SBI ECOWRAP

भारतीय स्टेट बैंक
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'Be the Bank of Choice for a Transforming India'

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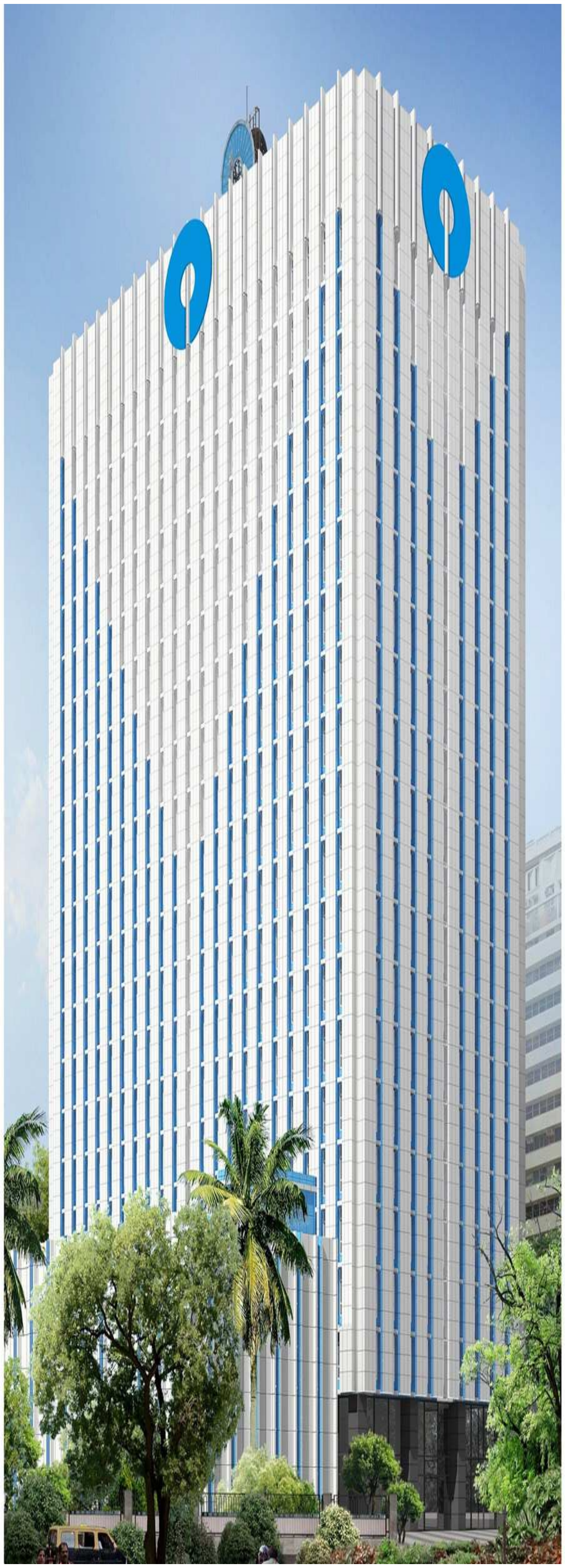


NBFC — FROM SHADOW TO SPOTLIGHT!!

Until now, in India NBFC sector thrived on the gap between traditional money lenders and banking institutions facilitated by regulatory arbitrage. For example, automobile companies had set up their own shop creating a sub segment within NBFC to capture captive clients. This also showed up in the PE ratios of these entities commanded. Mutual Funds found it hard to ignore the sector and were game for it.

While, NBFCs as a whole, played a pivotal role in financial inclusion, high leverage levels in large housing finance companies require some introspection. NBFC advances are clocking a CAGR of 15% from FY14 to FY18, primarily believed to be driven from subsectors such as Housing, MSME, Consumer Durable and Microfinance. NBFCs' market share in the systemic credit increased from 13% in FY13 to around 19% presently. Good asset portfolio may be up for grabs which could restore significant confidence in the market!

The funding pattern of NBFCs has been more or less same during last couple of years with some increase in reliance on NCDs. As per independent studies, majority of the liability i.e. 54% is to be repriced within FY19 and hence runs the risk of higher pricing in the current situation. NBFCs need to have an efficient ALM framework to address liquidity as well as margin. Regulator also needs to look into uniform regulations for NBFC and Banks.

There is multiplicity of Regulators—while Housing Finance Companies are regulated by NHB, Chit Fund companies are regulated by respective States and Nidhi Companies by Ministry of Corporate Affairs. Also, unincorporated bodies are under enforcement by state government. These all may also require rationalization and more closer look by regulators.

Overall, given the current backdrop in NBFC space, nothing much has changed in the financials of the sector per se and hence the concerns in the market may be a little overblown. The decadal rating transition matrix shows 98% NBFCs rated as AAA. Further, overall the asset quality and CRAR looks better than previous year and the model followed by NBFCs is more or less the same as hitherto. Some introspection into few pockets of NBFCs can set the future course on the right path.

Interestingly, if we look at the structure of global shadow banking, it is primarily concentrated in the advanced economies (AEs), particularly the US and the UK. AEs accounted for about three-fourth of the global shadow banking assets. The size of India's shadow banking sector accounted for a measly less than 2% of the total global shadow banking assets. Thus, the recent hullaballoo over the happenings in the financial market is a little unwarranted!

INCREASING LEVERAGE OF NBFC SECTOR

- Until now, NBFC sector thrived on the gap left between traditional money lenders and banking institutions. Driven by opportunity in Financial Inclusion, there was a rush to float NBFCs. Automobile Companies such as Bajaj Auto set up their own shop (finance companies) creating a sub segment within NBFC. The rational for foray into this segment by large corporate group/s was also well thought out. For example, Birla Group also formed Investment and Finance companies to make good of the captive opportunity. The shareholders were happy since the foray into NBFC by large corporate groups was maximising returns. This also showed up in the Price to Earnings Ratio (PE) these entities commanded. Mutual Funds found it hard to ignore the sector and were game for it. While overall leveraging in the NBFC sector stands at about 4x in 2018, leveraging in Housing Finance Companies appears to be high. For large Housing Finance Companies the same is 6.60x and 8.47x for the Medium and Small Housing Finance Companies for 2018. Overall, NBFCs advances are playing an important role and are steadily growing at a CAGR of 15% during FY14 - FY18 period. NBFCs' market share in the systemic credit increased from 13% in FY13 to around 19% presently.

Select ratios of NBFC Sector			
Year	GNPA	NNPA	CRAR
2014	2.7	1.2	27.5
2015	2.9	1.6	26.2
2016	4.3	2.4	23.9
2017	6.1	4.1	22.0
2018	5.8	3.5	22.9

Source: RBI; SBI Research

NBFCs Leverage ratio (Total Loan Funds to Shareholder Fund)						
Industry	2013	2104	2015	2016	2017	2018
Finance - Equipment - Leasing & Maintenance	5.83	5.51	5.71	4.48	4.01	4.07
Finance - Housing - Large	6.68	6.97	7.28	7.36	7.50	6.60
Finance - Housing - Medium / Small	7.69	8.48	9.06	10.54	7.71	8.47
Finance - Investment / Others	1.40	3.14	1.44	0.93	0.90	0.89
Finance - Large	3.42	3.58	3.48	3.48	3.30	3.70
Finance - Leasing And Diversified	5.46	4.00	2.94	3.11	3.32	3.53
Finance - Medium	3.92	4.72	5.10	4.74	4.48	3.79
Finance - Small	1.08	0.88	0.67	1.04	1.12	1.48
Finance - Term-Lending Institutions	5.81	5.77	5.62	5.56	5.12	5.66
Total	**3.83**	**4.30**	**3.94**	**4.06**	**3.99**	**3.98**

Source: CLine; Listed NBFCs ; SBI Research

- As of March 2018, there were 11,402 NBFCs registered with the Reserve Bank, of which 156 were deposit accepting (NBFCs-D). There were 249 systemically important non-deposit accepting NBFCs (NBFCs- ND-SI). All NBFC-D and NBFCs-ND-SI are subject to prudential regulations such as capital adequacy requirements and provisioning norms along with reporting requirement.

- The aggregate balance sheet size of the NBFC sector as on March 2018 was Rs 22.1 trillion. In FY18, there was deceleration in share capital growth of NBFCs whereas borrowings grew at 19.1%, implying rising leverage in the NBFC sector.

- BR Act and RBI Act lay down stringent controls over banks. However, controls over NBFCs are relatively much less stringent.

- Less provisioning and SLR/ CRR requirements give NBFCs much better cost advantage.

- While CRR for Banks is 4% as compared to nil for NBFC, the Capital Requirements of NBFC are higher.

Regulatory Norms			
		NBFC	Banks (As per BASEL III)
Prudential Norms (Capital Requirements)		NBFCs-ND(asset size of Rs. 500 crore and above) and NBFCs-D shall maintain minimum Tier 1 Capital of 10%	Tier 1 capital must be at least 7% of RWAs
		NBFCs-ND(asset size of Rs 500 crore and above) and NBFCs-D are required to have minimum CRAR of 15%	Minimum CRAR of 9%
		-	Capital conservation buffer of 2.5% of RWAs
Asset Classification Norms		Account to be classified as NPA after 90 days for NBFC-NDSI and NBFCs-D For NBFCs-ND it is 180 days	Account to be classified as NPA after 90 days
Provisioning Norms	Standard Assets	0.40% for NBFCs-ND-SI and NBFCs-D For NBFCs-ND it is 0.25%	0.25%-1.00%
	Doubtful Assets	25% to 100% of the secured portion depending upon the period for which the asset has remained doubtful	20% to 50% of the secured portion depending upon the period for which the asset has remained doubtful
	Sub-standard assets	10% of total outstanding	15% on total outstanding without making any allowance for ECGC guarantee cover and securities available.
SLR/CRR		15% SLR for NBFC-D	19.5% SLR+ 4% CRR

Source: RBI

RESOURCE PROFILE OF NBFCs/HFCs

- While analyzing composition of resource, it is observed that NCDs contribute major part of the funding (41%) while Banks are around 28% followed by CP (12%). The funding pattern of NBFCs is more or less same during last couple of years with some increased reliance of NCDs. Basically, they are using rollover model by raising funds for short term at lower rate and rolling it over albeit with re-pricing and ALM risk. NBFCs need to have an efficient ALM framework.
- HFCs are even drawing their resources more through NCD route and dependence on Banks is around 12% followed by CP at 9%.

Chart 1: Resource Profile of NBFCs

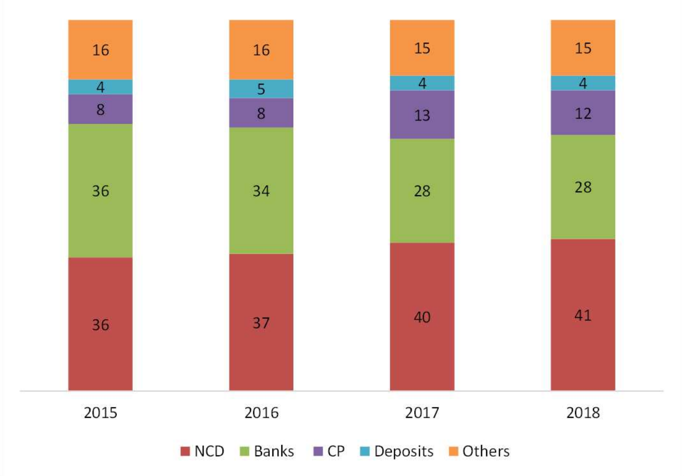
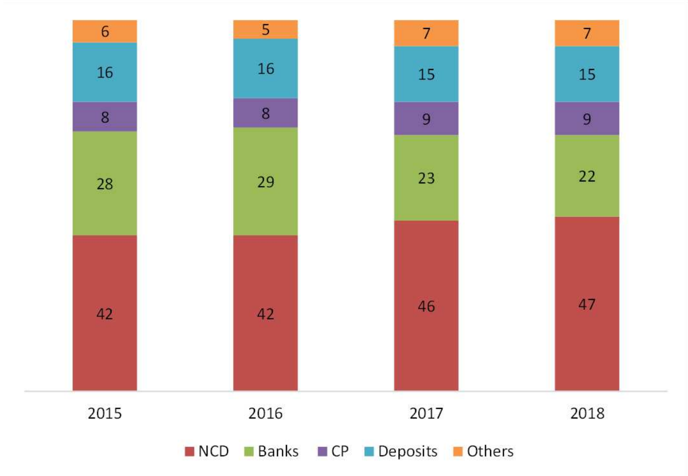


Chart 2: Resource Profile of HFCs



Source: SBI Research

MAJORITY OF LIABILITY TO BE RE-PRICED WITHIN ONE YEAR

- As per a study undertaken by CRISIL for players covering 90% of the industry, majority of the liability i.e. 54% is to be repriced within a year and hence runs the risk of higher pricing in the current situation. NBFCs need to have an efficient ALM framework to address liquidity as well as margin.

Repricing of Liabilities - March 18	
Tenor	Share (%)
1-30 days	10
1M-2 Month	8
2M-3 Month	10
3M-6 Month	9
6M- 1 Year	17
More than 1 year	46
Source: CRISIL; SBI Research	

IMPROVED UPGRADES TO DOWNGRADES

- Upgrades to downgrades ratio improved in the last two years. In FY18 U/D ratio was 2.8 x while the same has further improved to 3.6 x in first half of FY19.
- We feel rating agencies need to be thorough about the cycle approach and they also need to be more proactive in factoring market variables /developments including spread.
- However, it is also observed from the transition matrix (which indicates the instance of a given rating migrating to other rating category) during 2007-17 around 97.92% of AAA rating remained in this category at the end of one year and this number is 9.96% for AA rating.

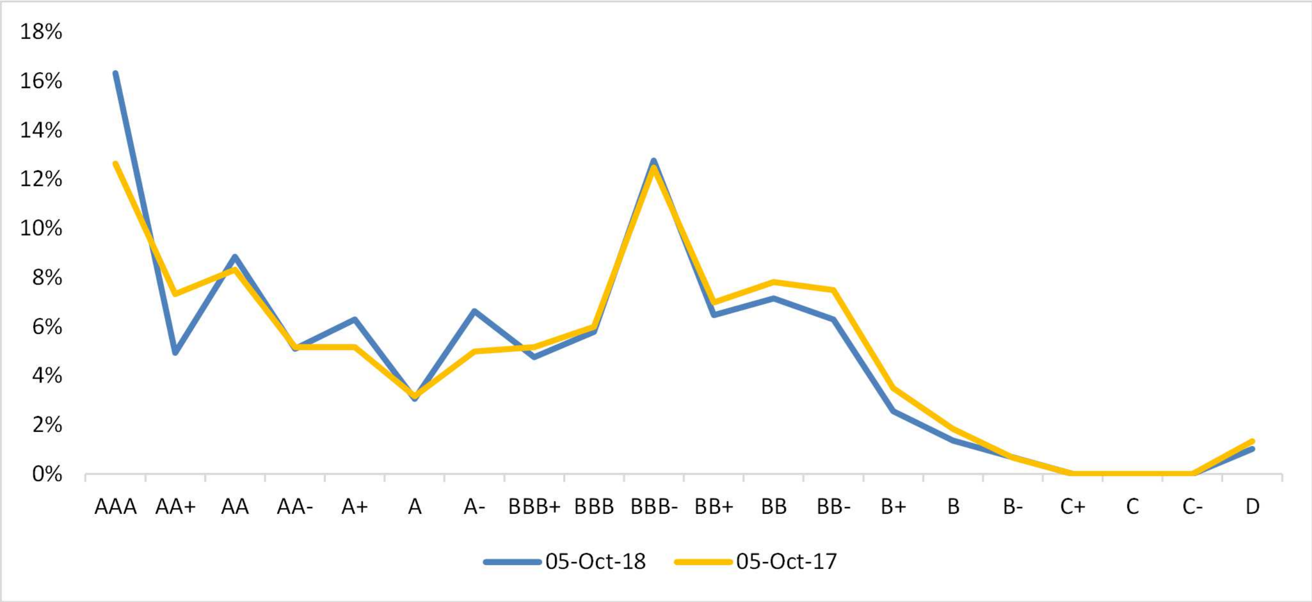
Number of upgrades & downgrades			
Period	Upgrades	Downgrades	Ratio
	No. of Companies	No. of Companies	
H1FY19	69	19	3.6x
FY18	75	26	2.8x
Source: Crisil, SBI Research; H1FY19 - up to 24th Sept 2018			

- Migration matrix for the period 2007-2017 is as under: -

Average one year transition rate for long term ratings (2007-2017) - annual static pool									
Rating Category	Issuer Years	AAA	AA	A	BBB	BB	B	C	D
AAA	962	97.92%	2.08%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
AA	2,223	1.39%	94.96%	3.10%	0.54%	0.00%	0.00%	0.00%	0.00%
A	3,907	0.03%	2.79%	91.91%	4.71%	0.33%	0.03%	0.03%	0.18%
BBB	12,213	0.00%	0.00%	2.52%	90.54%	5.66%	0.20%	0.15%	0.93%
BB	20,175	0.00%	0.00%	0.01%	3.97%	88.16%	4.00%	0.25%	3.61%
B	18,176	0.00%	0.00%	0.01%	0.04%	7.85%	83.67%	0.51%	7.93%
C	670	0.00%	0.00%	0.00%	0.00%	1.34%	20.45%	58.51%	19.70%

Source: CRISIL Ratings; SBI Research

Chart 3: Rating distribution of Financial Companies



Year	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	C+	C	C-	D
05-Oct-18	96	29	52	30	37	18	39	28	34	75	38	42	37	15	8	4	0	0	0	6
05-Oct-17	76	44	50	31	31	19	30	31	36	75	42	47	45	21	11	4	0	0	0	8

Source: SBI Research

NBFC: GLOBAL EXPERIENCE

- Shadow banking through NBFCs is a universal phenomenon, although it takes on different forms in different countries. In advanced economies where the financial system is more matured, the form of shadow banking is more of risk transformation through securitization; while in the economically backward economies where financial market is still in a developing stage, the activities are more supplementary to banking activities.
- There has been a steady expansion in the size of the global shadow banking sector in recent years from US$ 31 trillion in 2010 to US$ 34 trillion in 2015. The size of India's shadow banking sector stood at US$ 436 billion, accounting for 1.3% of the total global shadow banking assets in 2015.

- If we look at the assets size, the share of shadow banking in India to total domestic financial assets was about 14% in 2015 and similar to the size of other developing countries.
- In India, borrowings by NBFCs from various sources, which accounted for 70% of their total liabilities, increased by 12.1% in 2016-17 mainly through market-based instruments such as commercial paper (CPs) and debentures even as borrowings from banks contracted.
- If we look at the structure of global shadow banking, it is primarily concentrated in the advanced economies (AEs), particularly the US and the UK. AEs accounted for about three-fourth of the global shadow banking assets. The higher share of AEs in shadow banking activities could partly be attributed to tighter regulation of mainstream banks and low interest rates. Although securitisation declined in these economies, less risky shadow banking activities such as those undertaken by investment funds have expanded rapidly in recent years.
- US has the largest system of non-bank financial intermediation with assets of $ 26 trillion, followed by the Euro area ($ 22 trillion), the UK ($ 9 trillion) and Japan ($ 4 trillion). On an average, the size of non-bank financial intermediation in terms of assets was equivalent to 52% of the total global banking system. However, there were significant cross-country differences, ranging from 10% to 174%.

Chart4: Individual Country's Share in Total Global Shadow Banking Assets

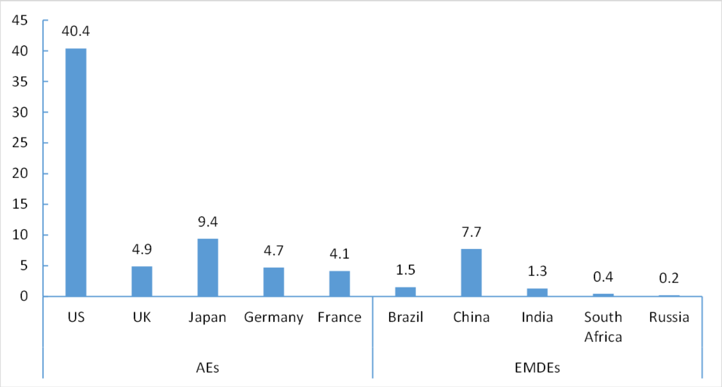
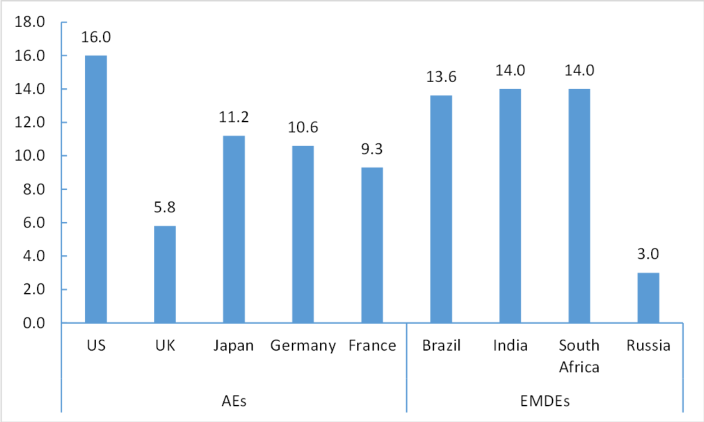


Chart5: Individual Country's Shadow Banking as % of Their Total Financial Assets



Source: RBI, SBI Research

CONCLUDING REMARKS

- Overall, given the current backdrop in NBFC space, nothing much has changed in the financials of the sector per se. Further, overall the asset quality and CRAR look better than previous year and the model followed by NBFCs is more or less the same. The rating upgrade to downgrade ratio looks better in the first half than compared to whole of last year. Efficient ALM and introspection in leverage ratios of large housing finance companies may set the future course of action.

ABOUT US

The Economic Research Department (ERD) in SBI Corporate Centre is the successor to the Economic and Statistical Research Department (E&SRD). The latter came into being in 1956, immediately after the State Bank of India was formed, with the objective of "tendering technical advice to the management on economic and financial problems in which the Bank has interest and which required expert analysis".

After the first reorganization of the Bank, when specialized departments like Management Science, Management Information Systems, Planning and Market Segment Departments took over the statistical work of E&SRD, the Department was renamed as ERD.

However, with the ERD team now taking on multidimensional functionalities in the area of risk management , corporate analytics, strategy and so on, who knows, the time may have come to rename it again!

DISCLAIMER

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