that will provide the money.
  - Credit rating firms will also have to analyse the deterioration of liquidity and also check for asset-liability mismatch.
- Prospective Regulations by RBI
  - Regulations on Asset Liability Management and Risk Management.
  - Regulatory reporting for NBFC-SI may be made monthly (quarterly at present).
  - RBI could introduce macro prudential regulation for NBFCs- countercyclical capital buffers/risk weights.
  - More focus on risk based supervision – forward looking. Focus on management – Role of Board and Independent Directors – Risk Management Committee – Whether any analyses in different scenarios of interest rates/liquidity.
  - Financial Stability Report-Dec- 2018 – Recommended “**Risk Sensitive”** oversight regime for FCs where the intensity of the oversight takes into account the size of the entity and the likelihood of an adverse event.

Outlook for the Sector

LOGO

- **NBFCs have filled the void created by PSBs crippled for capital**
  - *In the past three years,* ***NBFCs accounted for nearly a third of incremental credit*** *to retail & small business segments.*
  - ***Have played an important role in making credit available to those excluded*** *from the formal credit system.*
- *New Normal for NBFCs*
  - *Lending by banks and investments by MFs would be more selective – closer assessment of ALM- solvency – diversified asset portfolio – pedigree of NBFC- cost of funds to rise.*
  - *Credit will get concentrated in fewer & stronger hands, who have managed their liabilities & resources efficiently .*
  - *Squeeze on NIMs and slowdown in asset growth – back to more moderate growth*
  - *Valuations would moderate – esp growth in M-Cap*
- *Uncritical flow of private equity capital over the past few years into all kinds of NBFCs will slow down – however, many PE firms are in active dialogue with high- quality, well managed NBFCs & also with banks with a view to partnering with them as they evaluate portfolio purchases and loan co-origination.*

Outlook for the Sector

- Worst Case Scenario – High Risk companies would be NBFCs/HFCs with substantial exposure to real estate
  - Real estate markets are stagnant – no price escalation
  - Several companies are into Developer Financing, where equity of developer is low.
  - Some of these companies exposed to CPs. – they have to refinance CP redemptions through bank limits or longer term market borrowings – spate of NCD issues in market – some companies are going for private placements.
  - Alternate investment Funds (AIFs) – PEs, VC, Hedge Funds, etc are stepping in to fill the Realty Funding gap.
- Problem scenario – for NBFCs promoted by first generation entrepreneurs which have exposure to Real estate, LAP, long gestation asset portfolios. These would face challenges in mobilising funds.

Prospects for the Sector

Near Term – Upto March 2019

- Estimated (ICRA in Dec 2018) that Overall credit growth of NBFCs in 2018-19 would be 16-18% (23% for 2017-18) and HFCs 14-16% (22% for 2017-18).
  - Weighted average cost of funds to increase by 45-50 bps in FY2019 from 8.6% in Sept 2018. *(8.4% in March 2018, 9.5% in March 2017).*
  - Slowdown in credit to LAP, SMEs, Commercial Vehicles.
  - Contraction in Operating Profits and increase in Credit Costs – Net Profitability (Net Profit to Avg AUM) would come down from 2.0% in March 2018 to 1.6% to 1.8% in March 2019.
  - NIMs which averaged 8.5% in March 2018 would be impacted by 40 to 50 basis points.

Prospects for Economy

- Central Statistical Organisation – advance estimate of growth for 2018-19 is 7.2 % - revised downward from 7.5% projected by Finance Ministry. (6.7% for 2017-18).
  - H2 growth to dip to 6.8% from 7.6% achieved in H1 2018-19.
  - 2018-19- Major increase in manufacturing sector at 8.3% (5.7% in 2017-18), Electricity etc at 9.4% (7.2%), Construction at 8.9% (5.7%)
  - Gross Fixed Capital formation expected to grow at 12.2% up from 7.6% in 2017-18.
- Banking sector loan growth has increased to 13.1% in Sept 2018 (YOY) up from 9.8% in March 2018. (Source-RBI).
- **Recent Government measures**
- Big rural push – cash handouts- impetus to agriculture
  - Consumer goods, white goods.
  - Agri inputs.
  - Two wheelers, SUVs.
- MSME – structural measures
- Digital lending – Fintech space

SWOT

Strengths

- Key strengths of NBFCs lie in data analytics, fast verification tools, specialised underwriting & recovery skills, etc
- NBFCs have developed strong Economic Intelligence & Data Analytics capabilities, EWS systems
- NBFCs have increased their market share of Personal Loans, Mortgage Loans, Vehicle Loans/Loans against Property/SME loans.
- Have built up a dedicated clientele – those with no credit record– lending processes are smoother, hassle free and quick TAT.
- Reached out their services to inaccessible areas- innovative and nimble.

Weaknesses

- Loss of Confidence – lack of LOLR facilities
- ALM mismatch
- Exposure to developer financing – long duration assets vs short term borrowing
- Risk aversion by banks to lend

Opportunities

Govt focus on growth of MSME sector – NBFCs have developed credit scoring models -quick disbursal processes

NBFCs with robust risk management architecture, strong sell down desk, high quality asset book & hi level Corp Governance (promoter group backgrounds) will grow faster than before, once the dust settles.

So far no knee jerk reaction - Regulations likely to be not made too restrictive.

Threats

Bank growth pick up with recap and easing of PCA

Growth slowdown on the back of credit slowdown will adversely impact asset quality of financial intermediaries.

If one or two large NBFCs/HFCs face defaults by large developers – it would have a domino effect. Liquidity, funding for NBFCs would dry up.

TAKEAWAYs

- NBFCs have weathered several crises and come out of it
  - GFC of 2008
  - MFI crisis in Andhra Pradesh in 2012.
  - Growth Slowdown of 2012-13.
- Majority of NBFCs are diversified – retail customers/MSME/Hsg/Real Estate – assets deployed over a large no of customers, shorter repayment tenures, risk diversified. Since assets are of shorter duration, would not have substantial ALM mismatches.
- NBFCs – specialized and have a natural advantage in retail/MSME lending. However, need to accept environment has changed – cost of funds higher, NIMs would be squeezed, valuations would be a challenge.
- No of NBFCs have group backing – the parents would support them. But high standard of Corporate Governance would be prime criterion.

LOGO

- The important lesson from all such "Crises" can best be summarised in the following "quote" by Eduardo Galeano. "**History never really says goodbye. History says, 'See you later'.**"

- **THANK YOU**