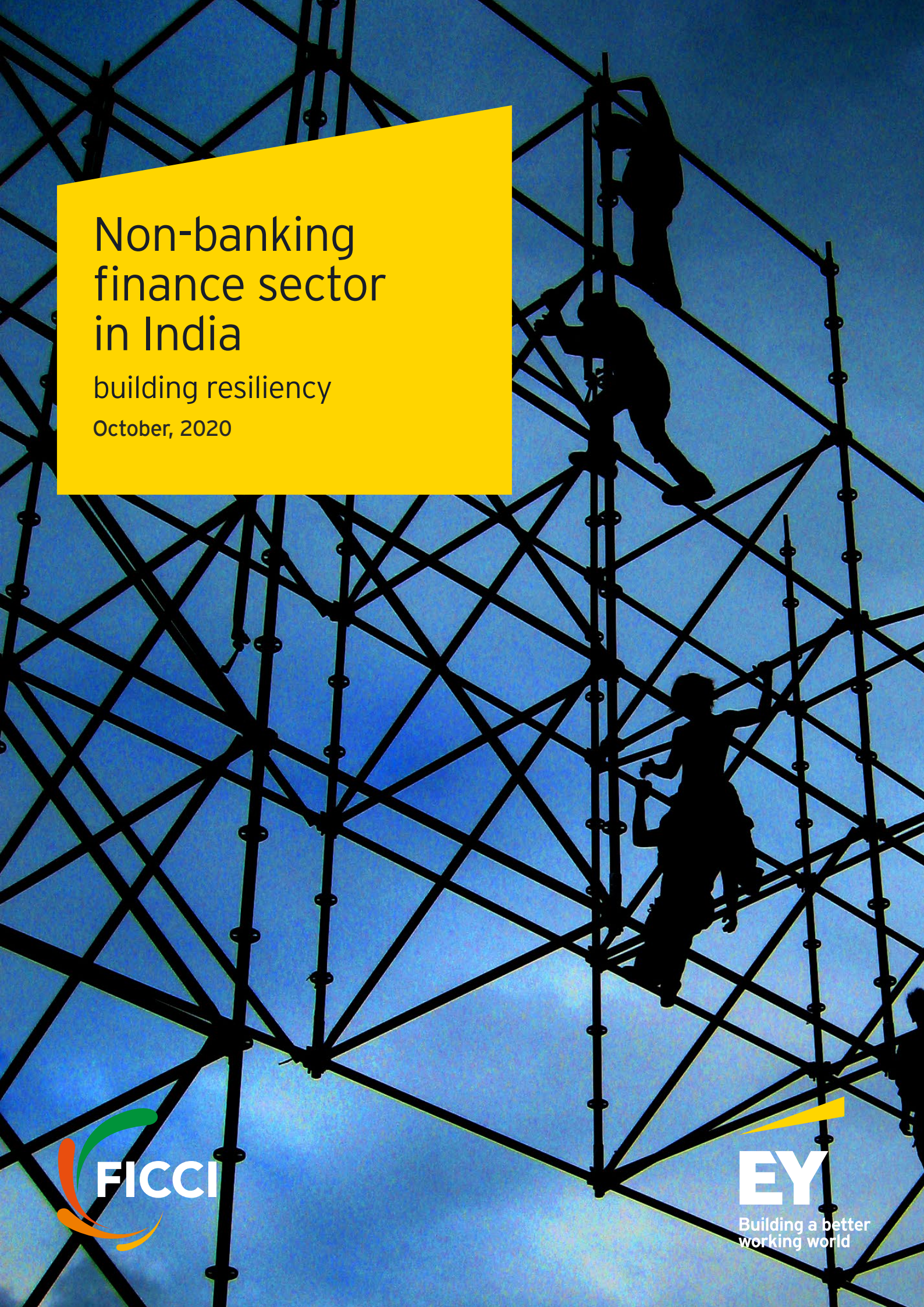


Non-banking finance sector in India

building resiliency

October, 2020

FICCI

EY

Building a better working world



Foreword

Non-bank lenders (includes both NBFCs and HFCs) are an important part of the Indian financial system today. Over the years, they have emerged as the primary financier to a vast section of the population including small and medium scale enterprises as well as the economically unserved and underserved individuals. Through their extensive geographical reach, understanding of varied financial needs of people and very low turnaround time, they have been able to serve specific requirements of borrowers in the most effective and timely manner.

Non-bank lenders therefore have not only played an instrumental role in furthering the cause of financial inclusion in this process but have also been a critical factor in driving the growth of millions of MSMEs and self-employed individuals. The growth of some of the important sectors of the economy such as automobiles, consumer goods, housing, etc. has also received greater push due to the larger role played by non-bank lenders in the consumer finance market.

Another vital area that has received tremendous boost due to the lending services of the NBFCs has been the development of the country's infrastructure. The long-term funding by non-bank lenders has helped in the financial closure and growth of many large infrastructure projects. Thus, the non-banking finance sector has played a crucial role in supporting the growth of our economy over the past years and has the potential of contributing immensely towards the future growth of India as well.

However, to realize this potential, it would be important to provide the sector a conducive and supportive environment for growth. The unprecedented crisis faced by some of the leading players has left a dent on the reputation of the sector as well as adversely impacted its liquidity and profitability. There has been a sharp erosion of investors' confidence, leading to drying up of capital flow towards a large section of this sector. Banks and other lenders too have taken a cautious stance towards non-bank lenders owing to their higher perceived credit risk. This has intensified the liquidity crisis in recent times, particularly for the small and medium sized non-bank lenders that lack institutional support either from the government or large corporates houses.

The Government has been swift enough to undertake several measures to ease the situation prevailing in the sector by way of providing liquidity support to NBFCs, HFCs, as well as MFIs and introducing partial credit guarantee schemes, etc. Though these initiatives have been able to provide some relief to the sector, the situation on ground remains challenging. The continuation of these challenges can undermine the long-term growth prospects of the sector significantly and this will be a great dampener for India's economic growth and for its aspiration to become a US$ 5 trillion economy by 2025.

In the above context, FICCI and EY have developed this report – Non-banking finance sector in India – building resiliency in an attempt to trace the growth and importance of the sector, capture the challenges faced by the players, and highlight some of the suggestions and action points for consideration of the policy makers and industry players. While it is important to tackle the immediate challenges emanating from the Covid-19 crisis, it is more important to address the structural issues and strengthen the regulatory and governance regime, which is essential to build a robust and resilient non-banking finance sector that remains undeterred in any circumstances.

Given the stage we are in, it is extremely critical that the Government and the RBI work towards removing the arbitrage between banks and non-bank lenders which is hindering non-bank lenders growth. It is equally important that the non-banking finance sector be looked at in a manner that brings out the differentiation amongst players and the same should get reflected in the regulations that apply to different sets of non-bank lenders. Further, as the recent experience shows, there is an imperative need to decouple non-bank lenders from banks on the liabilities side and broaden their options for raising money to support growth.

We hope that this report will add to the ongoing discussions on the non-banking finance sector in the country and prove to be an important input in the policy discourse. On behalf of the FICCI NBFC Committee, we would like to thank the team at EY for their support in putting this report together and the FICCI Secretariat for holding detailed consultations with industry members during the course of preparation of this report.

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1 Executive summary



Over the last decade, non-bank lenders have firmly established themselves as an integral part of India's financial ecosystem. They have witnessed exponential growth in the last decade driven largely by regulatory reforms and their ability to cater to unbanked areas through innovative products and service delivery mechanisms. This was further supported by their effective collection platforms. Today, non-bank lenders constitute about ~25% (over INR 35.9 lakh crore as on Sept-2019) of the systemic credit outstanding and have financed over 10 crore customers drawing strength from their extensive footprint largely in rural and semi-urban areas (~70% of total branches). Non-bank lenders form an integral part of the Indian financial ecosystem. They provide underbanked/unbanked individuals and MSMEs an opportunity to be a part of the financial mainstream. They have been successful in bridging the credit gap for the entire spectrum of customers ranging from high ticket structured loans to corporates/HNIs to microfinance customers, due to their higher risk underwriting capacity, superior credit-assessment skills and deep understanding of customers. They have emerged as a vehicle for financing business activities that Banks neglected due to regulatory restrictions such as credit exposure constraints and sector concentration norms. Furthermore, non-bank lenders collaborate with banks through various modes like securitization, on-lending, and business correspondents to complement credit dissemination by underwriting small ticket loans to the agriculture sector and MSMEs. Over the years, non-bank lenders have also acquired a skill-based arbitrage over banks due to continuous innovation in their business model and processes that rely on surrogate non-financial information, use of third-party sales channels and collection processes.

The sector has been exposed to intermittent periods of regulatory and business challenges in the last two years. Non-bank lenders have come under severe stress due to multiple adverse events which challenged their business models. Following the credit rating downgrade of a large infrastructure lender from AAA to default in H1FY19, there were concerns among institutional investors regarding the portfolio quality and asset-liability mismatch of non-bank lenders. The ability to raise funds for the entire non-banking finance sector was severely impacted as capital markets borrowings including mutual funds were reluctant to provide liquidity amid fear of systemic risks. Consequently, the strategic focus of a majority of non-bank lenders shifted towards liquidity conservation through elongation of lability maturities and maintaining liquidity buffers.

The outbreak of COVID-19 has further disrupted the existing stress in the system due to significant drop in customer acquisition, sharp fall in customer repayments/collections and liquidity stress emanating from increased risk aversion by banks. There is high probability that the Gross NPAs of non-bank lenders will increase by 100-200bps during FY21 as ~30%-75% of their loan assets are under repayment moratorium with collection efficiency reduced by over 30%. The consequent drop in related income streams without much reduction in costs is also likely to result in a drop of ROA by 70 bps – 100 bps in FY21 as per the FICCI-EY Business Confidence Survey - 2020. The liquidity squeeze and rising asset quality stress has put further pressure on the repayment ability of various small-mid-sized non-bank lenders largely driven by significant redemption pressure from capital markets investors and change in the credit risk profile of non-bank lenders.

> The liquidity crisis was a good opportunity for the non-banking finance sector. If COVID-19 had happened before the liquidity crisis, many non-bank lenders would have serious challenges in continuity
>
> **MD & CEO of a large diversified non-bank lender**

Despite a slew of multiple stimulus packages and regulatory measures announced by the RBI and MoF, funds are accessible only to a select few large non-bank lenders with strong parentage. For smaller non-bank lenders which primarily operate in a Tier-II and Tier III cities, access to funds remains a big challenge. Since many of these measures require banks as intermediaries, the liquidity transmission has not been effective. Only the high rated (AAA) corporates and public-sector financial institutions have benefitted under TLTRO-1. Even the TLTRO-2 which was specifically conducted to support a larger section of non-bank lenders (AA & below) witnessed a very lukewarm response from banks. This is primarily due to the adverse risk perception of the non-bank lending sector and likely risk avoidance behaviour of banks.



Currently, all non-bank lenders are looked at from the same lens irrespective of their asset size. The regulations have to be cognizant of the size and activity which may need a different type of licensing and supervision

Multiple leaders of the non-banking finance sector

Besides this, non-bank lenders remain exposed to unaddressed structural challenges including the need to enhance the current governance and regulatory framework. While the imperative in light of the COVID-19 crisis is to focus on the immediate challenges faced by the non-banking finance sector, it is equally important to use the learnings to recalibrate the sector's operating framework. Several measures are necessary to make the sector resilient to stress including, enhancing governance and building a holistic prudential framework. There is a need to streamline the structures/ categorization of non-bank lenders and ensure compliance levels vary based on asset size, deposit taking ability, etc. RBI should consider bringing all non-bank lenders with asset size >INR 5,000 crores under higher regulatory oversight coupled with extending flexibility in liability generation and access to public deposits. Further, the prudential and regulatory norms for all non-bank lenders with asset size >INR 50,000 crores could gradually be brought at par with banks. This may also provide well-managed non-bank lenders with a potential roadmap towards becoming a bank. A bank-like AQR for large non-bank lenders could ensure prudence of the balance sheet and help regain investor confidence. Based on AQR findings, the regulator could provide a dedicated liquidity window to non-bank lenders on selective basis to counter cyclical liquidity issues. In addition, the licensing norms may look to enhance the entry criterion in line with the recent proposal to increase minimum NoF for HFCs. This could also help reorganize the non-banking finance sector through rationalization and consolidation and curtail the long tail of non-bank lenders for large non-bank lenders to avail the much-needed bandwidth for oversight.

The perception of the non-banking finance sector should change. There is a need to acknowledge the soundness of the sector

MD & CEO of a large diversified non-bank lender

Regulator may encourage banks to lend to non-bank lenders in the ordinary course and not just under special circumstances. However, for mutual fund investors and banks to regain confidence, it is essential that non-bank lenders must recapitalize themselves and build the required governance on their part. Additional measures such as extending the tenure of special liquidity scheme, emergency direct line of credit at least for non-bank lenders with minimum investment grade credit rating and relaxing provisioning norms could play an important role in providing support in the short to medium term. Furthermore, the proposed regulatory framework for securitization and sale of financial assets would enable non-bank lenders to raise more funds through the securitization route in the long term. Going forward, given India's significant credit need, it is important that financing options other than banks are given due weightage. Strengthening existing non-bank lenders platform could provide an impetus to credit growth in the country.

It is difficult for non-bank lenders to grow once asset size reaches a threshold. Hence, it is important to have more disintermediation models whereby non-bank lenders can leverage their superior credit assessment and strong collection platform to create assets for someone with easy access to capital, possibly banks

MD & CEO of a large diversified non-bank lender



Recent adverse industry events and the outbreak of COVID-19 pandemic has proved that the sector needs to be more resilient and focus on realigning the business model tuned to capture future growth opportunities. In our view, this can be achieved by aligning focus on five core pillars and effective use of technology:

a) **Digital first approach towards products -** Acquiring new customers and cross-selling to existing customers through an assisted-digital model for unsecured and asset backed loans in a phased manner.

b) **Analytics driven decision making to prioritize customer use cases –** Using analytics across the value chain for data driven customer insights, customer acquisition, channel management, portfolio and performance management, productivity and service process and operations and support.

c) **Leverage partner driven ecosystem and collaborations to drive growth -** API-based business models in partnership with FinTechs to offer value added services.

d) **Technology enablement using innovative platform -** Optimizing the value chain through technology which encompasses real-time, event-driven and component-based characteristics.

e) **Maintain tight risk management controls:** Building robust technology infrastructure in risk management should be part of future roadmap to enable alignment, convergence and efficiencies.

f) **Attract, retain and grow the best talent –** Creation of talent hubs, building employer brand and restructuring of the workforce.

The above will ensure existence of resilient non-bank lenders that are equipped to capture future growth and ensure seamless transmission of credit. Besides, the regulator through policy measures, could ensure that both banks and non-bank lenders are able to leverage their respective inherent strengths and be complementary to each other. This will ensure existence of resilient non-bank lenders and seamless transmission of credit.

In conclusion, non-bank lenders are a significant part of the credit ecosystem of the country and are presently undergoing a change in their business model. This requires due support from the banking community to provide them timely leverage. The non-bank lenders on their part need to recapitalize themselves, build in the required governance and explore alternate forms of finance. The regulator needs to govern large non-bank lenders akin to banks and, at the same time, consider regulations around short-term liquidity support and a path to convert them to full or differentiated banks.





2

Non-banking finance sector: the journey so far

2.1 Background: emergence of the non-banking finance sector within the purview of the RBI

The RBI assumed supervisory control of the non-banking finance sector in 1964 to ensure all lending activities are under its purview with the amendment of the Reserve Bank of India (RBI) Act. However, the RBI had a light-touch approach of governance largely focusing on deposit taking activities. This was further enhanced to a comprehensive regulatory and supervisory framework for the sector in 1998 following the collapse of a leading entity. The new framework covered aspects such as entry point norms, capital adequacy, prudential norms on asset classification, provisioning for bad, doubtful assets, mandatory disclosures and accounting standards[1] thus ensured protection of a depositor's interests.

To further ensure financial soundness of non-bank lenders (NBFCs and HFCs), a minimum net owned fund (NoF) criteria was introduced by the RBI and an investment grade rating was mandated to mobilize public deposits. This led to a consolidation and closure of multiple non-bank lenders staring 1998. About 8,500 non-bank lenders remained operational after this and public deposits held by non-bank lenders witnessed a sharp decline from INR 13,500 crore to INR 2,000 crore over a decade.

The dependence of non-bank lenders on public deposits gradually declined with the emergence of alternate sources of funding in the form of capital market borrowings and FDI investments in the early 2000s.

Reassessment of prudential framework

In the latter half of 2000, the non-bank lenders highlighted their importance in financial intermediation with their greater ability to reach out to inaccessible areas and act as substitutes to banks[2]. They derived their strength from lower cost of operations and diverse product offerings. The RBI had set up a committee to examine and address issues such as providing level playing field and achieving regulatory convergence. Based on its recommendations, a revised regulatory framework[3] was introduced covering minimum capital adequacy norms, NPA recognition, and asset classification guidelines in line with that of banks.

1. RBI: Working Group on the Issues and Concerns in the NBFC Sector; Reports and Recommendations
2. RBI: Non-banking Finance Companies in India's Financial Landscape
3. RBI: Revised Regulatory Framework for NBFCs, March 2015
4. RBI grants "In-principle" Approval to 10 Applicants for Small Finance Banks, September 2015
5. RBI grants "in-principle" approval to 11 Applicants for Payments Banks, August 2015
6. RBI grants "in-principle" approval for banking licences, April 2014

Transition to specialized banks and emergence of new business models

As the agenda of financial inclusion gained prominence, a task force led by Nachiket Mor was setup to explore means to increase financial inclusion. Accordingly, the concept of differentiated banking regime in India was introduced and the RBI provided approval to setup 10 Small Finance Banks[4], 11 Payment Banks[5] and 2 Universal Banks[6] to primarily to non-bank lenders.

> **12 non-bank lenders were awarded differentiated banking license, for the first time since 1994**

During the same time, non-bank lenders transitioned their business models to focus on diversified retail products. Non-bank lenders are now heterogeneous in terms of their activities and size of operations, they serve as critical financial intermediaries for credit seekers of the country. They have transformed their business models from monoline business segments to diversified niche products over the past decade.



Exhibit 1: Evolution of non-banking finance sector[7]

Source: RBI circulars, EY analysis



7. Periodic publications and working papers of RBI

1. Convergence between banks and non-bank lenders on NPA recognition, asset classification norms and provisioning basis Nachiket Mor Committee suggestions
2. Focus of non-bank lenders shifted from wholesale to retail segments
3. Non-bank lenders gain share in multiple segments on account of slowdown in banks due to asset quality issues

2012 - 2017

4. Liquidity crisis – Default of a large infra lender and large HFC
5. Differentiated banks regime initiated; NBFCs transition to Banks - 10 Small Finance Bank, 11 Payments bank and 2 Universal bank licenses issued

Business transformation amid cyclical slowdown

1. Liquidity crisis forces players to curtail disbursements; Investment into bonds of non-bank lenders reduced
2. Digital lending/ FinTech gains prominence; Non-bank lenders lead the BFSI industry in adoption
3. RBI assumes regulatory control over HFCs from NHB

2017 - Present

4. Lapses in corporate governance of a few non-bank lenders impacts the sector including capital flows to the sector
5. Disruption in the business due to COVID-19; Relief packages provided by the government/ RBI

Emergence of FinTech players and Liquidity crisis

1. Alternate funding sources emerged - CP issuance, ECB guidelines introduced. Non-bank lenders dependence on public deposits declined gradually
2. Reverse merger of a leading financial institution with its subsidiary bank

2000 - 2003

3. ALM guidelines introduced for NBFCs with asset and deposit base of over INR 100 crore, INR 20 crore respectively.
4. Up to 100% FDI allowed into NBFCs along with minimum capitalization norms (ranging US$ 0.5 million to US$ 50 million)

Increasing depth in the sector

1. NBFCs with asset size over INR 100 crore classified as systemically important entities
2. Bank finance to non-bank lenders liberalized to allow working capital and term loans
3. Non-deposit taking NBFCs with over INR 100 crore NoF permitted to issue credit cards

2003 - 2007

4. Equipment Leasing, Hire Purchase NBFC categories combined to form Asset Finance Company category
5. Brokerages were allowed to provide loans against marketable securities and Distribution of Mutual Fund products by non-bank lenders

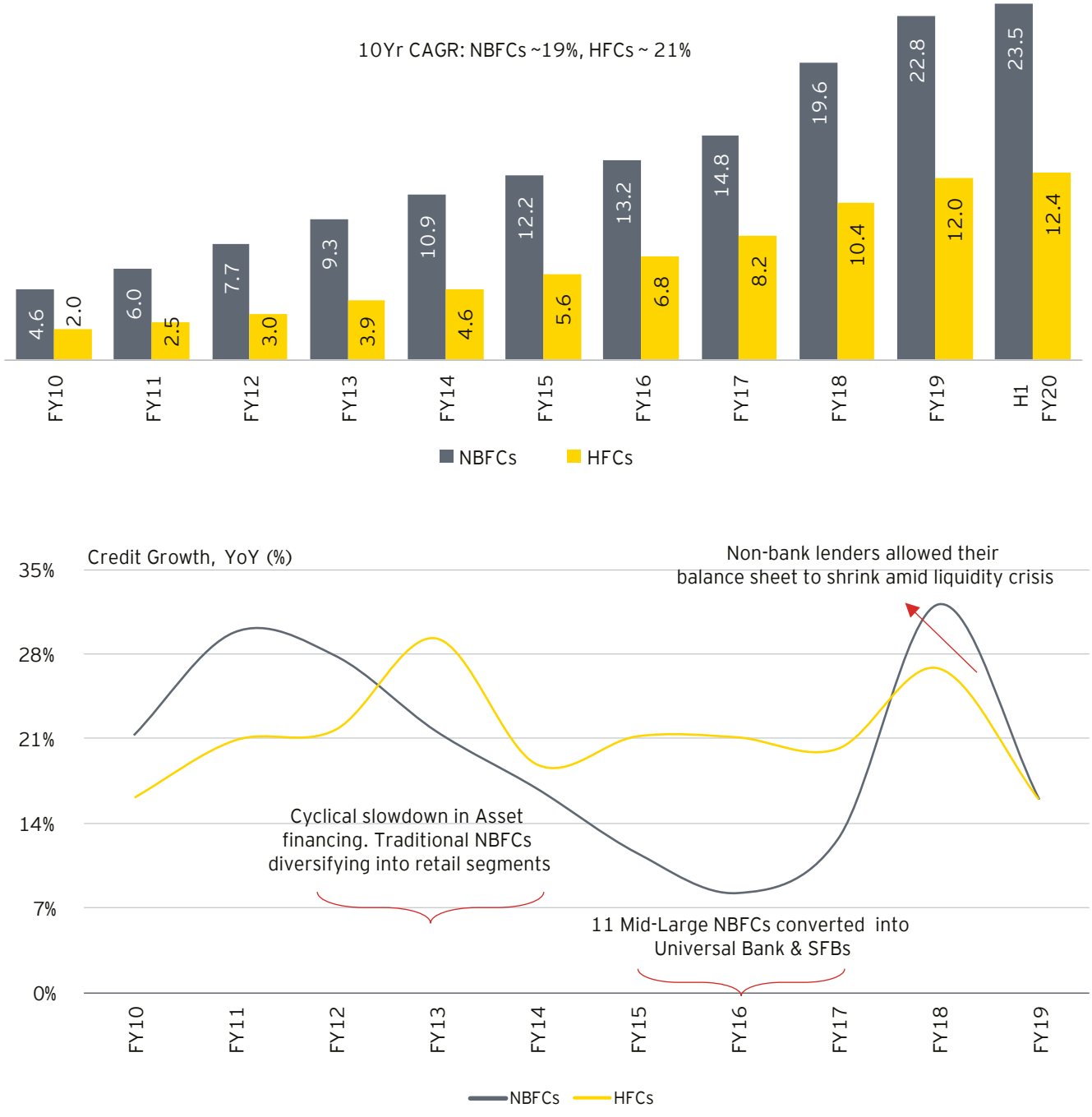
Gaining prominence

2.2 Evolution of non-bank lenders: an impressive growth story in the last decade

Non-bank lenders have grown significantly in the last decade driven by regulatory reforms and critical evaluation of their business models. Of ~9,600 non-bank lenders, 274 are classified as 'Systemically Important', 99 as HFCs and 82 as deposit taking NBFCs. Non-bank lenders have financed over 10 crore customers till date deriving strength from their extensive footprint which is largely located in rural and semi-urban areas (~70% of total branches).

Exhibit 2: Trend in credit deployment by non-bank lenders (INR Lakh Crores)

Source: RBI[8], NHB[9], EY analysis



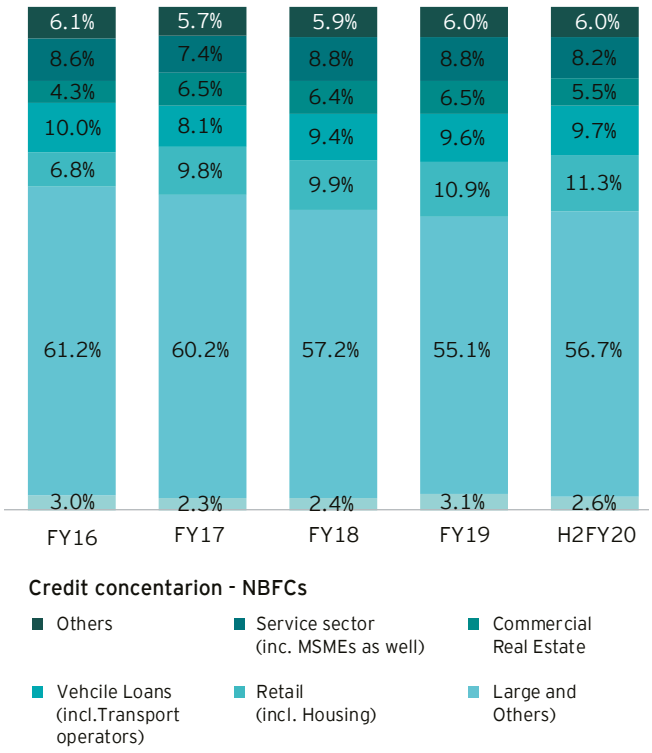
8. Reports on Trend and Progress of Banking in India, RBI
9. Reports on Trend and Progress of Housing in India, NHB

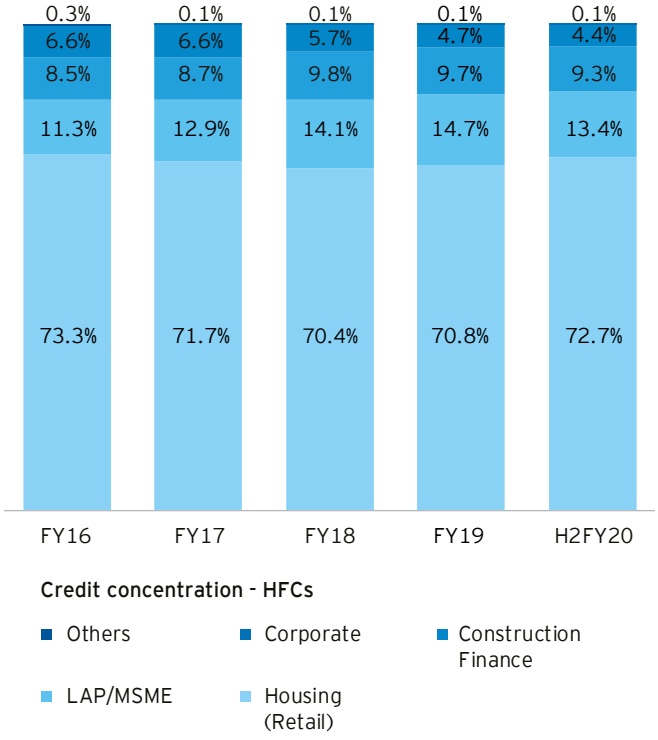
The overall credit deployed by non-bank lenders is over INR 35.9 lakh crore (as on Sept-2019) and contribute to ~25% of the domestic credit in the system. The sector has witnessed intermittent periods of regulatory and business challenges during this period. However, it has not deterred the sector from making investments into technology, enhancing last mile presence and developing niche products.

Historically, non-bank lenders benefitted from regulatory arbitrage which focused on light touch approach with relaxed supervision norms such as fewer compliance obligations when compared to banks. The regulatory arbitrage involves exemption from sector concentration norms, acceptable collateral as well as credit standards.

Exhibit 3: Credit concentration of non-bank lenders

Source: RBI[10], NHB[11], EY analysis





While NBFCs managed to grow at an impressive annualized rate of 19% over the last 10 years, this growth has been volatile (as reflected in Exhibit 2) given the cyclical slowdown in key product segments such as vehicle finance and wholesale loans. This prompted non-bank lenders to shift their focus from a monoline business segment to a diversified suite of retail lending segments.

Unlike NBFCs, HFCs have had a linear growth - an annualized rate of 21% during the same period. These specialized mortgage financiers have carved out a niche for themselves in an intensely competitive (bank dominated) market by lending to self-employed/ informal sections of society while maintaining healthy asset quality. About three-fourth of loans assets are attributed to individual retail borrowers for purchase/ construction of housing units.

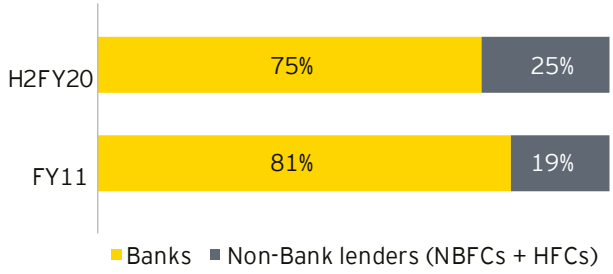
10. Report on Trend and Progress of Banking in India, RBI
11. Report on Trend and Progress of Housing in India, NHB

This was done with the objective to ensure that that non-bank lenders could complement banks with their diverse financial products and reach a large cross-section of population through innovative credit delivery and collection mechanisms. Non-bank lenders became a vehicle for business activities that banks were unable to undertake due to regulatory restrictions.

Non-bank lenders have gained market share from banks in key segments such as retail consumer loans, lending to micro-small enterprises, vehicle loans and housing loans. They have been able to capture share by catering to underserved and unbanked customer segments.

Over the past two years, the non-banking finance sector came under stress due to multiple adverse events which impacted growth and profitability. COVID-19 has further amplified the stress in the system. Loan volumes for most of the non-bank lenders have come down considerably, particularly for lenders who are directly competing with banks and have limited pricing power. These lenders are preserving liquidity and in the process are shrinking their balance sheets.

Exhibit 4: Market share trend between banks and non-bank lenders



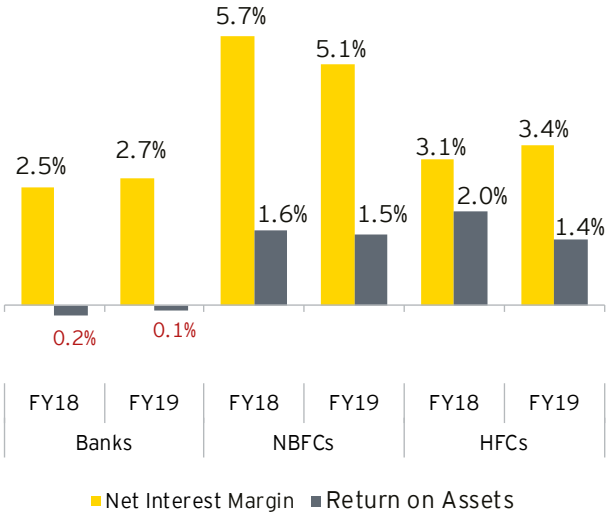
Source: RBI, NHB, EY analysis. Note: Bank credit to NBFCs is reduced from the computation of overall systemic credit

2.3 Performance of non-bank lenders: largely outperforming banks

Non-bank lenders continue to perform better than banks in terms of balance sheet growth and overall profitability. On relative terms, non-bank lenders can garner higher yields on their underlying assets than banks given their higher exposure to informal segments. Further, despite higher cost of funds, their net interest margins are higher translating into better risk-adjusted return (even after they operate at lower leverage vis-vis banks).

Exhibit 5: Key financial parameters of banks and non-bank lenders

Source: RBI, NHB, EY analysis



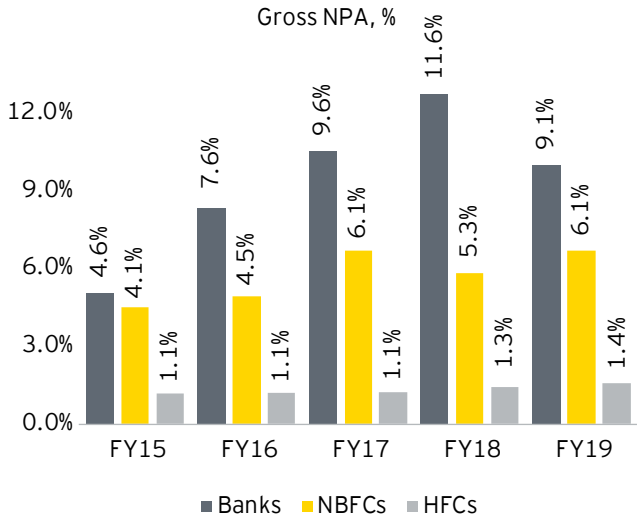
Non-bank lenders have a dedicated product focus, a good understanding of customer segments in their target markets and a robust collections capability. In terms of asset quality, the non-banking finance sector has performed better than banks.

Gross non-performing assets of 6.1% and 1.4% for NBFCs and HFCs respectively against 9.3% of banks as of FY2019. This is despite non-bank lenders moving to stricter NPA recognition and provisioning norms under Ind-AS during FY18.

Non-bank lenders have had a superior financial performance compared to banks consistently over the years

Exhibit 6: Trend in Asset quality of banks and non-bank lenders

Source: RBI, NHB, EY analysis. Note: Non-bank lenders transitioned to 90dpd NPA recognition starting FY18 from 180dpd in FY15

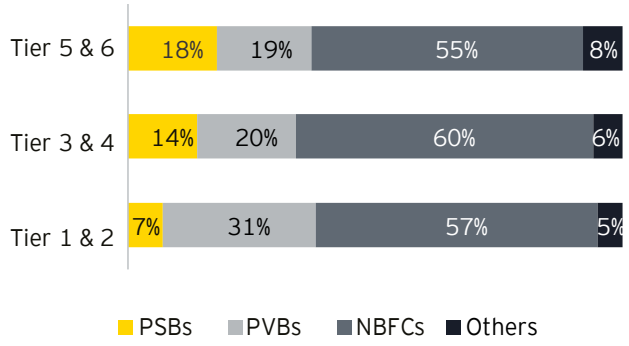


2.4 Role of non-bank lenders: strong play in last-mile delivery of financial services

a) **Penetrating underbanked areas and driving financial inclusion:** As highlighted earlier, non-bank lenders play a key role in the distribution of financial services in underbanked areas. They target an audience of customers with limited banking access in urban and rural areas. On the contrary, banks face challenges in their outreach to customers in these areas. As shown in Exhibit 7, non-bank lenders have dominated the sourcing of 'New to Credit' customers accounting for over 50% of incremental credit flow to this segment across geographies.

Exhibit 7: Share of loans to 'New to Credit' customers (FY19)

Source: TransUnion CIBIL[12], FICCI



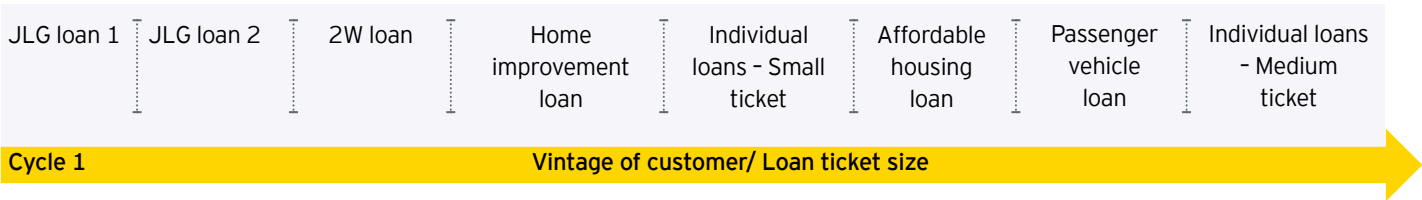
Many small and medium sized non-bank lenders provide last-mile credit to underbanked areas. Over the years, they have increased their branch footprint located in semi-urban and rural areas (~70% of total branches).

Over the last few years, microfinance emerged as a product to promote financial inclusion and has been termed as "Next wave of Financial inclusion"[13]. It is argued that microfinance can facilitate the achievement of national policies that target poverty reduction, assisting vulnerable groups and improving standards of living. Exhibit 8 highlights the journey and inclusion of a typical microfinance customer where their income is expanding due to credit access. Therefore, customers have a varied choice of financial products. The Microfinance sector has grown over the years to reach a market size of ~INR 2 lakh crore with 6.4 crore unique live borrowers[14].

Non-bank lenders fill the credit gap by lending to customer with limited access to formal banking

Exhibit 8: Financial inclusion journey of a microfinance customer

Source: Industry interactions, EY analysis

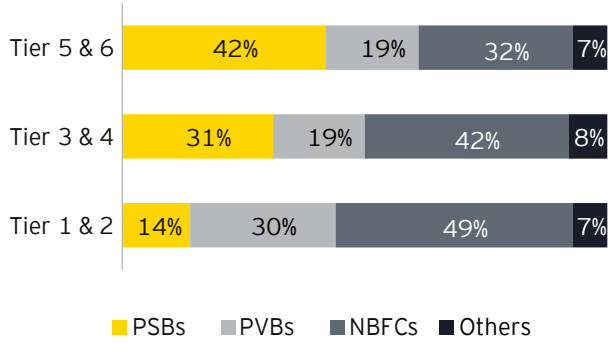


12. Products included are Auto Loans, Personal Loans, Housing Loans, Consumer Loans, Business loans, LAP, Gold Loan, Credit cards, Agri-Priority, CVs and CEQ Loans. Others include Co-operative Banks, MNCs and Regional Rural Banks
13. SIDBI National Microfinance Congress 2019
14. Microfinance pulse – SIDBI – Jan 2020

b) **Complimenting credit dissemination ability of banks:** Non-bank lenders are increasingly being recognized as complementary to the banking system and are capable of absorbing shocks at times of financial distress. They support the vast financing needs of sections that are outside the catchment of banks and drive financial penetration. As seen in Exhibit 9, non-bank lenders fill the vacuum created by private banks in rural/ semi-urban India and account for one-third of loans originating in the financial system.

Exhibit 9: Share in new loans originated – Region wise (FY19)

Source: TransUnion CIBIL[15], FICCI



Furthermore, non-bank lenders collaborate with banks through various modes like securitization, on-lending, business correspondents etc. to help disseminate credit by underwriting small ticket loans to agriculture and MSMEs. These loans are eligible under priority sector lending (PSL) targets for banks and hence, many of them are dependent on non-bank lenders to meet the PSL targets. There is a strong interconnectedness between banks and non-bank lenders for instance ~31.8% of NBFC-ND-SI borrowings originating from banks as on H1FY20[16] (26.9% through direct lending and 4.9% through debentures and commercial papers).

Non-bank lenders play an important role by complementing the formal banking system and there is a strong interplay between banks and non-bank lenders

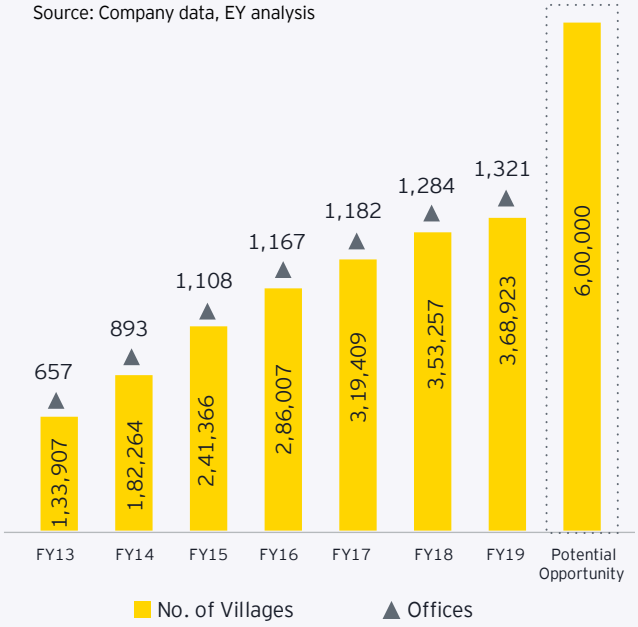
Supporting financial inclusion through extensive reach

Many non-bank lenders focus on rural and semi-urban geographies. With a large on-ground presence in these areas coupled with underwriting expertise, non-bank lenders position themselves to effectively cater and target 'new-to-credit' customers and customers in the 'bottom of the pyramid'. They provide high-risk / high-yielding loans which are outside the focus segment of the banks.

Case is point is a large rural focussed non-bank lender which has its 1,000+ branch network caters to ~two-thirds of the over 600,000 villages in India.

Exhibit 10: Presence of a large non-bank lender in rural areas

Source: Company data, EY analysis



15. Products included are Auto Loans, Personal Loans, Housing Loans, Consumer Loans, Business loans, LAP, Gold Loan, Credit cards, Agri-Priority, CVs and CEQ Loans. Others include Co-operative Banks, MNCs and Regional Rural Banks

16. Report on Trend and Progress of Banking in India 2018-19

c) **Delivering niche products:** Non-banking finance companies form an integral part of the Indian financial ecosystem, they provide underbanked/unbanked individuals and businesses an opportunity to be a part of the financial mainstream. Over years, non-bank lenders have developed/ acquired a skill-based arbitrage in comparison with banks due to continuous innovation in their business model and processes that rely on surrogate non-financial information, use of third-party sales channels, and collection processes.

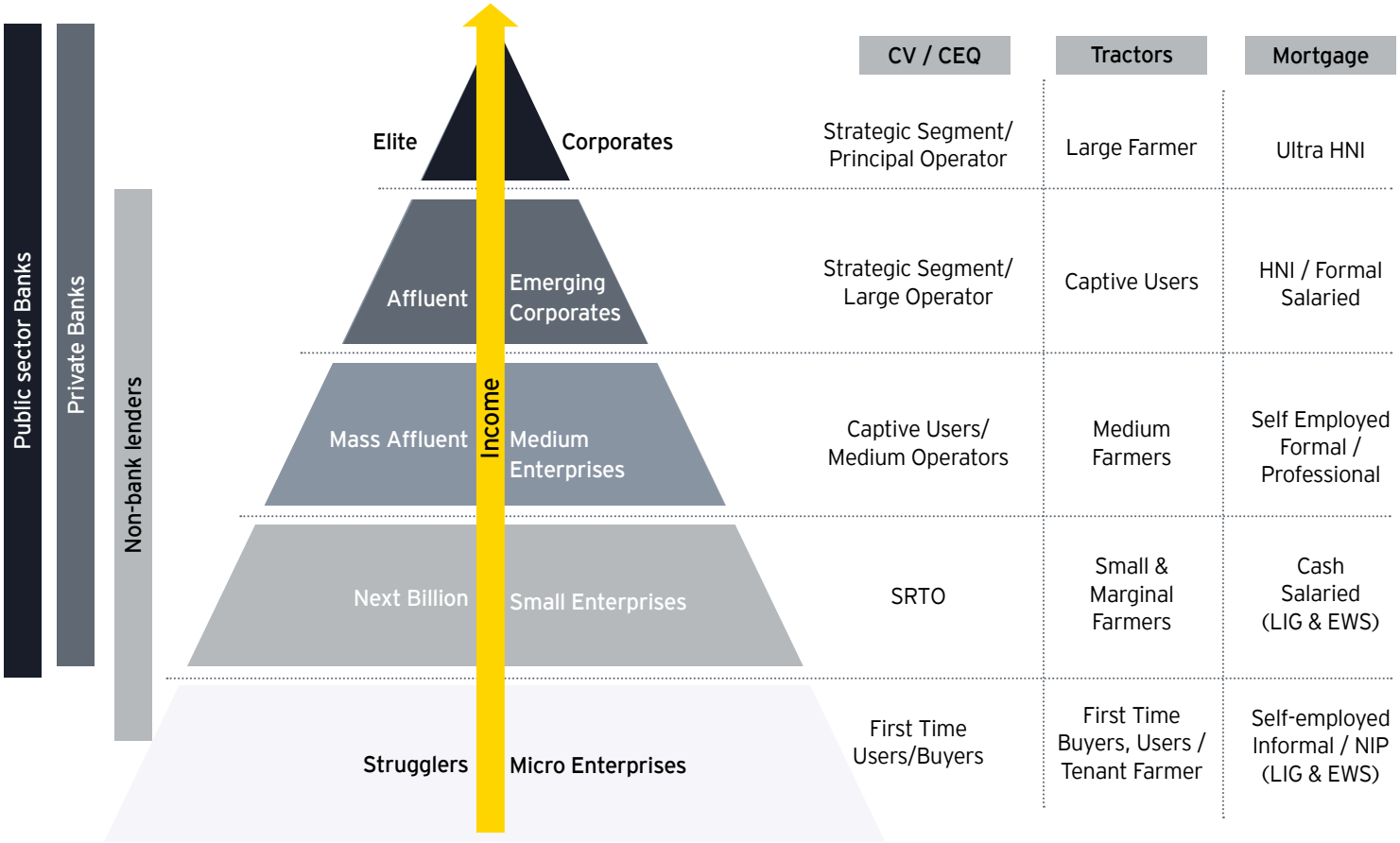
Non-bank lenders have been successful in bridging the credit gap for the entire spectrum of customers ranging from high ticket structured loans to corporates/ HNIs to microfinance customers due to their higher risk underwriting capacity, credit-assessment skills and deep understanding of customer or of an asset being financed. Non-bank lenders developed a niche on specific product segments which are generally overlooked by banks such as used vehicles, gold loans, and affordable housing. These segments contribute to significant portion of their lending mix compared to Banks. This helps provide required management focus for the development of the segment.

The ground-level presence and high-touch based collection mechanism is the key differentiator

d) **Augmenting growth of key segments:** Non-bank lenders play an important role in the economy by financing micro and small-scale industries (informal sector) and provide employment and entrepreneurial opportunities at a ground level. Banks prefer lending to entities with stronger balance sheets or to lower risk segments such as the salaried class of people. Non-bank lenders support financially weaker sections of society by channelizing financial resources to capital formation. A large share of their assets (~45%) is deployed into retail, MSME and vehicle finance segments.

Exhibit 11: A comparative view of customer segments catered to by banks and non-bank lenders in sample product segments

Source: EY analysis





3

Non-banking finance sector: a strong pillar in the financial services ecosystem

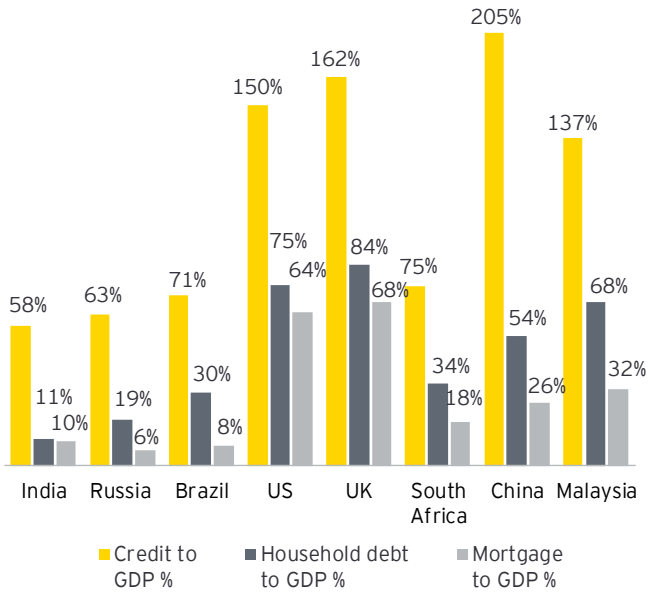
Non-bank lenders have emerged to play a key role in the last-mile delivery of financial services. This is owing their ability to complement banking credit dissemination and cater to the informal and bottom-of-the-pyramid customer segment. As India aspires to be a US$ 5 trillion economy, the sector is expected to play a larger role in the coming years with its ability to bridge the financing gap in sectors such as consumer, MSME and housing.

3.1 India's growth aspirations - endless opportunities

Credit accessibility in India remains comparatively lower against developed nations and other BRIC economies. This is evident from the credit to GDP ratio for India which stands at 58% compared to 150% and 205% in the US and China respectively. Additionally, mortgage to GDP ratio in India is low at 10%. This indicates significant opportunity to bridge the gap in credit penetration in India.

Exhibit 12: Credit accessibility – cross country comparison

Source: BIS, World bank, IMF, EY analysis



The key levers to bridging this gap includes

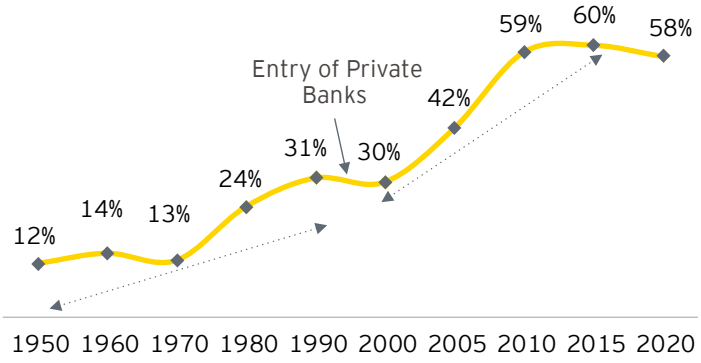
Expected consumption growth	Indian middle-income population **~80% in 2030** **~50% in 2019**	India's per capita income is estimated to increase to US$ 3,500 by 2024 from US$ 2,100 in 2019. Movement of population to higher income categories will drive both consumption in the economy and associated credit need. Increased consumption is also expected to be aided by the spread of mobile usage and technology which is bridging credit access to customers.
Favourable demographics	'Demographic Dividend' – Working age population[17] **~60% in 2041** **49.3% in 2019**	With a working age population rising by ~9.6 crore every year, it is expected to reach over 120 crores by 2031 (amongst the largest workforce). Thus, it would provide impetus for consumption and credit growth.
Conducive policy framework	GST, Make in India, FDI norms liberalization, Atmanirbhar Bharat package	The policy and reform measures taken by the government are expected to provide a conducive platform for growth in investments across sectors.
Increased Urbanization	India's urban population **40% by 2030**[18] **35% in 2019**	Increased population moving to urban centres is expected to spur credit demand.
Increased Infrastructure build up	**INR100 lakh crore** worth of **investment in infrastructure** assets	The GOI's massive investment on building modern infrastructure is expected to have a cascading effect on the economy. Increased money supply I expected to drive consumption demand especially in rural areas.

17. Economic survey 2019
18. Data from the World Bank

Given India's significant credit need, it is important that financing options other than banks are given due weightage. Non-bank lenders have already proved as a strong platform for credit dissemination in India. Strengthening this platform provides an impetus to credit growth in the country. Case in point is with the entry of private banks, the credit to GDP metric had grown significantly as indicated in the Economic Survey of India 2019-20.

Exhibit 13: Credit to GDP trend in India

Source: BIS, RBI, EY analysis



Sectoral reforms like granting of private bank licenses impact credit growth positively as indicated in Exhibit 13. Non-bank lenders, which have traditionally worked alongside banks, are facing hurdles and slow growth over the past two years. Non-bank lenders can provide the much-needed push to credit growth by undergoing suitable reforms and in process play a key role in India becoming a US$ 5 trillion economy by 2025.

Sectors such as MSMEs, housing, automobiles and consumption play an important role in driving overall economic growth. Non-bank lenders have contributed towards product and process innovations. In the forthcoming section, we will highlight the contribution of non-bank lenders in these areas.

> Currently, only a few large public and private banks play an active role in catering to financing needs of the country. Hence, there is a need to further leverage existing well-established platform of non-bank lenders to meet the future financing needs of the country
>
> **MD & CEO of a large non-bank lender**

3.2 Critical to support growth of Micro, Small and Medium Enterprises (MSMEs)

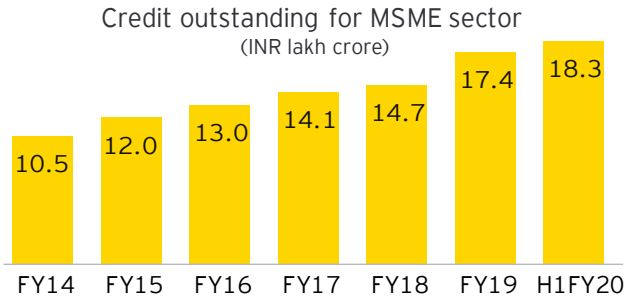
India has ~6.3 crore MSMEs operating in the country which contribute to 28.9% of the GDP while employing 11 crore people. With over 3 crore MSMEs (51% of total MSMEs) based in the rural areas, they form an important part of the rural ecosystem[19].

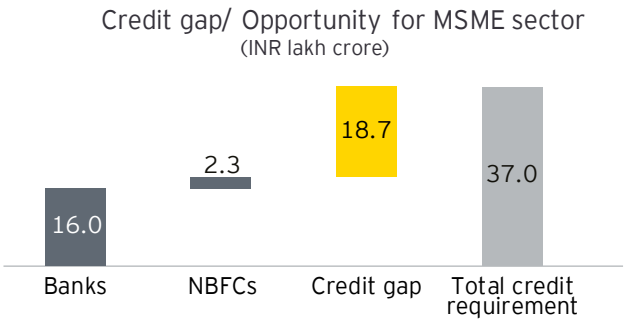
Given their overall economic importance, easy access to credit for the sector is vital to ensure its growth. Exposure of banks and non-bank lenders to the sector increased by ~75% since FY14 to reach ~INR 18.3 lakh crore as on H1FY20. Despite a jump, formal credit access through banks and non-bank lenders contribute to ~49% of the overall credit requirement of MSMEs as shown in Exhibit 14[20].

The growth of non-bank lenders in financing the MSME sector can be attributed to the following factors

Exhibit 14: Credit to MSME sector

Source: SIDBI, MSME Pulse Report, EY analysis





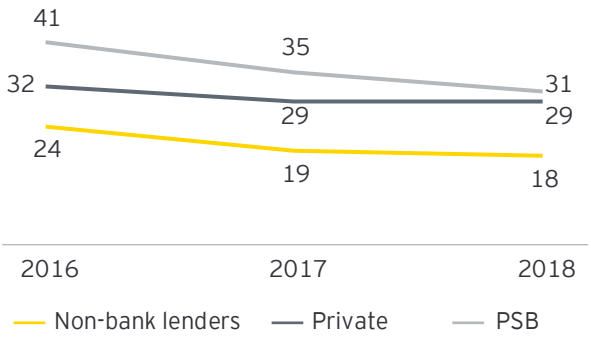
19. 2018-19 Annual report of Ministry of Micro, Small and Medium Enterprises, Report of the Expert Committee on Micro, Small and Medium Enterprises, published in Jun 2019, RBI
20. Report of the Expert Committee on Micro, Small and Medium Enterprises, published in Jun 2019, RBI, IFC

a) **Efficiency in underwriting:** Between 2016 and 2018, all lenders effectively reduced the processing time for MSME loans. Accordingly, non-bank lenders have the lowest TAT in the industry for processing MSME loans[21].

India has 6.3 crore MSMEs which contribute to 28.9% of GDP

Exhibit 15: Turnaround time for loans

Source: SIDBI, MSME Pulse Report, TransUnion CIBIL, EY analysis



b) **Differentiated approach to MSME financing:** MSME creditworthiness assessment, more specifically for small and micro segments which have a higher proportion of customers with limited income proofs, requires a strong understanding of the sector and micro-market. Non-bank lenders underwrite based on the cashflows as opposed to a balance sheet-based approach. This approach requires significant investment in effective assessment, monitoring and collections. Consequently, the cost of servicing the segment is relatively higher. Hence, non-bank lenders with their strong network and underwriting capabilities are better placed to continue servicing this sector.

> Non-bank lenders with their strong network and underwriting abilities are better placed in servicing MSMEs, particularly small and micro segment
>
> **Chairman of a large diversified non-bank lender**



21. MSME Pulse reports published by SIDBI-TransUnion CIBIL

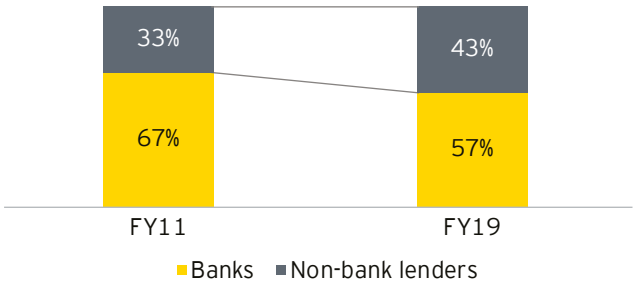
Below is a comparative view of banks and non-bank lenders in servicing MSMEs

	PSU banks	Private banks	Non-bank lenders	Non-bank lenders - FinTech
Focus segments within MSME	Large, medium, small businesses	Large, medium to small businesses Limited focus on retail segment	Small, micro/ retail businesses (formal, informal) Self employed professionals	Small and Micro SMEs (formal, informal)
Geographical reach	Across geographies	Primarily urban/ metro; cater to semi-urban geographies in a limited way	Primarily urban and semi-urban geographies	Primarily urban
Channels	Primarily branch sourcing	Primarily Branches, Digital, DSAs, Direct sourcing (including outbound calling)	Primarily DSAs, Direct sourcing (including outbound calling)	Primarily Digital sourcing
Product offerings	Current Account, Cash credit/ overdraft, Trade/ Value chain finance, LAP, Transaction Banking	Current Account,Cash credit/ overdraft,Trade/ Value chain Finance, LAP, Transaction Banking	LAP, Unsecured Loans, Professionals loans, Trade/ Value chain Finance, Bridge financing	LAP, Unsecured loans, Professionals loans, Bridge financing
Average TAT	31 days	29 days	18 days	< 1 week
Assessment methodology	Primarily based on balance sheet or collateral	Primarily based on balance sheet or collateral	Based on cash flows or collateral	Based on cash flows or collateral

3.3 A crucial role in development of the housing sector

Exhibit 16: Market share of Banks vs. non-bank lenders in Home loans

Source: RBI, NHB, EY analysis



The Indian housing finance market is catered to by ~100 HFCs (specialized non-bank lenders catering to mortgage requirement) and banks. The total home loans outstanding are expected to reach INR 35 lakh crore by FY22 from INR 20 lakh crore in FY19 with HFCs having ~43% market share (in terms of loans outstanding)[22]. While banks have a larger market share, HFCs have gained over the years.

The key levers driving growth in housing finance include urbanization, housing shortage, fall in average household size, rising affordability and lower penetration in rural/ semi-urban areas. With a significant shortage in the EWS and LIG segments, it is estimated that India will need 8 crore to 10 crore units until 2022[22]. With an aim of facilitating construction of 2 crore houses in urban locations, the government launched an initiative called "Housing for All by 2022" in 2015 targeted towards low-income population. A credit linked subsidy scheme (CLSS) was launched to provide an impetus to achieving the target.

22. RBI: Report of the Committee on the Development of Housing Finance Securitisation Market 2019

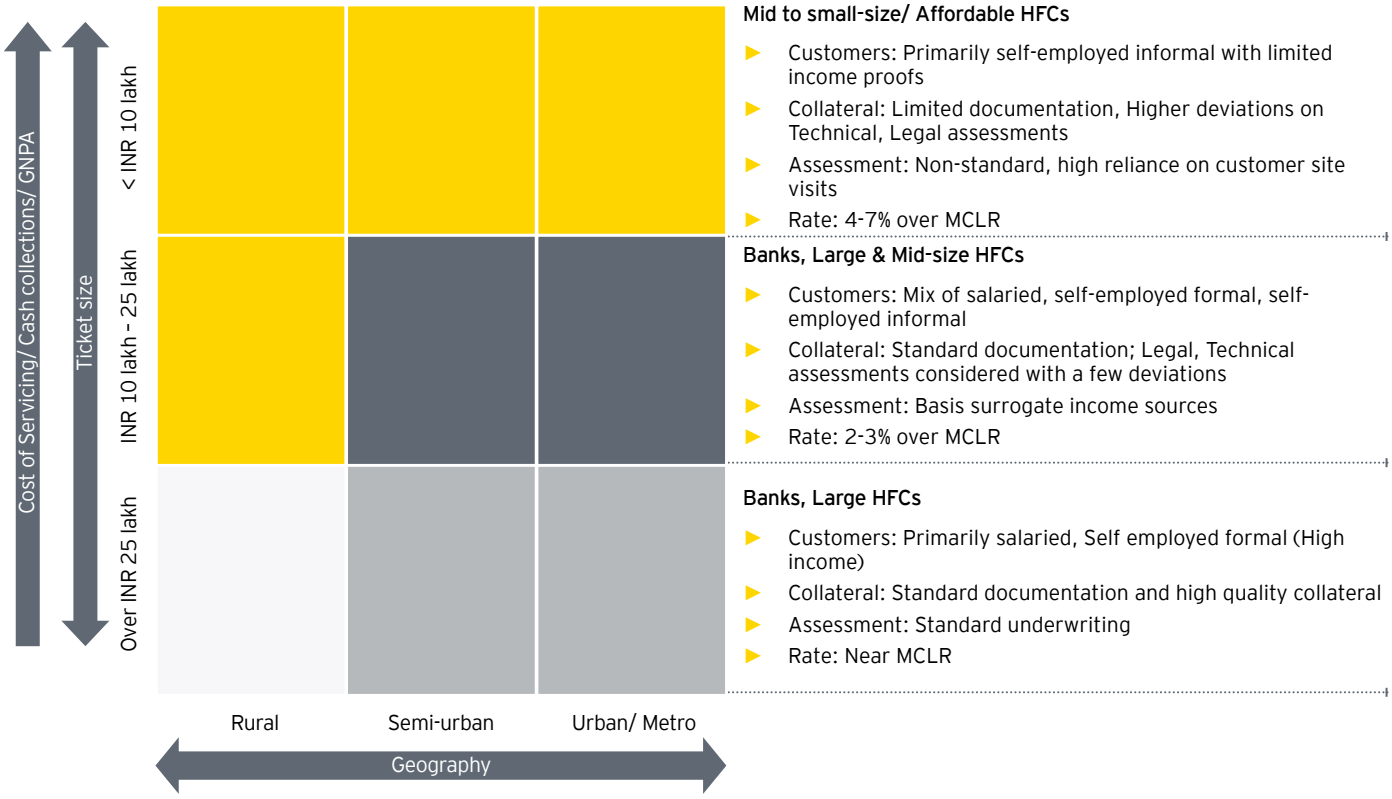
The share of HFCs increases as we move towards the lower end of the consumer spectrum - EWS and LIG, and towards lower ticker sizes. In terms of geographical presence, HFCs have a higher market share in rural and semi-urban regions. Accordingly, between FY17 and FY19, 70% of the disbursements made under CLSS was to HFCs[23]. Exhibit 11 gives a view of the product and customers seeking housing finance and the focus of financiers.

Given the emergence of HFCs in catering to low-income groups and informal segments, they will continue to play a critical role in the housing finance market.

> Affordable HFCs play an important role in implementation of key government schemes. For instance, a leading HFC covers ~80% of PMAY-CLSS locations across the country
>
> **MD & CEO of a mid-sized housing finance company**

Exhibit 17: HFCs play a crucial role in providing housing finance to low-income groups in the rural and semi-urban geographies

Source: Company reports, EY analysis

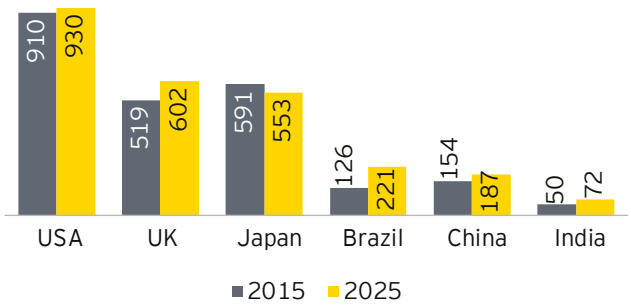


23. NHB Trends and progress report 2019

3.4 Strong enabler for vehicle purchases in the self-employed segment

Exhibit 18: Motorization rate - Passenger vehicles

Source: NCD prospectus of a leading vehicle financier



With ~50 cars per 1,000 people, passenger vehicle penetration in India is lower in comparison with other economies[24]. The same is the case in other key segments such as farming, where there is a scope of higher mechanization compared to other economies.

The vehicle finance market in India, comprising of loans towards purchase of passenger vehicles, commercial vehicles, construction equipment, farm equipment, three and two wheelers, both new and used, is estimated to be around INR 5.6 lakh crore (as on H1FY20). It is growing at an annualized rate of 11% for the past three years. Non-bank lenders hold a share of 40% in this highly competitive market.

This share of non-bank lenders in vehicle financing can be attributed to the following factors:

a) **Ecosystem approach to sourcing:** In vehicle financing, non-bank lenders focus largely on sourcing riskier customer profiles such as new to credit, first time users/ buyers, small road transport operators, small to medium size farm owners, customers who have limited income proofs. This segment requires significant effort and on ground presence to source and collect. The consequent higher cost of sourcing, servicing required for this customer segment creates a barrier for entry of banks into this segment. Further, the presence of non-bank lenders across the ecosystem, like transport hubs in case of commercial vehicle, help maintain their lead in certain product segments.

   Non-bank lenders also have a strong play at the vehicle dealerships. They provide dealerships with short-term revolving credit for inventory purchase and commissions for customer referrals. The interest-free nature of this short-term credit offered by many non-bank lenders helps them leverage the influence of dealerships on customer's financing decision.

b) **Robust risk management practices:** Most customers targeted by non-bank lenders have limited resources and rely on cashflows from the asset being financed for their primary livelihood. This risk is mitigated by bundling custom health and life insurance products as part of financing. An added strong collections practices of many non-bank lenders help protect the assets being financed and continue financing the segment. These practices also help non-bank lenders sustain market share in rural and semi-urban locations.

3.5 Supporting growth in key sectors – Consumer

Consumer finance market is largely underpenetrated over other comparable countries as indicated in Exhibit 12. The consumer loans market is estimated to be around ~INR 10 lakh crore as on H1FY20 and has grown at an annualized rate of ~30% over FY16-H1FY20[25]. Key factors for the growth in the sector include easy availability of credit, reduction in the replacement cycle of consumer products, increasing affordability, higher penetration of new players and increase in the product portfolio offered for financing.

Non-bank lenders have played a vital role in the growth of this segment over the last decade. Accordingly, the share of non-bank lenders has grown to 23% from 15% in the last three years[26]. The increasing penetration of non-bank lenders is majorly attributed to the following factors:

a) **Creating an ecosystem:** The evolving digitalization trend has brought an increased connectedness within the ecosystem - OEM, dealer, customer, financier. In addition, near automated underwriting and increased penetration of e-commerce has helped the consumer lending market grow. Non-bank lenders have been pivotal in channelizing subventions through OEMs, thus creating a robust ecosystem.

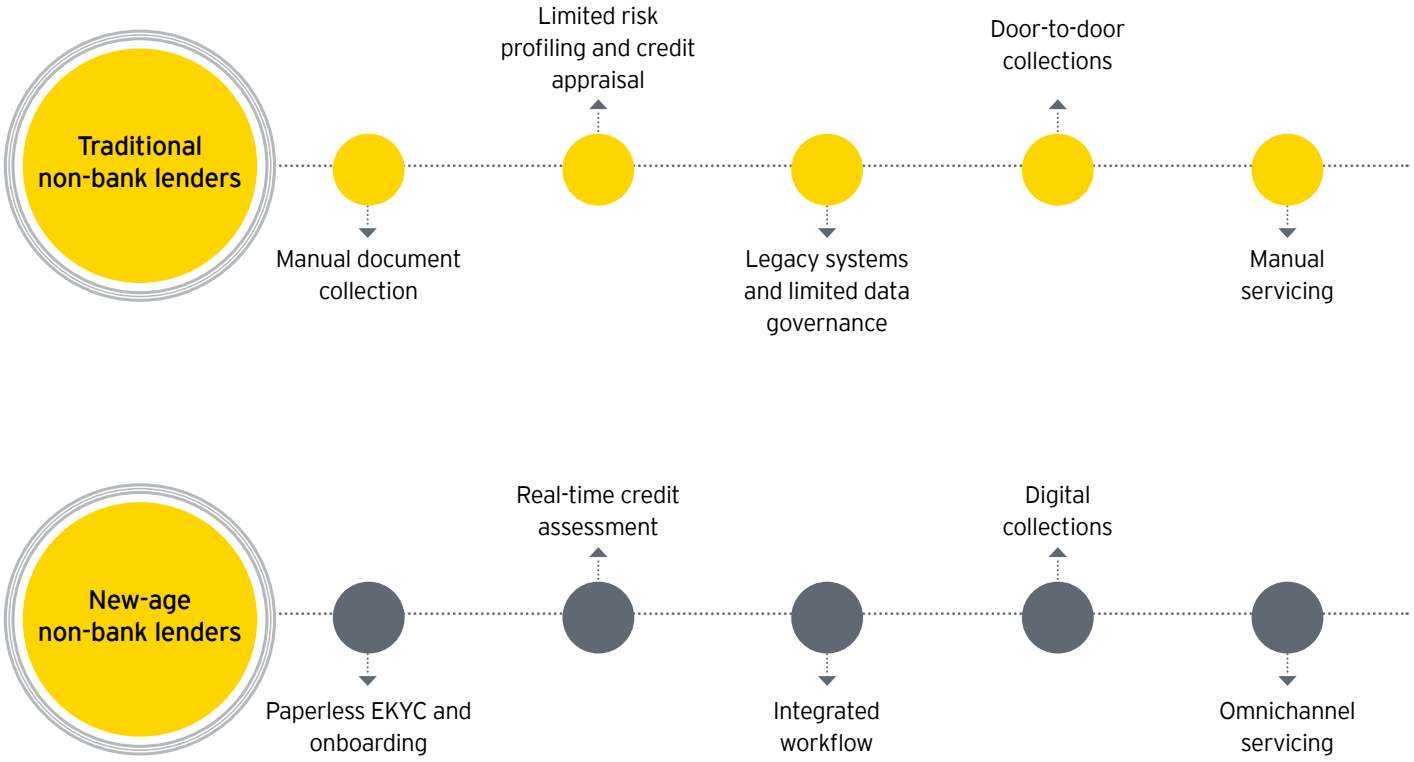
24. NCD Prospectus of a leading vehicle finance company in India
25. Report on Trend and Progress of Banking in India 2018-2019. Consumer loans include Personal loans, Consumer loans and Credit Cards receivables
26. Report on Trend and Progress of Banking in India 2018-2019, EY analysis

Further, emergence of non-bank lenders with a dedicated focus on the consumer segment have helped in expanding the market. Accordingly, they hold the highest market share by volume % across all geographical tiers (3 and below) in India[27]. This is primarily attributed to their ability of offering attractive schemes and multiple financing options carving a niche in the market.

b) **Flexible offerings:** Non-bank lenders service a gamut of customer profiles rendering greater flexibility in financing options. Their proximity to the consumer, understanding of consumer psyche and ecosystem approach serves as an advantage. Their ability to efficiently and profitably offer shorter tenure, smaller ticket size loans, interest free EMIs, attractive financial schemes complement their presence in consumer loans segment. Whereas, banks prefer lending for comparable ticket size but for a higher average tenure of 24 months. For example, in Q3FY19, over 75% of the personal loan originations were in the micro segment with a loan size up to INR 25,000[28] much of which is attributed to non-bank lenders.

3.6 Driving innovation in the financial services space

Non-bank lending sector evolved over the years to play a key role in fulfilling the financial needs in the retail and MSME segments. The earlier innovations revolved around business and operating models which have helped them establish their niche through their non-standard business models. As consumer preferences evolved and non-bank lenders faced stiff competitive and cost pressures, they have reinvented themselves. Consequently, the current phase of innovations revolves around quick disbursals, innovative product offerings and streamlined processes to provide seamless customer experience, lower acquisition costs or establish a framework to their non-standard business models.



27. TransUnion CIBIL
28. TransUnion CiBIL IIR Report, Sep 2019



4

Challenges that may impact the long-term growth of the non-banking finance sector

Non-bank lenders have been the cornerstone of growth in the retail and micro lending business in India. Over the past two years, the sector came under stress which severely impacted its liquidity position and profitability.

4.1 Deficiencies in the prevailing regulatory framework

a) Enhancing the compliance and risk management guidelines

As discussed earlier, the non-bank lending sector in India plays a very important role in financial inclusion and it is an inherent part of the credit delivery system. This is more pronounced in retail credit segments due to their customer outreach beyond the banking system. Further, non-bank lenders are heterogeneous in nature, given their varied size, focus assets classes and borrower segment. The risk-return profiles and overall financial position of these players are also quite diverse in terms of profitability and funding profile.

Supervision and regulation of non-bank lenders at an optimal level is an essential requirement for the overall financial growth of India. It is pertinent to note that the non-bank lenders in India have always been under regulatory regime, unlike other countries. The regulatory framework for non-bank lenders has been evolving from time to time to ensure prudent supervision and regulation. The current regulatory framework covers various aspects such as Capital Adequacy, Acquisition/ Transfer of Control, Governance, Information Technology, Outsourcing, Liquidity Coverage Framework, Asset Liability Management, amongst others. Whilst the current regulatory framework helps provide a strong vigilance, there may be a few unaddressed challenges faced by the sector.

- Limited size-based differentiation in regulations among non-bank lenders
- Long tail of non-bank lenders curtailing bandwidth for oversight of large non-bank lenders
- Limited focus on utilizing the respective strengths of banks and non-bank lenders
- Scope to tighten the overall supervisory and corporate governance framework specifically for large non-bank lenders

These challenges translate as actions around re-evaluation and streamlining of licensing norms, re-look at the classification criteria for systemically important NBFCs. This will provide a level playing field for non-bank lenders vis-à-vis banks and further strengthen the sector.

> Currently, all non-bank lenders are looked at from the same lens irrespective of their asset size. The regulations have to be cognizant of the size and activity which may need a different type of licensing and supervision
>
> **Multiple leaders of the non-banking finance sector**

b) Need for a robust supervisory and governance framework

Lapses in the corporate governance of a few non-bank lenders has had an impact at a sectoral level including the impact of capital flows to the sector. The liquidity profile and growth of the non-banking finance sector was thereby severely impacted over the last two years owing trust deficit in the sector. This was despite relatively no change in business activity in the rest of the sector.

An effective corporate governance is critical to the proper functioning of any organization and strong corporate governance promotes trust across all stakeholders. Hence, it is critical that the RBI addresses the above areas by introducing tighter control and supervisory frameworks for strengthening the foundation of the sector and avoid a systemic crisis by addressing issues requiring immediate focus.

The regulator has recently put in place a slew of regulatory and supervisory measures as below.

a) Power to appoint and supersede the Board of non-bank lenders

b) Mandatory appointment of Chief Risk Officer

c) Oversee implementation of a stringent ALM framework

However, these measures announced in response to certain challenges emerging from the liquidity crisis are reactive in nature and would entail broadening the scope to enhance supervision of larger non-bank lenders.

> The levels and cost of compliance are increasing as a response to specific incidents being witnessed by the sector. There is a need to adopt proactive approach to supervision through a collective responsibility by promotor, auditor and the regulator
>
> **MD & CEO of a mid-sized housing finance company**

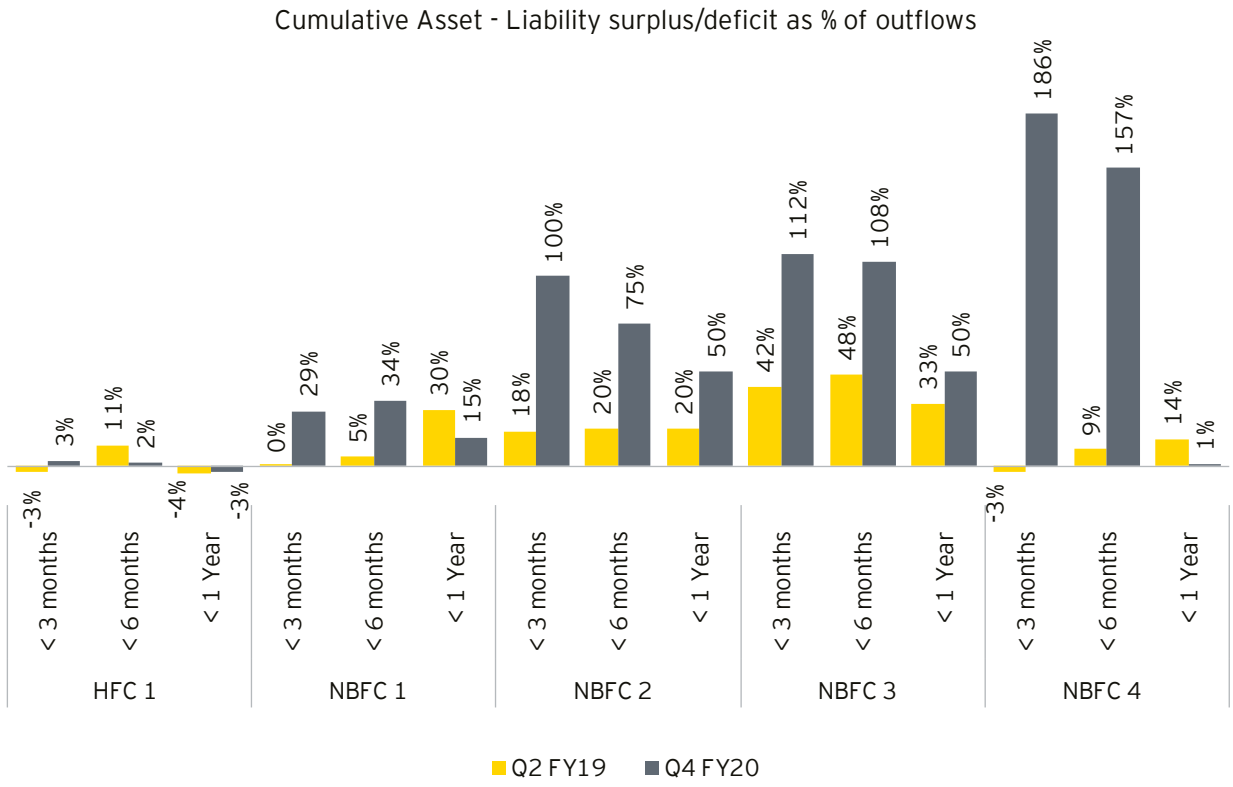
4.2 Structural problem of the balance sheet

Ample liquidity in the system and expanding bond markets had increased competitiveness of capital market borrowings over bank borrowings by H1FY19. Owing to this, the non-banking finance sector saw an increased reliance on capital market borrowings. Further, while interest rates for short-term commercial papers (CPs) ranged 4.75% - 6.75%, long-term borrowings rates were higher by ~3%. Accordingly, many non-bank lenders leveraged this high arbitrage to rely heavily on low cost CPs. In a few cases, these short-term borrowings were also used to fund long-term assets.

However, when credit rating of a large infrastructure lender was downgraded to default from AAA in H1FY19, there were concerns among investors regarding the asset quality of non-bank lenders. Consequently, capital market flows curtailed due to fear of a systemic crisis. The increased scrutiny by the investors highlighted the structural problem with many non-bank lenders who were financing long-term assets through short-term borrowing. This was prevalent even among highly rated non-bank lenders. While the impact was more pronounced on long-dated asset creators like HFCs and infrastructure financiers, the fund-raising ability of the non-banking finance sector was impacted. As non-bank lenders continued to face pressures in rolling over existing short-term liabilities, they adopted prudent ALM practices while being subjected to an increased monitoring by the RBI.

Exhibit 19: Positive ALM, non-bank lenders are carrying excess liquidity on the balance sheet

Source: ALM reporting of NBFCs and HFCs, EY analysis



Starting September 2018, most non-bank lenders have elongated liability maturity thereby correcting short-term ALM mismatches and strengthened their balance sheets. The continuing uncertainty in sourcing liabilities in the non-banking finance sector had led many non-bank lenders to significantly ramp up the liquidity profile in the short-term by as high as 200%. This will negatively impact capital efficiency and consequently the overall NIM. However, it would provide a liquidity buffer to counter uncertainty in the fund flows. This liquidity build-up assisted non-bank lenders to manage liquidity crunch in the wake of the COVID-19 pandemic to a large extent.

"Given the uncertainty surrounding the macro environment, majority of non-bank lenders are focusing on liquidity conservation through elongation of lability maturities. While this will help them tie down liquidity issues in the short-term, it will lead to capital inefficiencies"

The liquidity crisis was a good opportunity for the non-banking finance sector. If COVID-19 had happened before the liquidity crisis, many non-bank lenders would have serious challenges in continuity

MD & CEO of a large diversified non-bank lender

4.3 Liquidity squeeze impacting the funding cost for non-banking finance sector

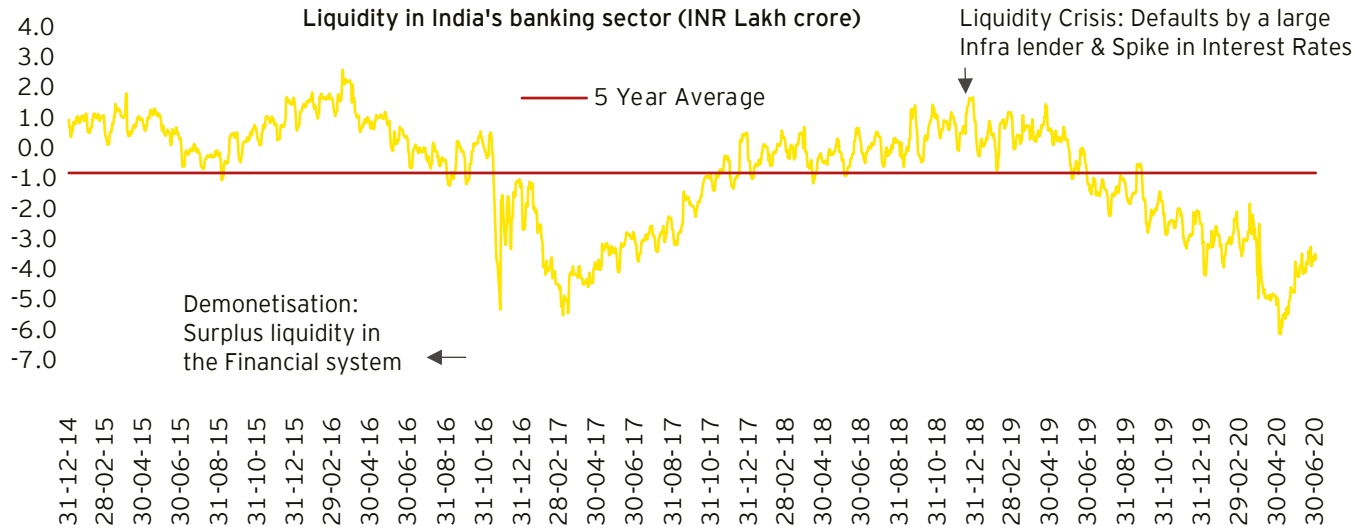
Liquidity in the form of financial savings surged post demonetisation which benefited the non-banking finance sector and aided in its growth till September 2017. The fallout of a large infrastructure lender and consequent spill over effects led to a liquidity crisis in the non-banking finance sector starting September 2018 and caused curtailment of incremental funds. This was further amplified due to governance lapses seen in a few large non-bank lenders. Liquidity which remained constrained till May 2019 gradually eased out by February 2020. The current system-wide liquidity surplus is at its highest level since Demonetization and aided by a decline in loan growth of Banks from 13.2% in FY19 to 7.3% in FY20.

However, the liquidity situation turned volatile starting March 2020 when a mid-sized private bank was placed under a mortarium by the RBI and an unprecedented lockdown in the wake of COVID-19 pandemic. This prompted banks and other lenders to adopt a more risk averse approach toward non-bank lenders owing to their higher perceived credit risk. Consequently, several medium and smaller sized non-bank lenders started facing difficulty in accessing credit from the system. The implications of the liquidity squeeze are as follows.

Banks are flushed with liquidity, but they are not lending to non-bank lenders, especially smaller ones due to risk aversion

Exhibit 20: Interbank liquidity has improved significantly since mid-May 2019

Source: Bloomberg, EY analysis. Note: A negative value indicates liquidity surplus



> Biggest challenge faced by non-bank lenders is liquidity and money does not come at a reasonable cost. There is a need to reduce over reliance on banks for financing
>
> **MD & CEO of a large diversified non-bank lender**

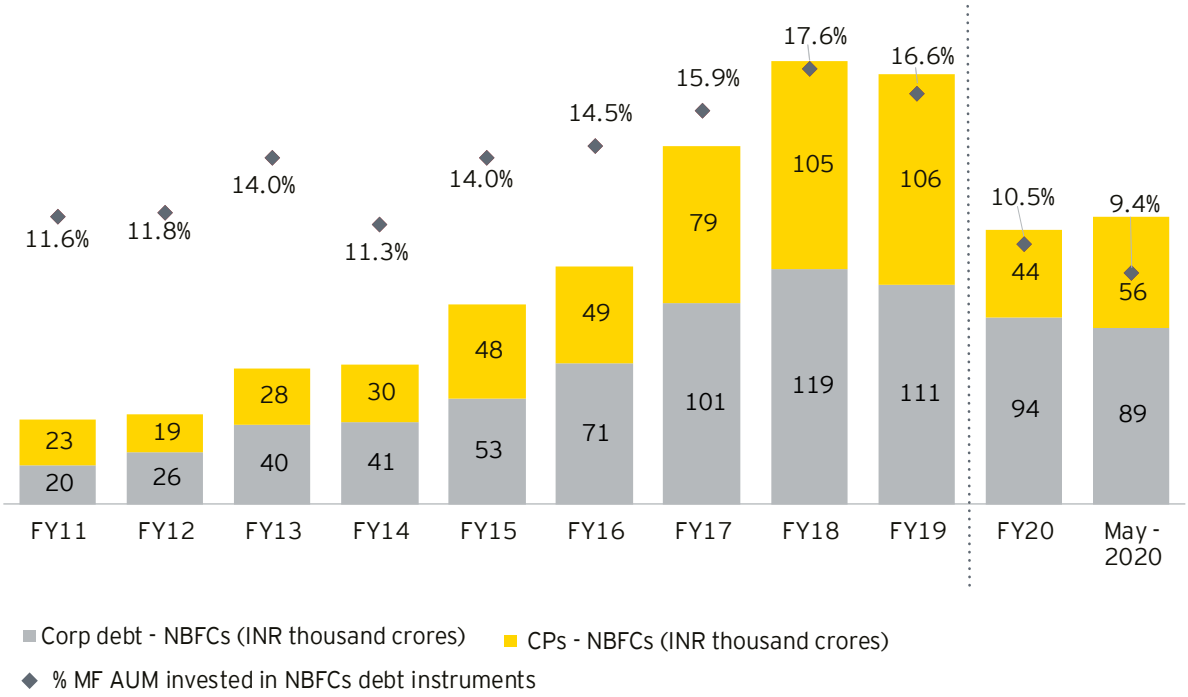
a) Drying up of funding sources – capital market borrowings

Rapid growth and attractive returns offered by non-bank lenders, compared to banks, attracted investments from mutual funds which were flush with inflows between FY14 and FY18. Mutual fund investments into CPs and bonds of non-bank lenders witnessed a 2x increase during this period. This was further aided by the strong growth momentum in the Indian corporate bond market.

However, the non-banking finance sector witnessed a curtailment of funds as investor confidence was impacted with the liquidity crisis. This constrained ability of non-bank lenders to raise funds from capital markets which accounts for a substantial portion of the borrowing mix as seen in Exhibit 20. This impact was pronounced in the case of non-bank lenders with higher proportion of wholesale assets due to increased scrutiny from investors on asset-liability mismatch resulting in a higher cost of liquidity.

Exhibit 21: Outstanding mutual fund's investments in debt instruments of NBFCs have declined by 36% YoY in FY20

Source: SEBI[29], AMFI, EY analysis



With the outbreak of COVID-19, funds are accessible only to a select few non-bank lenders with strong parentage. This is driven by significant redemption pressure from capital markets investors and change in the credit risk profile of non-bank lenders. In our view, the change in macro-economic dynamics and an expected slowdown in growth of non-bank lenders will likely deter equity investors in the near-medium term. Debt investors, on the other hand, might gradually resume participation as confidence improves.

29. Deployment of funds by all mutual funds (Published Monthly) by SEBI

b) Rising bond yields and increasing credit risk spreads

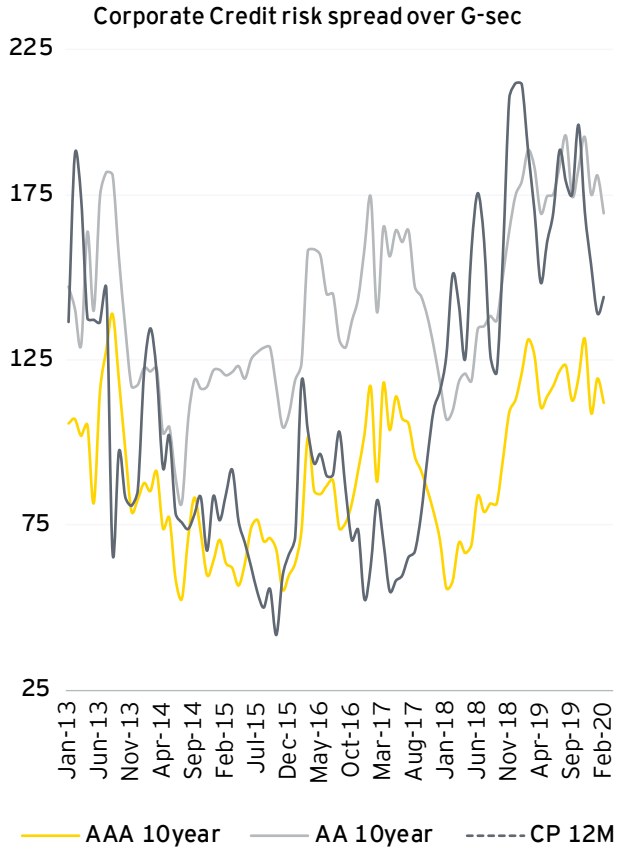
Liquidity squeeze and uncertainty in capital markets led to an increase in the cost of funds for the non-bank lending sector by ~20 bps-45 bps since H1FY2018. Credit spread between AA and AAA bonds of non-bank lenders rose sharply to as high as ~80 bps from 40 bps-50 bps earlier.

Despite a slew of measures announced by the RBI (partial guarantee scheme, CRR exemptions, push for co-origination/ onward lending, etc), the bond market did not witness a meaningful contraction in spreads. While relatively large and better-placed non-bank lenders are gradually returning to capital markets (including CPs) and the risk spreads have normalized to pre-COVID levels, lower rated non-bank lenders are focussed on preserving liquidity.

> For smaller non-bank lenders which primarily operate in a small region, availability of funds is more important than the cost
>
> **MD & CEO of a leading housing finance company**

Exhibit 22: Non-bank lenders caught up in the contagion effect; Credit spreads widened despite excess liquidity

Source: Bloomberg, EY analysis



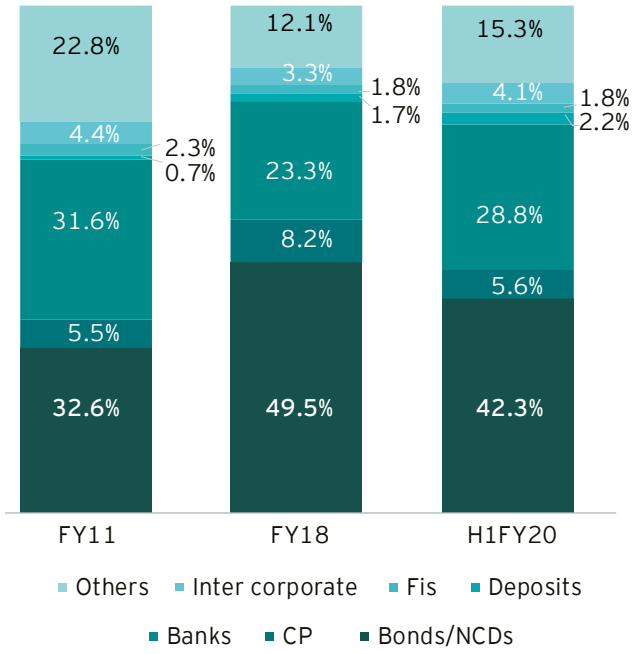
> There is an increased risk aversion towards the non-banking sector. This is despite no relative change in the business models post the event in Sep-18
>
> **MD & CEO of a leading housing finance company**

c) **Changing borrowing mix creating an over dependence on banks**

Between FY14 and FY18, non-bank lenders benefitted from an expanding bond market and increased liquidity. Many non-bank lenders witnessed an increase in the share of capital market borrowings in their overall borrowing mix. Notably, the proportion of short-term borrowings increased significantly in anticipation of fall in interest rates.

Exhibit 23: Changing borrowing mix of NBFCs

Source: RBI, EY analysis

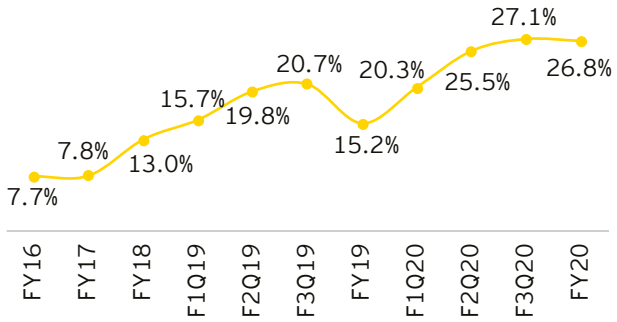


The liquidity crisis starting Sept-18 curtailed incremental fund flow from capital markets. This prompted non-bank lenders to focus on alternate funding sources like bank borrowings, ECB and retail deposits. The RBI relaxation on ECB also helped non-bank lenders to this effect. Accordingly, debt borrowings in the borrowing mix of NBFCs declined from ~58% in FY18 to 48% in H1FY20. This decline was more pronounced in commercial papers whose contribution reduced meaningfully as non-bank lenders started to build long funding duration.

The dependence of non-bank lenders on bank borrowings rose materially post Sept-2018 as other institutional lenders turn risk averse. Consequently, bank lending to NBFCs continued to grow at 30% YoY, contributing ~27% of incremental lending by banks. Also, securitization has emerged as a key funding source for non-bank lenders. Non-bank lenders raised ~INR 3.4 lakh crore during the last 18-month period (October 2018 to March 2020) through sell down of loan assets either under the securitization or direct assignment route.

Exhibit 24: The composition of incremental funding to Non-bank lenders has gotten skewed towards Banks

Source: RBI Monthly Credit Deployment, EY analysis



4.4 Business challenges impacting growth

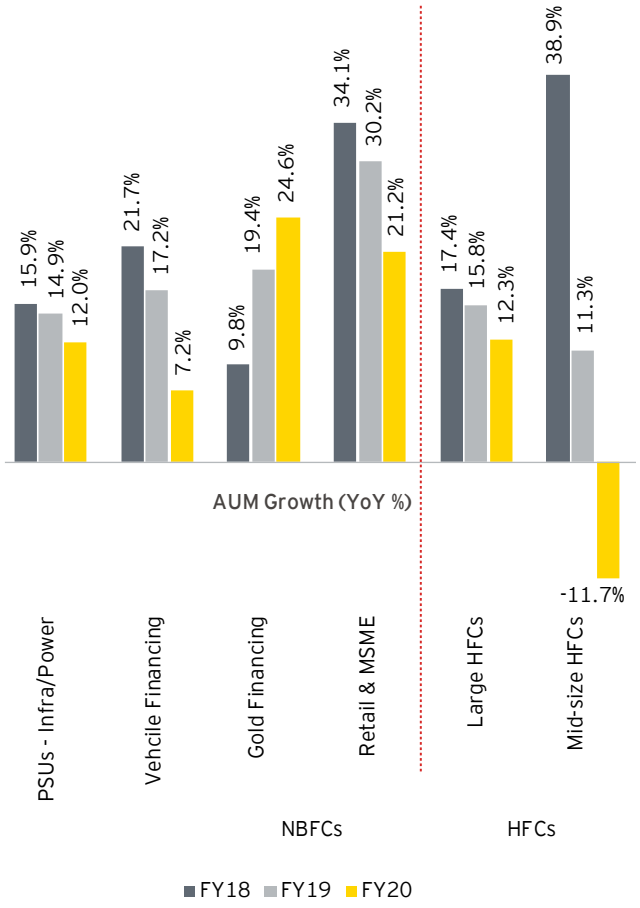
a) **Disruption in the growth trajectory of most non-bank lenders**

Non-bank lenders gained scale over the last decade owing to declining cost of funds and niche product offerings. They have carved a niche in personal and housing finance, which are key focus areas of banks and expanded beyond their traditional bastions like vehicle finance.

However, since H1FY19, non-bank lenders are increasingly challenged for growth on account of liquidity crisis in the sector. The key factors which exposed them to growth challenges include difficulty in rolling over existing debt and raising new debt due to liquidity squeeze. Loan growth for most of the non-bank lenders has come down considerably post H1FY19 as they focused on managing liquidity. This is more pronounced for non-bank lenders who are directly competing with banks and lack pricing power (high ticket and long tenure loans).

Exhibit 25: Loan book contracts for Non-bank lenders with higher wholesale exposures

Source: Company data[30], EY analysis



With the liquidity crisis, investors increased scrutiny of non-bank lenders and preferred to invest in those with differentiated business models and low leverage.

b) Intense competition from banks in retail lending

Slowdown in the credit dissemination by PSBs due to introduction of AQR by the RBI in 2015 and subsequent rise in stressed assets enabled non-bank lenders to increase market share. Furthermore, large and well-rated non-bank lenders also benefited from having a lower funding costs over many mid to small-sized banks during this period.

However, starting September 2017, as bond yields and market borrowing rates rose sharply, pricing power swung in favour of banks. While both short-term and long-term market borrowing rates have shown an upward trend since H1FY2018 (+ 20 bps-45 bps), SBI's one-year MCLR is down by 25 bps. This hampered the growth of non-bank lenders.

Furthermore, starting FY18, increased focus of banks towards retail lending led by surplus liquidity helped them to fill the space vacated by the non-bank lenders and recouped their lost market share. Large banks continued to have an advantage over non-bank lenders on account of low cost of funds. Non-bank lenders having high overlap with banks in target segments face dual challenges from rising borrowing rates and pricing competition from banks.

Rising market borrowing rates for non-bank lenders coupled with decline in cost of funds for banks created a distinct advantage starting FY18 for banks

Non-bank lenders focusing on niche segments are in a better position

Banks focus on product segments with relatively large-ticket, longer-tenor loans. These include home loans to salaried and affluent segments; large-ticket SME loans, loans against property and high-quality corporate loans. Non-bank lenders focusing on below segments are comparatively in a better placed to capture growth and earn higher spreads

- Vehicle finance for business, commercial usage to first time borrowers (used and new)
- Small-ticket business loans
- Two-wheeler loans, consumer durable loans, small ticket personal loans
- Structured finance to stressed corporates, special situations funding and credit to smaller developers

In our view, non-bank lenders operating in these niche segments where there is a higher credit risk owing to information gaps should sustain near-term headwinds.

30. The categorization is made basis a set of sample non-bank lenders which are representative of the sub-sectors. PSU- infrastructure / Power includes 2 large PSU NBFCs; Vehicle financing includes 3 large vehicle finance focused NBFCs; Gold financing includes 2 large gold financing NBFCs; Retail & MSME includes 2 large Retail and MSME focused NBFCs; Large HFCs include HFCs with AAA credit rating, asset size over INR 1 lakh crore; Mid-size HFCs include HFCs with credit rating below AAA and asset size less than INR 1 lakh crore

c) Growing pressure on spreads for housing finance companies

The banking system was flushed with liquidity post demonetisation and with limited avenues to deploy the funds. Banks were exposed to the challenges of capital inefficiency. This prompted them to shift focus towards retail lending and more prominently towards home loans through aggressive pricing and lower spreads. Given that banks are price setters in these segments, non-bank lenders were exposed to an increased competition and pricing pressure. The relatively lower risk weights on housing loans also prompted banks to have increased focus towards this segment.

Further, with liquidity crisis post September 2018, non-bank lenders faced challenges in raising funds even at higher rates. The impact was more prominent for non-bank lenders focusing on long-dated assets like home loans where the weighted average funding costs is higher than SBI MCLR. Accordingly, the spread of quoted rates over benchmark lending rates reduced from as high as 60 bps to less than 10 bps.

Exhibit 26: Incremental home loan spreads remain under pressure in home loan category

Source: SBI Interest Rates[31], Bloomberg, EY analysis

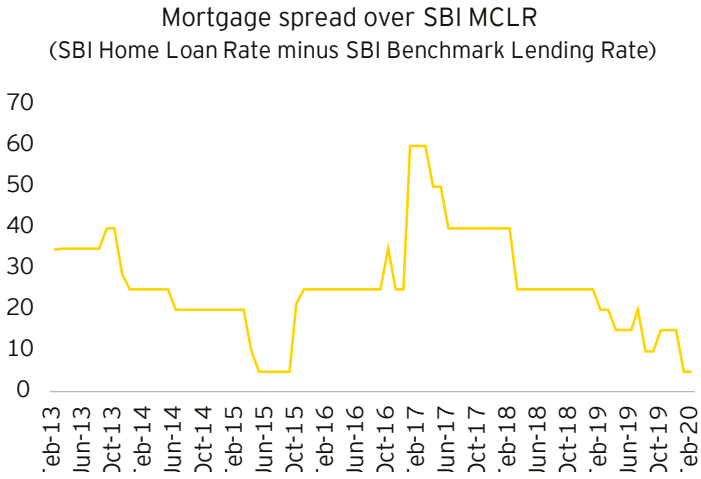
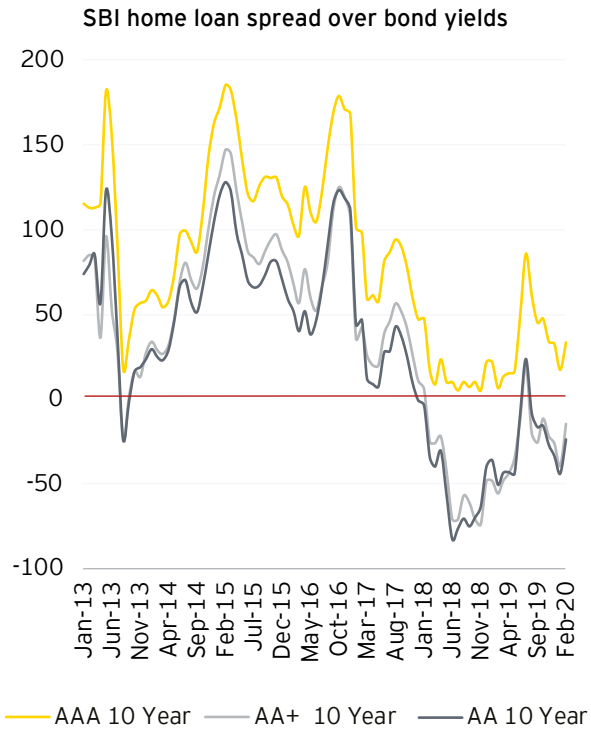


Exhibit 27: Only AAA rated non-bank lenders have a positive spread over SBI Home loan rate

Source: SBI Interest Rates[32], Bloomberg, EY analysis



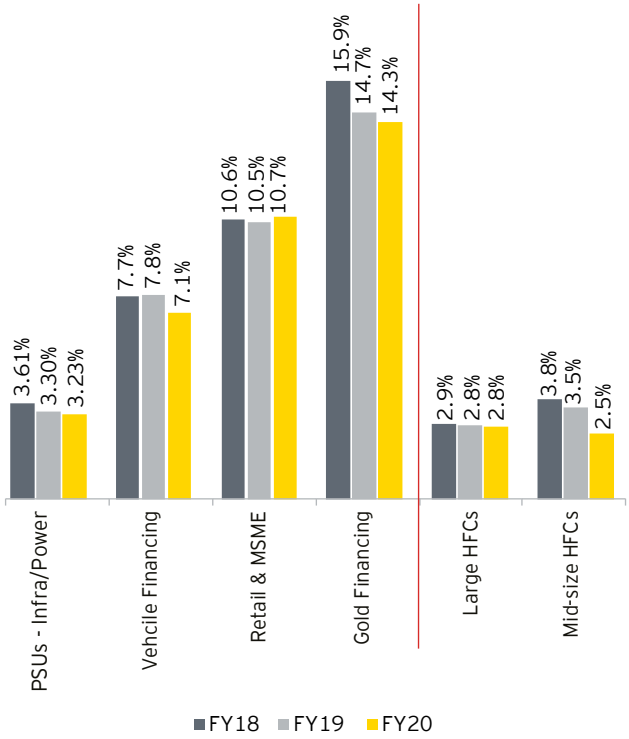
On the macro front, sharp rise in wholesale borrowing rates for non-bank lenders widened gap with effective bank lending rates. This put further pricing pressure on non-bank lenders as they look to balance growth and spreads. In addition, the spread between AAA-rated bond yields and AA-rated bond yields widened during this period due to tightened liquidity situation thereby impacting spreads of low-rated non-bank lenders. Consequently, the spread which was 20 bps - 25 bps increased to as high as 100 bps.

Most NBFCs have realigned their product mix towards high yielding customer/ product segments owing their diversified presence to help protect spreads. HFCs, on the other hand, could not increase exposure towards high yielding developer loans and LAP due to growing stress in these segments. As a result, spreads for mid-size HFCs without parentage came down by ~150 bps since FY18 against 50 bps for HFCs with strong parentage.

31. SBI interest rates accessed from its website in March 2020
32. SBI interest rates accessed from its website in March 2020
33. The categorization is made basis a set of sample non-bank lenders which are representative of the sub-sectors. PSU- infrastructure / Power includes 2 large PSU NBFCs; Vehicle financing includes 3 large vehicle finance focused NBFCs; Gold financing includes 2 large gold financing NBFCs; Retail & MSME includes 2 large Retail and MSME focused NBFCs; Large HFCs include HFCs with AAA credit rating, asset size over INR 1 lakh crore; Mid-size HFCs include HFCs with credit rating below AAA and asset size less than INR 1 lakh crore

Exhibit 28: Net Interest Margins for mid-size HFCs have come under pressure

Source: Company data[33], EY analysis



d) Difficulty in attracting talent when compared to banks

Banks in India are typically perceived to be institutions that have resilient business operations and financial standing. Owing the mere scale of operations and breadth of servcies offered, they are perceived to offer far more oportunities for building rewarding careers. Their presence across markets is seen as an opportunity for long term growth and development of high performers.

This perception is further strengthened by relatively less favourable regulatory environment for non-bank lenders in the recent times, thus positioning banks on the forefront. For both experienced professionals and new graduates seeking to gain a foothold in financial services industry, the above mentioned perceptions contribute to banks becoming the employer of choice for their career.

In the current situation however, non-bank lenders offer a unique opportunity to attract talent. Being focused set-ups, they typically have a nimble business model, thus offering exponential opportunities for growth. In the wake of the pandemic, as non-bank lenders prepare and re-design the business models in line with the new normal, attracing and retaining a highly capable talent pool will be imperative to drive business growth. Simple and lean organization structures, devoid of multiple layers and bureaucracy typically associated with the large banks, will become a key competitive advantage. In addition, with the enhanced adoption of digital tools and technology along the business value chain, non-bank lenders will be more prepared for running operations remotely – thus addressing a core talent need of the hour.

The perception of banks being resilient is strengthened by less favourable regulatory environment for non-bank lenders

Differing market perceptions – Banks vs Non-bank Lenders

Business Resilience & Financial stability	Perceived to be large players, inherently more stable offering higher pay	Typically perceived to be smaller players, and therefore less resilient to withstand external disruptions
Career Stability	Perceived to offer stable career paths – employment for life	Are not usually seen as long term career choices
Growth Opportunities	Being larger entities, Banks are perceived to offer more opportunities for internal growth and exposure across domains	Typically focused on fewer product lines and hence perceived to have limited opportunities for a cross-domain exposure
Brand Value and Visibility	Tend to be large entities with a global presence and visibility, resulting in more opportunities cross-regional roles and global mobility.	Being local and regional players, there are perceived to offer few opportunities for global mobility

4.5 Segment specific challenges

Non-bank lenders have also been facing certain segment specific challenges which was impact growth in the segment. This is in addition to liquidity challenges over the past two years

a) Housing finance

The housing sector sales were impacted starting FY17 with the implementation of RERA and other macro events which led to fewer launches and muted demand. This was further accentuated with the liquidity crisis faced by non-bank lenders. The challenges faced by the housing finance sector are as follows:

1. **Stress in the real estate sector**: It is estimated that potential stress in the real estate sector is increasing. As per a sample study of the RBI, the impairment levels on exposure of HFCs to real estate companies witnessed a jump from 0.03% in June 2018 to 2.09% in June 2019[34]. Accordingly, starting FY20, many non-bank lenders reduced their exposure to the sector and started focusing on near completion projects, Further, the outstanding portfolio is expected to be impacted due to COVID-19.

2. **Curtailment in developer led sourcing:** The stress also resulted in reduced business from under-construction houses for large non-bank lenders. For instance, compared to FY19, a mid-sized HFC has seen disbursement towards under-construction houses decline by a third in FY20[35]. NHB's notification on discontinuation of interest subvention by developers might also further impact sourcing.

> Currently, the entire developer sector is penalized due the stress of a few developers. Housing finance sector will grow only with adequate support to the developer ecosystem.
>
> **MD & CEO of a large diversified non-bank lender**

b) Vehicle finance

Vehicle sales were subdued in FY20 which is expected to continue during FY21 amid the ongoing COVID-19 pandemic. Auto sector is highly reliant on external factors like economy, rainfall and regulatory transitions for example, BS4 to BS6 norms. The key challenges faced by the associated vehicle finance sector are as follows:

1. **High impact of externalities:** Non-bank lenders iterate that the cyclical nature of the underlying auto sector and monsoons as key factors driving disbursements and collections in auto finance. Case in point being below normal monsoons in FY14, FY15 led to stress in auto finance portfolios of non-bank lenders with lower disbursements growth, lower profitability. While the current auto slowdown is cyclical, poor freight availability, lower freight rates amid lockdown due to COVID-19 are adding factors towards slack demand.

   Further, regulatory changes related to vehicles also impact vehicle sales. For instance, with new axle norms for the commercial vehicles, there was a deceleration in growth and hit demand. Further, the transition to BS6 norms and electric vehicles is expected to have an impact on the vehicle and associated financing market.

2. **Increased risk on sourcing channels:** Declining vehicle sales led to a stress on auto dealerships. Dealerships are reliant on funding from banks and non-bank lenders and their exclusion from MSME definition reduce funding access. In the wake of declining sales, leading banks have extended credit period to stressed dealers by as much as 50% and the risk is further accentuated due to COVID-19. The increased risk on the vehicle supply chain is also expected to impact the retail financing in terms of lower disbursements.

34. Financial Stability Report of December 2019
35. Conference call transcript of a mid-sized HFC for Q3 FY20

c) Microfinance

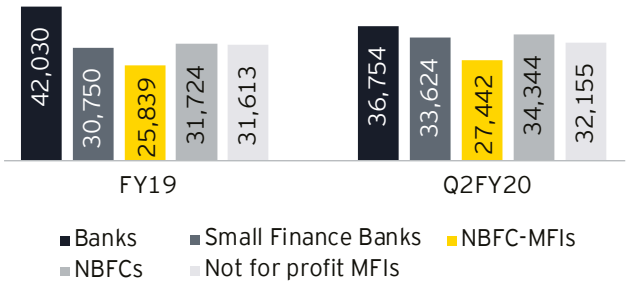
Microfinance is a strong enabler for financial inclusion. Growth of the microfinance sector has attracted numerous investors and players in the last decade. However, the sector is prone to macro-economic shocks as witnessed in the last few years. Other elemental challenges that have been looming in the sector are as illustrated below:

1. **Deteriorating collection efficiencies:** Microfinance has a higher proportion of repayments made through cash over other asset classes owing cash-based earnings of customers. This is despite multiple measures to increase adoption of digital repayment modes. This reliance on cash makes the sector vulnerable to natural calamities and COVID-19 like situations where customers are impacted by lower incomes and outreach becomes difficult. This, coupled with loan moratorium extended by MFIs, resulted in collection efficiencies to drop below 10% in April and May (vis-à-vis 98% under normal circumstances)[36]. Further, in the medium-term, this is expected to dilute credit discipline among the customers.

2. **Increase in borrowing leading to stress:** As number of MFIs increased in the last decade, multiple MFIs chased the same borrowers. The RBI prescribes limits on number of MFIs lending to a borrower and borrower indebtedness. These limits are applicable only for NBFC-MFIs thereby leaving ~60% of MFI portfolio out of its purview. Consequently, the stress on borrowers is increasing with 12% of them having active loans from over two lenders in FY19, compared to 5% in FY17[37].

Exhibit 29: Average ticket size trend in microfinance loans (INR)

Source: Microfinance pulse report by SIDBI, Equifax; EY analysis



36. A Study on Impact of Unfolding COVID 19 on MFIs and Clients, published by Sa-Dhan in May 2020
37. CRIF Highmark media release in Business Standard dated Jun 3, 2019 and accessed on 26 May 2020
38. Microfinance Pulse reports published by SIDBI, Equifax; EY analysis
39. MSME Pulse report April 2020 published by TransUnion CIBIL and SIDBI
40. MSME Pulse report published by TransUnion CIBIL and SIDBI

The uneven competing environment translates as 20% - 60% lower average ticket size of MFI loans offered by NBFC-MFIs in FY19 compared to other entities which reduced to 20% - 35% in Q2FY20[38]. Accordingly, there are discussions around introduction of a sector-wide responsible lending framework which is yet to be formalized.

d) MSME finance

MSMEs play a vital role in the growth of the Indian economy. The share of non-bank lenders in MSME lending increased from 7.9% in Dec 2015 to 12.5% in Dec 2019[39]. Despite the tremendous potential the segment promises, share of non-bank lenders are plagued by below challenges:

1. **Higher risk of delinquency:** Non-bank lender's exposure to MSME segment has a high gross NPA between 8.5% to 20% over the last five years[40]. This higher NPA rate is on account of MSMEs being constrained for liquidity due to their limited bargaining power and delayed payments from clients. Further, high reliance on a few large clients make MSMEs prone to business and cyclical stocks.

2. **Limited take-off of alternate finance options:** There are ~INR 5 lakh crore worth receivables outstanding for MSMEs from public sector undertakings, government and major industries[41]. Despite this, short-term financing options which assist MSMEs in receivables management have limited traction. The seven NBFC-Factors have ~INR 3,500 crore of funds in use (outstanding loans), which is small share of MSME financing[42].

   TReDS was introduced in 2014 to assist MSMEs manage liquidity through short-term funding through a connected ecosystem with Corporates and Financiers. However, only 3,708 MSMEs are registered and INR 6,669 crore worth invoices were financed[43].

3. **Limited use of physical and digital combination restricting scale:** Smaller MSMEs are largely informal with limited business documentation and collateral. This requires an understanding of the micro-market and a high touch approach to underwriting which increases cost of servicing thereby creating barriers.

   A few non-bank lenders and FinTech players cater to this micro MSME market through cashflow based underwriting using surrogate information, digitalized processes and templates. The approach of players is limited either by use of technology or micro-market understanding which impacts the scale of operations.

41. MSME ministry media release on 25 May 2020 accessed from Economic Times
42. Company Annual reports, EY analysis
43. Report of the Expert Committee on Micro, Small and Medium Enterprises, published in Jun 2019, RBI



5

Recent events impacting the non-banking finance sector

The COVID-19 pandemic has disrupted the global economy at unprecedented levels in a short span of time. As the world fights this health crisis, the impact is felt on economic activity and volatility of global financial markets. Though companies are trying to navigate through the crisis, they are not completely immune to financial and regulatory disruptions. Going forward, under the most likely scenario, the economy could witness a 'See-Saw' shaped recovery.

Most likely scenario



- **Protracted slowdown**, followed by a slower recovery
- **Higher public deficit levels** due to stimulus programs
- Protracted weak **demand** and global **value chain disruptions**
- Higher **capital outflows and currency depreciation**

Recovery with ups and downs

Within the non-banking finance sector, the challenges within Housing finance, MSME finance and MFI would remain amplified due to extended lockdown. COVID-19 added to the stress in the system in the following ways:

- Significant drop in new customer acquisition
- Sharp decrease in customers repayments/ collections due to customer related stress
- High liquidity stress due to dependence on wholesale funding sources and drying up of new funding/ capital

5.1 Challenges amplified by COVID-19 which need immediate attention

a) Disruption in collections leading to stress in asset quality

Business and supply chains, both globally and locally have come to a standstill due to the lockdowns amid spread of the COVID-19 pandemic. This has impacted trade and receivables resulting in reduced liquidity for both self-employed and corporates. However, the impact was relatively lesser in case of the salaried class.

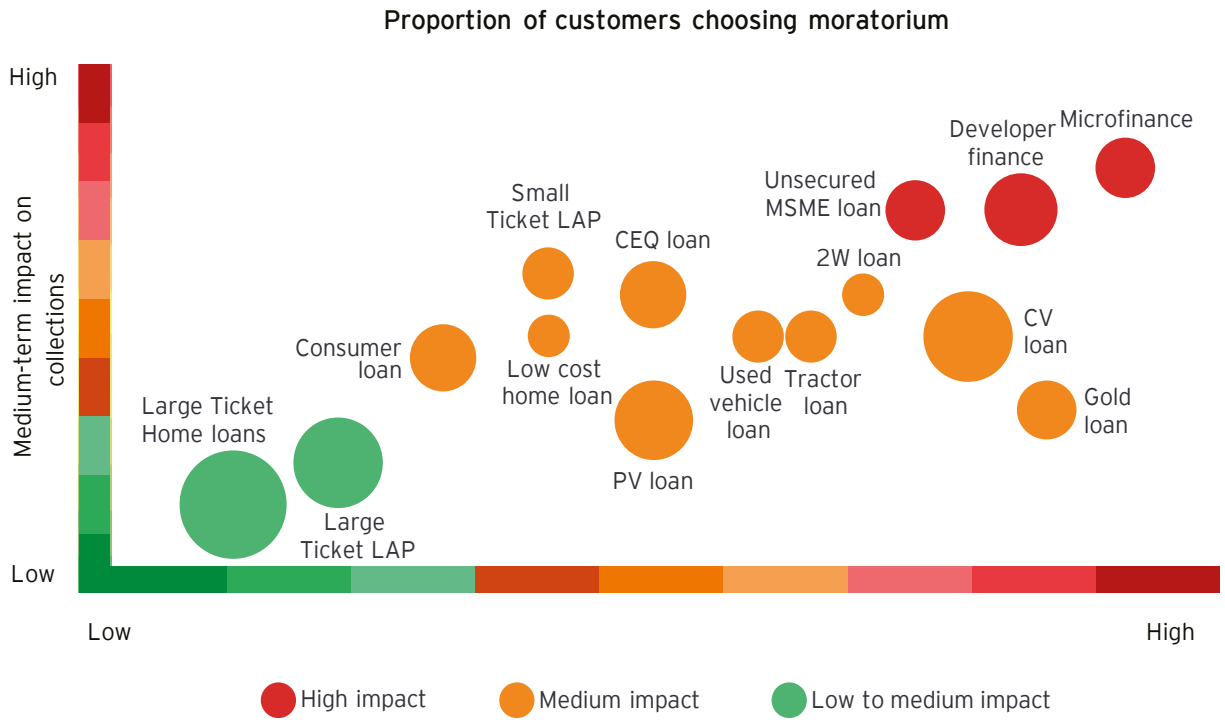
Further as the regulator extended moratorium on term loans, the collection efficiencies dropped across asset classes for non-bank lenders. The customer segment, proportion of cash collections and new to credit customers are key factors driving proportion of customer opting for moratorium. Accordingly, we have seen that self-employed informal segment has availed moratorium facility the most, as highlighted in EY-FICCI Business Confidence Survey for the NBFC sector. As shown in Exhibit 30, disruption and resultant NPA will be higher in segments which are vulnerable. Microfinance, small and micro MSME customer are segments where this disruption is high and likely to persist in the medium term. While the initial impact on asset classes like Gold and two-wheelers is high, they are expected to recover as the business and economic sentiment improves.

As per EY-FICCI Business Confidence Survey for the NBFC Sector, over 75% of the respondents consider recovery of loans as a key challenge amid the COVID-19 pandemic given the drop-in collection efficiencies by over 30%.

As the moratorium ends in August, the focus is expected to shift towards monthly collection efficiency trends. However, cumulative collection efficiency could be a better indicator of asset quality risk than monthly collections.

Exhibit 30: Impact of COVID-19 on collections of various asset classes

Source: EY analysis



b) Drop in business metrics – disbursements and profitability

The COVID-19 imposed lockdown has brought business activity to a halt. Consequently, many non-bank lenders have reported a 20%-30% drop in disbursements volume in Q4FY20 over the previous year. It is estimated that they will further see up to 90% drop in disbursements during Q1FY21. Against two consecutive years of drop in disbursements growth rates seen by the sector, we anticipate a degrowth in disbursements in FY21. As per EY-FICCI Business Confidence Survey for the NBFC Sector, it is likely to take one to two years for disbursements to reach FY19 levels.

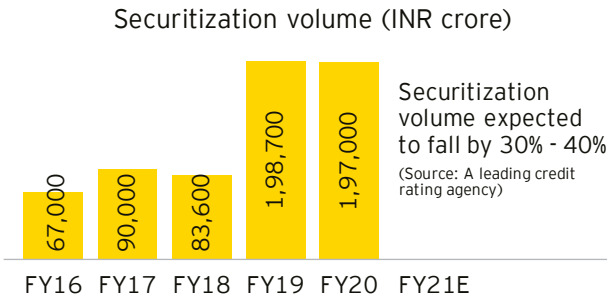
The consequent drop in related income streams without much reduction in costs is also likely to result in a drop of ROA by 70 bps – 100 bps in FY21 as per EY-FICCI Business Confidence Survey for the NBFC Sector.

c) Fall in securitization volumes severely affecting liquidity for non-bank lenders

Non-bank lenders relied on securitization as a tool for raising funds and address ALM mismatch with its volume reaching as high as 30% of the assets for a few non-bank lenders. However, the uncertainty from the outbreak of the COVID-19 pandemic, long moratorium period and resultant economic slowdown has impacted the loan volumes.

Exhibit 31: Trend in securitization volumes by non-bank lenders

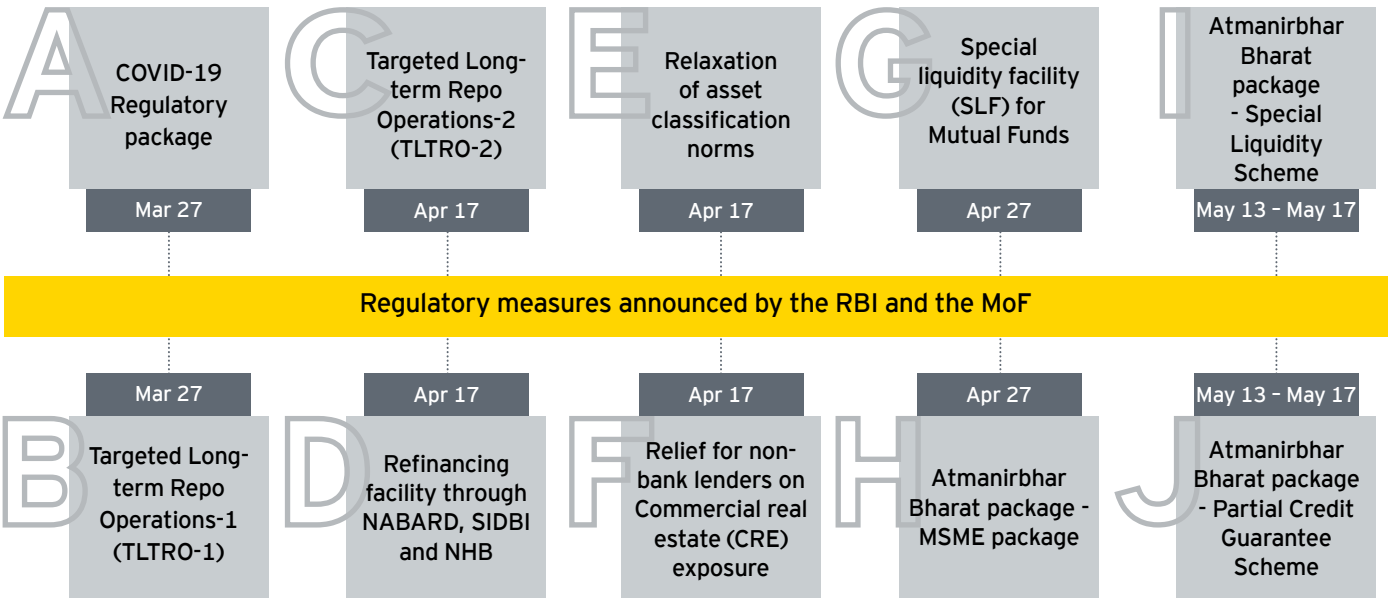
Source: ICRA, RBI, EY analysis



Securitization market is expected to remain subdued for a while due to outstanding concerns of investors over the portfolio performance and potential deterioration in asset quality. Consequently, investors are wary of taking fresh exposure and may take time to rebuild their confidence in the quality of the portfolio as the consumer behaviour towards loan repayments could be impacted due to the extended moratorium period. This is expected to further dent in the liquidity position of many non-bank lenders. The challenges in raising funds from securitization route was also highlighted in the EY-FICCI Business Confidence Survey for the NBFC Sector.

5.2 Interim revival measures: brief background on MoF and RBI stimulus packages

To assist non-bank lenders to cope with the COVID-19 challenges, the MoF and the RBI have extended following relaxations and stimulus packages[44]:





44. Multiple announcements by the RBI and the MoF on relaxations and stimulus packages during COVID-19 packages impacting non-bank lenders

#	Package	Coverage
A	**Moratorium on loans under COVID-19 regulatory package**	The RBI allowed all lending institutions to offer a 3-month moratorium to borrowers on all term loans. This was further extended by another 3 months until August 31, 2020.
B	**TLTRO-1**	The RBI provided INR 1 lakh crore liquidity to Banks to utilize at least 50% of the funds towards non-bank lending sector by investing in their corporate bonds, commercial paper.
C	**TLTRO-2**	The RBI announced INR 50,000 crore window ensuring a specific allocation of at least 50% dedicated at small and medium sized non-bank lenders (AA and below).
D	**Refinancing facility through NABARD, SIDBI and NHB**	Liquidity support worth INR 50,000 crore to NABARD, NHB and SIDBI to refinance loan assets of non-bank lenders (including RRBs and Co-operative Banks) to meet sectoral credit requirements.
E	**Relaxation of asset classification norms**[45]	The period of moratorium is to be excluded from the 90-day NPA classification norms of the RBI for accounts that have availed the moratorium facility.
F	**Relief for non-bank lenders on commercial real estate (CRE) exposure**	The RBI allowed restructuring of loans to CRE projects by extending date of commencement of commercial operations by 1 year.
G	**Special liquidity facility (SLF) for Mutual Funds**	The RBI announced an INR 50,000 crore window for Mutual Funds facing liquidity pressure on account of increased redemptions. The same was subsequently extended to banks for providing loans or for purchase of investment grade corporate bonds, commercial paper or certificates of deposit held by Mutual Funds.
H	**Atmanirbhar Bharat package – MSME package**	The MoF provided a fully guaranteed scheme worth INR 3 lakh crore for banks and non-bank lenders to extend collateral-free loans to businesses, including MSMEs.
I	**Atmanirbhar Bharat package – Special Liquidity Scheme**	Announced INR 30,000 crore liquidity for a PSB operated SPV to utilize funds towards non-bank lending sector by investing in their investment grade bonds, commercial paper. These securities, from primary and secondary transactions, would be fully guaranteed by the government.
J	**Atmanirbhar Bharat package – Partial Credit Guarantee Scheme (PCGS)**	Announced INR 45,000 crore liquidity measure to cover initial 20% loss on primary issuances of bonds and commercial paper of low rating non-bank lenders (AA or below, unrated).

45. Asset Classification and Provisioning published on 17 April 2020

5.3 Unaddressed critical issues requiring support

Multiple stimulus packages from the RBI and the MoF are welcome measures which will give an interim relief to non-bank lending institutions and borrowers alike. However, since many measures require banks as intermediaries, transmission is uncertain. This is primarily due to the adverse risk perception of the non-banking finance sector and likely risk avoidance behavior of banks. The abovementioned challenges and liquidity issue can be managed through the following measures.

a) Extending the tenure of special liquidity scheme

The government on July 1, 2020 launched a special liquidity scheme for non-bank lenders under which they will be extended short term liquidity through a special purpose vehicle (SPV) set up by SBI Capital Markets Limited (SBICAP), a subsidiary of the State Bank of India. Besides laying out certain eligibility criteria for to be able to access the funds under the scheme, the RBI notification further mentions that the SPV will purchase short-term investment-grade papers (both CPs and NCDs) from eligible non-bank lenders with a residual maturity of not more than three months for up to INR 30,000 crore. The facility will not be available for any paper issued after September 30, 2020 as the SPV will stop making fresh purchases.

Given the current circumstances, the 3-month liquidity window seems short sighted. Non-bank lenders are anticipated to continue to face liquidity challenges for the next 12 months or more. Hence, the tenure of this facility be extended from 3 months to at least 1 year.

b) Relief to non-bank lenders under one-time restructuring scheme

The circular on one-time restructuring dated August 6, 2020 fails to provide relief to the non-banking finance sector which was already under dual stress caused by the IL&FS crisis as well as the COVID-19 impact. The scheme mentions as follows:

- Financial services providers as per the IBC definition as borrowers not eligible under this framework which includes non-bank lenders.
- On the other hand, non-bank lenders are covered under lending institutions whose borrowers can take relief under the circular. This may put further stress in the cashflows of non-bank lenders and lead to ALM mismatch.

This is unfair to the non-bank lending sector which, like banks, have lent to borrowers impacted by COVID and hence their borrowings, which are from banks should also be allowed to be restructured under the one-time restructuring scheme. In addition, the scheme could do with other aspects such as cut off dates for delinquencies, 2-year timeline and the need for flexibility in restructuring options which would be dealt with through another letter. Thus, the one-time restructuring circular may be modified to include non-bank lenders with certain changes in the provisions of the circular as mentioned above.

c) Need for direct finance by the RBI

Non-bank lenders are expected to remain exposed to asset quality challenges given their higher exposure to the MSME, infrastructure and real estate sectors which are most impacted by COVID-19 related stress. Thus, they will continue to face liquidity challenges for the next 12 months or more in the absence of any specific liquidity support. The RBI could:

- consider an emergency direct line of credit for non-bank lenders with minimum investment grade credit rating at a pre-fixed rate having regards to tenor and rating of the borrower. This will enable non-bank lenders to raise funds to refinance the maturing debt and manage ALM.
- encourage banks to lend to non-bank lenders in ordinary course and not only under special circumstances. For the same it may be imperative for RBI to prescribe certain minimum obligations for banks on lines like priority sector.

d) NABARD, NHB, SIDBI Refinance – additional recommendations

To improve transmission, a direct 2-year financing scheme through SIDBI or NABARD or NHB for appropriate portfolios could be introduced. Alternatively, a credit guarantee facility could be considered.

e) Relaxation in NPA classification and provisioning on loans under moratorium

The RBI has prescribed a provision be created of up to 10% (or as per the Board approved policy under Indian Accounting Standard) in respect of all loans which are at least 1 day past due. Considering the customer segment served by non-bank lenders, it is a normal practice for customers to service the loans before they become 30 days past due. It is thus recommended that, on the loans under moratorium, the RBI allow provisioning only on loans that are over 30 days past due or as per the discretion of the management.

Further, our on-ground check reveals that significant number of customers particularly belonging to retail and MSME segment will require time to get back to normal operations and the situation may hopefully normalize in next 6-9 months.

RBI should consider temporarily relaxing the NPA recognition norms such that NPAs would be reckoned if remain past due for 180 days (instead of 90 days past due at present). The special mention account (SMA) definitions may also be accordingly revised wherein the SMA-1 definition be changed from 1-30 days to 1-90 days and SMA-2 definition be changed from 31-90 days to 91-180 days to address this situation.

This relaxation should be extended till March 31, 2021, thereafter it may be gradually brought back from 180 DPD to 90 DPD for NPA classification. It will significantly help in serving the millions of retail as well as MSME customers tide over the liquidity crunch and manage their operations during these tough times.

f) Utilizing statutory reserves to make additional provision for COVID-19

The ICAI has vide its advisory dated 31st March, 2020 advised non-bank lenders to measure the impact of COVID-19 on the portfolio quality in the form of risk of default (PD), estimated amount of default (LGD) with adverse impact on the business of the borrowers or debtors due to COVID-19 on one hand and prudential regulatory actions to sustain the economy such as loan repayment holidays, reduction in interest rates etc. on the other hand. As per Ind-AS 109 and 107 both of which are applicable in respect of ECL measurement and disclosure in the financial statements, non-bank lenders will be required to make additional provisioning in terms of ICAI advisory and it will surely make a severe dent on their profitability and net worth particularly considering the impact of COVID-19 on the vulnerable sections of society viz. daily wage earners and informal segment self-employed customers and marginal farmers.

Non-bank lenders appropriate profits to earmarked statutory and other reserves. Utilization of these reserves is governed by the statute requiring its creation. The pre-existing economic slow-down with its significant impact on loan book growth, further exacerbated by COVID-19 is an unprecedented adverse event for the financial sector. There is an imminent need for extraordinary measures to deal with the emergent situation.

While non-bank lenders would create normal ECL provisions out of their current year profits, RBI should consider, as a one-time measure, to allow non-bank lenders to draw-down from their reserves including those also created under section 45-IC of the RBI Act and adjust towards additional ECL provision requirement, in excess of provision calculated as per normal probability of default and loss given default. This will enable these lenders to shore-up their balance sheet strength by reporting a more fortified ECL provision cover against their likely increase in delinquent loans and remain eligible to access equity/debt capital when situation normalizes.

g) Deferment of RBI circular on "Implementation of Indian Accounting Standards"

RBI circular on Implementation of Indian Accounting Standards dated March 13, 2020, requires non-bank lenders to compare provisions required under RBI IRAC norms with ECL provision required under Ind-AS and in case the provision computed under RBI IRAC norms is higher, the difference should be appropriated from the profit and loss account to an 'Impairment Reserve', which shall not be reckoned as capital. This circular also requires that lifetime ECL shall not be reckoned for regulatory capital while it shall be reduced from risk weighted assets.

Under the Ind-AS, lifetime ECL is recorded where the NBFC/HFCs determine that there is a significant increase in credit risk. Assets with increased credit risk do not require NPA classification under extant RBI IRAC norms but they carry a much higher ECL provision. Such ECL provision is not considered as Tier-II capital (as laid own in this circular) will negatively impact capital adequacy of non-bank lenders in current uncertain scenario. As another important matter, this circular also requires that regulatory ratios and disclosures shall be based on Ind-AS figures. This requirement significantly impacts margin computation across micro-finance institutions. The maximum permissible margin would exceed if the yield on assets securitized and EIR adjustments are considered for margin computation, resulting in a significant adjustment to be made by NBFC-MFIs in one go.

Considering the current economic uncertainty and consequent anticipated asset quality stress for non-bank lenders, it may be difficult for non-bank lenders to implement this circular with immediate effect. The RBI can consider deferring implementation of this circular for a minimum period of six months.

h) Atmanirbhar package for MSME financing – additional recommendations

One of the key announcements made under 'Atmanirbhar Bharat' scheme is introduction of Collateral Free Automatic Loan for Businesses including MSMEs. The objective of this special scheme is to provide 100% Government-guaranteed credit facility in the form of additional working capital term loan facility (in case of banks and financial institutions), and additional term loan facility (in case of non-bank lenders) to existing Business Enterprises (Non-MSMEs) / MSME borrowers, including interested PMMY borrowers. While this was a right step towards increasing credit access to MSMEs, the following could be further considered:

Current provision/ Issue	Recommendation/ Clarification
▶ The GECL shall be an additional term loan (in case of NBFCs) and may run up to 20% of the outstanding loan on February 29, 2020 ▶ If there are more than two lenders, there is a requirement for the borrowers availing additional credit from one borrower to obtain a NOC from the other borrowers.	▶ Originator and servicer of the loan should be allowed to provide 20% additional loan on outstanding amount in case of DA transactions. Being originator and servicer, they are best placed to serve the customer's needs. ▶ Letting the customer decide who he wants to take total 20% of his loan outstanding to ensure faster access to money.
▶ Under the present scheme, proprietorships are included for availing the scheme benefits, but individuals are not included.	▶ Individual loans for business purposes (tractor, equipment loans etc.) extended to micro borrowers should also be covered.
▶ All Business Enterprises /MSME borrower accounts with combined outstanding loans across all MLIs of up to INR 25 crore as on 29.02.2020, and annual turnover of up to INR 100 crore for FY 2019-20 are eligible. ▶ MLIs to check with credit bureau for the overall outstanding of the borrower to assess the eligibility of the borrower.	▶ Where credit bureau data as on February 2020 is not available, the last available data may be considered for determining eligibility of the borrower.
▶ 2% interest subvention scheme on outstanding amount taken as loan from Banks/NBFCs was announced in November 2018.	▶ Considering the current financial crunch, MSMEs are facing due to covid-19, it is suggested that the scheme should be extended further for at least two years till Financial Year 2021-22.

i) Other recommendations

The credit bureaus do not capture whether a borrower has taken moratorium or not. The only way to detect this is through bank account transactions. This means that non-bank lenders are at a structural disadvantage while lending to new customers – retail individual or smaller businesses over the next 12-18 months. It is not feasible to collect bank statements of individual borrowers in all cases as it creates friction in the journey and hence at times adverse selection. The impact of moratorium on ability and to an extent willingness to pay is significant. This information asymmetry can really hurt new age lenders. The credit bureaus should start capturing moratorium + restructuring data in a very explicit way given the unprecedented scale.



6

Build resilience in the sector - a robust regulatory and governance regime

While the priority considering the COVID-19 crisis is to focus on the immediate challenges faced by the non-banking finance sector, it is equally important to use the learnings to recalibrate the sector's operating framework. The important measures to focus include enhancing governance and building a holistic prudential framework to ensure long-term resiliency.

6.1 An enhanced governance and prudential framework

The role of non-bank lenders has evolved from being a shadow lender to one that is serving the latent credit needs of emerging India. With the exponential growth of non-bank lenders over the past five years and the white spaces emerging in the rural and semi-urban geographies, there is a need to usher them on a clear growth path through appropriate reforms across the following areas:

"

The perception of the non-banking finance sector should change. There is a need to acknowledge the soundness of the sector

MD & CEO of large diversified non-bank lender

a) Streamlining the classification and chartering a course to become a bank

The current threshold for identifying systemic importance of a non-bank lender is set at an asset size of over INR 500 crores. This brings ~270 non-bank lenders into the ambit of high-touch regulations. In our view, this is set low and creates higher compliance (as governance, key management personnel and reporting) for small non-bank lenders requiring higher cost. In addition, it could be challenging for the regulator to extend supervisory attention to a large number of entities. More than half of the respondents in EY-FICCI Business Confidence Survey for the NBFC sector highlighted the need to improve the segmentation of non-bank lenders based on asset size, deposit taking ability, etc.

"

There is a need to streamline and simplify the structures for non-bank lenders. The compliance levels may vary as per the size and activity

Multiple leaders of the non-banking finance sector

Increasing this threshold of INR 500 crore and adding tiers coupled with a finer categorization could further allow the regulator to provide required supervisory attention basis materiality. The regulator could consider providing non-bank lenders with asset size over INR 5,000 crore the access to raise public deposits upon meeting certain stated criteria. Further, the prudential and regulatory norms for non-bank lenders with asset size over INR 50,000 crore could gradually be brought at par with banks. This may also provide well-managed non-bank lenders with a potential roadmap towards becoming a Bank. The regulator may consider classification of non-bank lenders basis their size on the following lines.

Assets under Management	Current categorization	# companies	Possible considerations
Below INR 500 crore	NBFC-ND NBFC-D	~9,300	Consider light-touch compliance to help focus on business growth
INR 500 crore – INR 5000 crore	NBFC-ND-SI NBFC-D	~250	Consider a higher regulatory oversight to balance growth with prudence
INR 5,000 crore – INR 50,000 crore		~20	A mix of higher regulatory oversight coupled with flexibility in liability generation, including access to public deposits
INR 50,000 crore and above		~15	Highest level of governance, supervisory framework and prudential norms

b) Rationalizing the long tail of non-bank lenders

Currently, relevant guidelines provide direction on aspects related to process, eligibility, etc. with respect to applying for a non-bank lender license or acquiring an existing license. However, in the recent past, it is witnessed that additional benchmarks are being sought by the regulators. It may be a welcome move to spell out of the objective criterion for evaluation of an applicant. This will help boost investor confidence especially the foreign investors given the focus on encouraging foreign inflows into India.

Further, the licensing norms may look to enhance the entry criterion in line with the recent proposal to increase minimum NoF for HFCs. This could also help reorganize non-banking finance sector through rationalization and consolidation and curtail the long tail of non-bank lenders for large non-bank lenders to avail the much-needed bandwidth for oversight.

> There are too many non-bank lenders to be regulated effectively. There is a need for fewer number of well-governed non-bank lenders
>
> **Multiple leaders of the non-banking finance sector**

c) Enhanced risk management and liquidity framework

While the regulator has taken measures such as revision of liquidity coverage ratio norms for a better liquidity management, a holistic view at liquidity management could be looked at for non-bank lenders. This importance of a liquidity and risk management framework is also impressed upon in the Financial Stability Report. One of the measures in this direction could be strengthening of regulatory vigilance through mandatory asset quality review (AQR) for large non-bank lenders. A bank-like AQR (as conducted in 2015) for large entities like NBFC-SI could ensure prudence of the balance sheet and help regain investor confidence. Based on AQR findings, the regulator could provide a dedicated liquidity window to non-bank lenders on selective basis to counter cyclical liquidity issues. This will, in addition to providing liquidity to well managed companies, help single out non-performers.

6.2 Increased collaboration between banks and non-bank lenders

Non-bank lenders, with their unique business model and significant outreach has proven that they can be an integral part of financial ecosystem and be complementary to banks. Given India's vast unmet financing needs, it is imperative that there is a need to enhance the complementary and constructive interplay between banks and non-bank lenders.

The current collaboration between banks and non-bank lenders does not leverage the inherent strengths of each of them in entirety. Having a strong collaboration could provide an increased financing outreach, better servicing of the priority sectors and increased translation of liquidity. Collaboration can be enhanced by further leveraging the existing modes as below:

a) Banks to serve as a capital provider while non-bank lenders to enhance reach: Banks have an advantage when it comes to access to diverse long-term capital sources including the low-cost savings deposits. Banks can leverage the strong distribution network of non-bank lenders for identification of potential customers, collection, preliminary application processing etc.

- Removal of restriction for direct lending in case of priority sector lending, allowing banks to leverage on-lending mechanism to channelize credit through non-bank lenders
- Extension of the ambit of co-origination by banks and non-bank lenders to non-PSL loans from the current PSL loans
- Implementation of the draft guidelines on securitization

b) Restricting banks and non-bank lenders under the same umbrella: The extant practices include a promoter groups having both banks and non-bank lenders operating under a same umbrella or as a sister concern. This creates a possibility of not operating at an arms-length and hence, promoting the sector would imply discouraging such practices.

"

It is difficult for non-bank lenders to grow once asset size reaches a threshold. Hence, it is important to have more disintermediation models whereby non-bank lenders can leverage their superior credit assessment and strong collection platform to create assets for someone with easy access to capital, possibly Banks

MD & CEO of a large diversified non-bank lender

6.3 Streamlining accounting treatment between banks and non-bank lenders

a) **Disparity on asset classification under Ind-AS and IGAAP:** Banks and non-bank lenders follow different accounting frameworks. Banks are under the erstwhile accounting GAAP where provision is driven by IRACP norms whereas most non-bank lenders have moved to Ind-AS where provisioning requirements are driven by expected credit loss (ECL) model due to which non-bank lenders do not get a direct relief offered by the regulator in terms of repayment moratorium.

   The RBI vide its asset classification and provisioning notification dated April 17, 2020 laid down that the moratorium granted even to standard assets as at February 29, 2020 shall be excluded from the computation of number of days past-due for the purpose of asset classification under IRAC norms by lending institutions. The RBI has accordingly laid down that the asset classification shall stand frozen even for the standard assets that have been granted moratorium. However, RBI also stated that non-bank lenders shall be guided by guidelines as approved by their Boards and as per ICAI (Institute of Chartered Accountants of India) advisories.

   Therefore, a specific notification from the ICAI or the MCA should be issued urgently that even in the Ind-AS framework, this RBI notification is superior as it is a regulatory override and should be adhered to for treatment in the financial statements of non-bank lenders. The temporary freezing in the classification (staging) requirements would ease out the current precipitated COVID-19 related credit weakness for non-bank lenders.

b) **Uncertainty around measurement of Expected Credit Losses:** ECL computation is a complex exercise requiring estimation of variables such as PD (Probability of Default), LGD (Loss given default) and macro-economic factors. In the current scenario, due to the slowdown in the economy, it will be extremely difficult to predict these variables with any degree of certainty, creating issues in accounting as well as for the auditors to provide an opinion on these numbers.

The regulator could consider providing the following guidance to the non-bank lenders:

- Recommend certain minimum thresholds for benchmark PD rates or percentages as a management overlay.
- Prescribe minimum haircuts on LGD computation for different types of collaterals including practical expedient on determination of appropriate LGD for entities with main source of recovering loans is physical or door to door recovery which will be impacted significantly.
- Provide some practical expedient on recognition of interest income on credit impaired asset in the current scenario.

c) **Sale to ARC by non-bank lenders under SARFESI as true sale:** With the implementation of Ind-AS for non-bank lenders, the entire accounting paradigm with respect to the sale/transfer of stressed assets to an asset reconstruction company has undergone a significant change. Referring to the requirements under Ind-AS 109 "Financial Instruments", it suggests that the stressed loans transferred to an ARC cannot be derecognized on the books of the non-bank lenders and would have to continue to be accounted for as if no such transfer took place. By implication, impairment of each such loan would have to be recognized by lenders in line with the expected credit losses and investments in SRs issued by the ARC/SPV cannot be held as investment by the respective lenders. This creates a strange situation where these lenders are forced to account for an asset it does not have, but not account for an investment, which is legally held by it.

   Banks have currently not transitioned to Ind-AS, if a portfolio with similar characteristics is sold by a bank to an ARC where "True Sale" criterion is met, the bank would be able to derecognize the loans (Financial Assets) under RBI guidance, while non-bank lenders cannot do so given that Ind-AS does not allow it. Thus, It is unfair for non-bank lenders as they are covered by the same provisions of the SARFAESI Act like banks.

We believe, that when a specific law is available which requires certain accounting treatment to support the industry and economy, Ind-AS guidance cannot override it to provide an absolutely differing picture to readers. Business model and result reading and presentation and accounting presentation cannot look in opposite directions.

Thus, the government may consider allowing banks (whenever they transition to Ind-AS) and non-bank lenders to recognize Investment in SRs and derecognize financial assets, if control has been transferred to an ARC. As mentioned, this does not affect true and fair view, given that expected credit loss would continue to be provided on such SRs, and the fair value of SRs would reflect the expected credit loss.

6.4 Measures to create a level playing field for non-bank lenders

a) **Diverse avenues of funding sources:** The regulatory regime for non-bank lenders has evolved largely whereby their asset side of the balance sheet has been harmonized with that of banks. On the liabilities side, alternate funding mechanisms such as introduction of refinance scheme similar to those available for banks/HFCs and on-tap issuance of secured debentures be allowed. Additionally, an umbrella prospectus with validity for more than a year and a reduced minimum investment amount may be considered.

b) **Access to public deposits:** The RBI has discontinued granting deposit accepting licenses to NBFCs in 1997 and still there are about 82 deposit accepting NBFCs as on September 2019. There appears to be no objective criteria comprising asset quality, credit rating, and capitalization that determines the continuation of the deposit acceptance license nor there is any sunset provision to such deposit licenses. Hence certain old non-bank lenders, including those part of industrial houses continue to have access to public deposits just by virtue of their date of registration. This creates an unequal playing field in the market.

The NHB has issued a draft discussion paper, through which it is proposing to reduce the maximum leverage to 12 and minimum capital adequacy to 15% in a phased manner. This revised limit applies equally to deposit accepting as well as non-deposit accepting HFCs. A level playing field should be created for all non-bank lenders while ensuring that the interest of depositors, especially small depositors are not compromised. Hence, all non-bank lenders which are rated A and above by at least two credit rating agencies with capital/net worth in excess of INR 1,000 crores should be given deposit accepting licenses.

In addition, the regulator could look at extending the deposit insurance cover for deposits placed with non-bank lenders which is likely to boost deposit mobilization and enhance depositor confidence. Currently, an insurance cover of up to INR 5 lakh is provided by the Deposit Insurance and Credit Guarantee Corporation (DICGC) as a measure to protect depositors in banks.

c) **Relaxations for raising funds through External commercial borrowings:** The RBI in consultation with the government of India on July 30, 2019 relaxed end-use restrictions relating to External Commercial Borrowings ("ECB") for Working Capital requirements, General Corporate purposes and Repayment of Rupee loans. The RBI stipulated tenor restrictions as below for availing the relaxations:

- ECBs with minimum maturity of 10 years can be used for working capital, general corporate purposes
- NBFCs can raise ECBs of a minimum 10-year maturity for on-lending for the above purposes
- ECBs with a minimum average maturity period of 7 years can be availed for repayment of Rupee loans availed domestically for capital expenditure
- NBFCs can raise ECBs of minimum 7-year maturity for on-lending for the above purpose

Overall, the above relaxation was in the right direction, however, considering the existing scenario where on account of COVID -19 fund raising have become difficult for the above relaxations to be effective, certain modifications as under may be considered:

- There is a very limited non-existent market for non-bank lenders (for that matter any Indian borrower) to raise 7/10-year ECBs for on lending or refinance. In order to make this window a real source of funding, ECBs having a maturity of 3 / 5 years should also be allowed for on lending or refinance. Alternatively, a sub limit of say 25% within the overall ECB raised should be allowed for refinancing existing Rupee debt for non-bank lenders.
- HFCs are permitted to raise ECBs for financing purchase of affordable housing units. This should be expanded to include all types of home loans.
- Further, there exists a prescribed cap on ECB pricing. Withholding tax is a charge borne by the domestic borrower. This increases the overall cost of funding. There was a window created for raising ECBs without withholding taxes. This exemption from withholding tax for ECBs should be extended on a long-term basis.

d) **Enhancing recovery mechanism:** The RDDBFI Act 1993 and the SARFAESI Act 2002 are legislations for lending institutions to take recourse towards debt recovery. The following measures could further boost debt recovery

- Non-bank lenders be permitted to debt recovery through Debt Recovery Tribunals, similar to that given to Banks, under the RDDBFI Act.
- The applicability of SARFAESI Act may be enhanced to cover all non-bank lenders without the loan size restriction of INR 50 lakh in line with that of Banks/ HFCs. Further, this is currently applicable only to lenders with an asset side of INR 100 crore and above.

e) **Promoting innovations in customer verification:** Usage of e-KYC has simplified customer on-boarding and has reduced administrative burden for financial intermediaries which have been allowed to use this facility. Extension of such innovations to non-bank lenders will ensure streamlining customer onboarding and allow enhanced due diligence.

- The introduction of V-CIP will be critical in conducting customer identification in the post COVID-era. Allowing for a seamless digital process to auto capture the OVD displayed or the OTP read out by the customer will be beneficial in streamlining the process.
- The regulator may allow on-boarding done by non-bank lenders (which are also reporting entities) using CKYC services as "full KYC". Further, this may be mentioned in the master direction of KYC along with a time limit for uploading customer KYC records. This will result in wide-spread adoption of CKYC Registry, bring in standardization of KYC records and reduce compliance cost/ additional due diligence towards customer onboarding.

f) **Income-tax related measures (Nil TDS for non-bank lenders):** The Government has introduced several measures in the past on the income-tax front by bringing parity between banks and non-bank lenders. However, the applicability of a 10% tax deducted at source (TDS) on interest payments (as applicable under Section 194A of the Income Tax Act) is one operational issue which has been bothering the non-bank lenders for years now. It is to be noted that sub-section 3 of Sec. 194A provides for non-applicability of Sec. 194A in certain cases, and that includes banking companies to which Banking Regulation Act applies. However, such exemption has not been extended to non-bank lenders. Thus, non-bank lenders do not quite enjoy a level playing field vis-à-vis banks despite the fact that both banks and non-bank lenders indulge in similar lending activities and both are regulated by the Reserve Bank of India. These lenders do have the option to apply for a lower withholding certificate under Sec. 197 of the Income Tax Act. But, in practice, it is extremely difficult to obtain this certificate given the huge number of customers, which, in many cases, runs into thousands. Also, this would involve extensive paperwork and administration, coupled with huge collection costs, filing of quarterly returns, etc. making the entire TDS collection process quite costly and time consuming.

The TDS issue has only complicated matters for non-bank lenders, this has also emerged as a major challenge for the co-lending program. For the financing of the same asset, the interest component earned by non-bank lenders is subject to TDS (@ 10%), whereas the parallel interest income earned by the bank is exempt from TDS. This makes the process more rewarding for banks, although both non-bank lenders and banks are to jointly share the risks and the rewards from the co-lending program.

It is, therefore, high time to address the TDS issue. To overcome this problem, the government may actively consider treating NBFCs, at least the systemically important ones, at par with banks and extend them the benefit of 'Nil TDS'. Further liberalization/ introduction of new measures pertaining to tax deductibility of provisions for doubtful debts and deduction for special reserves created as per RBI norms are likely to boost the sector.

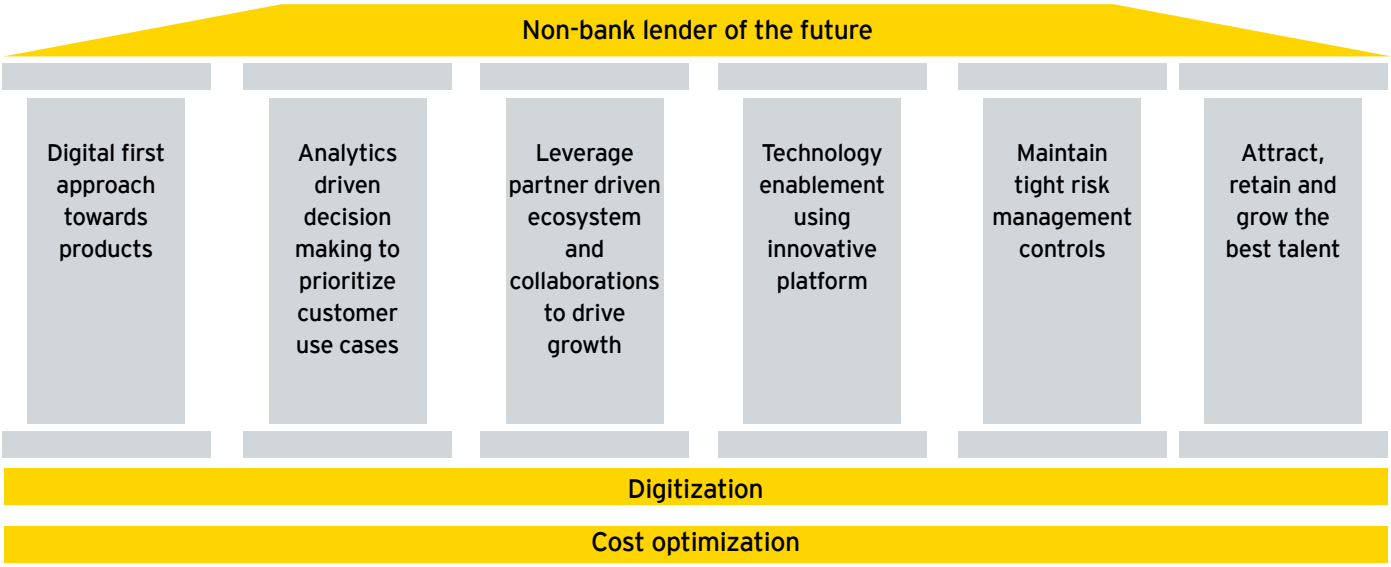
g) **Access to CRILC records:** CRILC is a central database for data on borrowers having aggregate exposure of INR 5 crore and above across all lending institutions. This is an important tool towards credit assessment and in turn helps towards monitoring assets. Whilst reporting is mandated for all institutions, this repository is accessible only to banks. In order to aid in credit appraisals and overall governance with respect to provision of credit, it is recommended that non-bank lenders also be provided access to CRILC.

7

Building non-bank lender of the future – resilient and equipped to capture growth



We have seen that non-bank lenders are exposed to a few near-term as well as structural challenges. Recent adverse industry events and the outbreak of the COVID-19 pandemic has proved that the sector needs to be resilient and focus on realigning the business model tuned to capture future growth opportunities. In our view, this can be achieved by aligning focus on six core pillars that will help build a non-bank lender of the future. Non-bank lenders have harnessed digitalization, cost and resource optimization in order to innovate and provide effective customer experiences as illustrated:



What the sector leaders have to say about the future of non-bank lenders

"There is definitely need to reinvent and reorganize the business model with digital focus

"Technology will play an increasing role in reducing cost going forward; Operating model cannot be high cost

"Success lies in marrying Banks (have capital), non-bank lenders (have the reach) and FinTech (have cutting edge technology)

"Non-bank lenders will have to invest in reinventing business models. Automation, WFH and leveraging digital (for customer onboarding, collection, processes) will be new normal

"Collaboration between Banks/ non-bank lenders and FinTechs will grow since FinTech capabilities offers differentiation credit assessment, credit collections, digital gateways

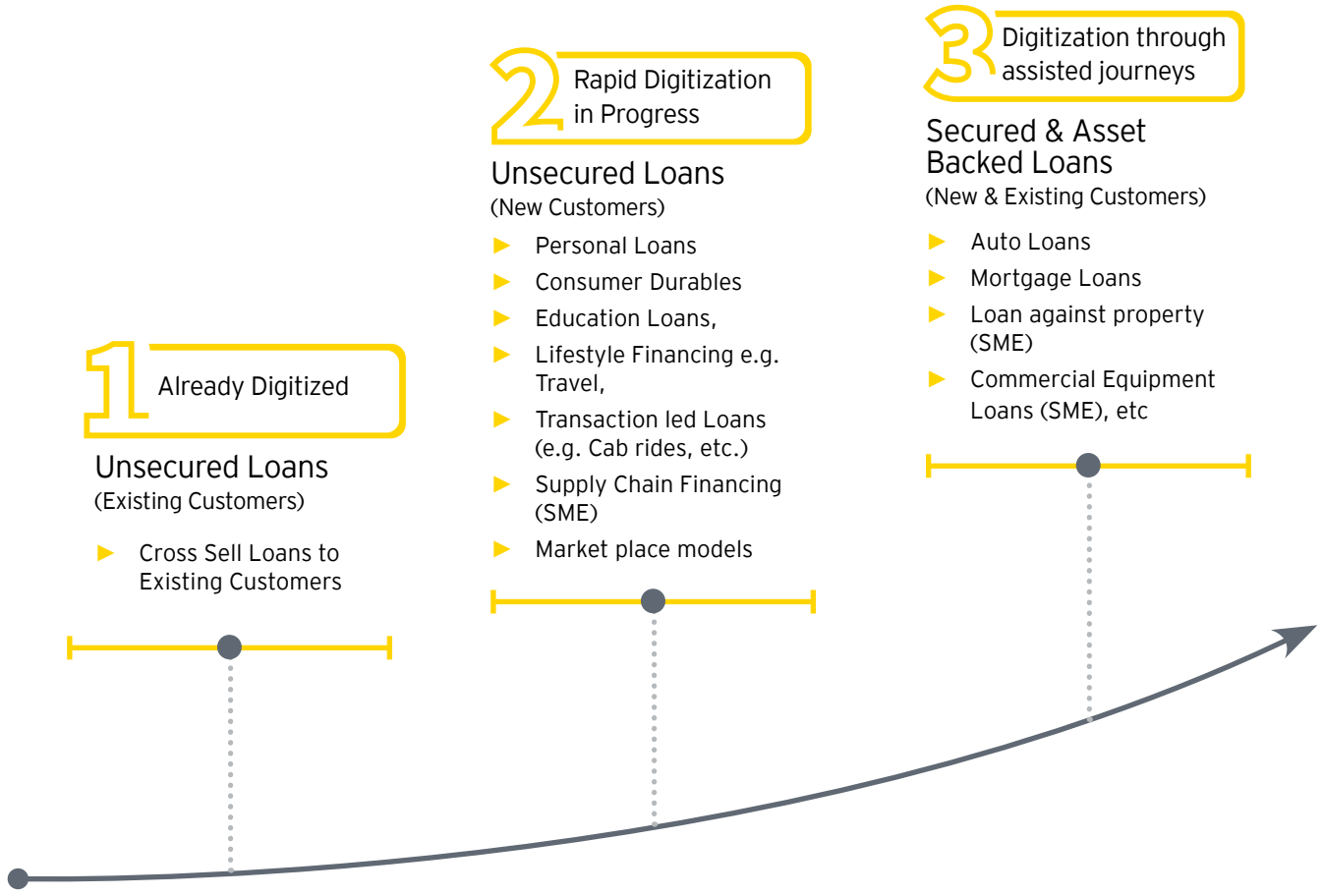
7.1 Digital first approach towards products

Increasing customer awareness is among the key enabler for product digitization with non-bank lenders taking a lead. Product digitization to enrich customer experience is now a key customer acquisition strategy.

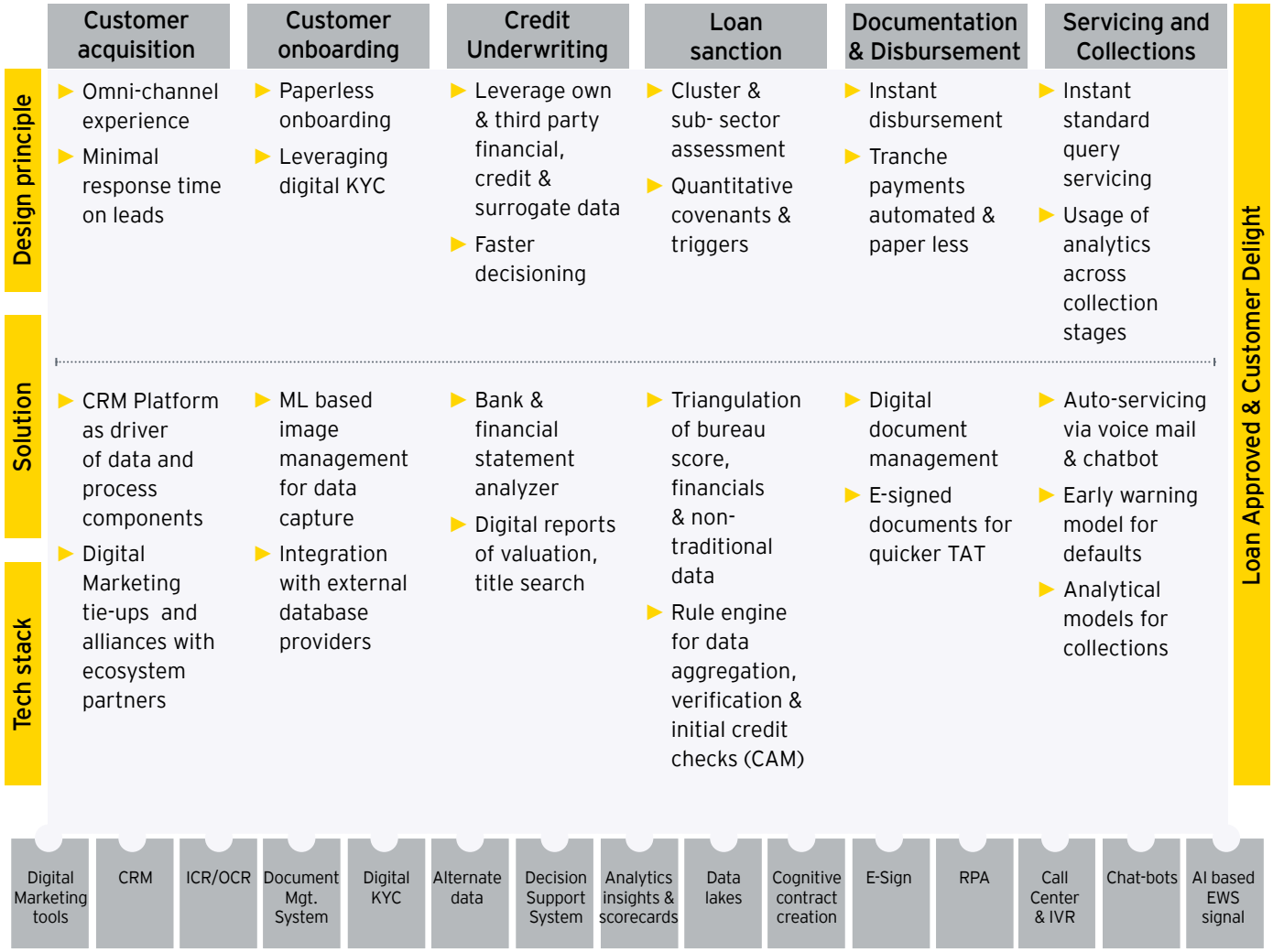
The early phases of product digitization journey focused on cross selling unsecured loans to existing customers primarily through e-commerce partnerships and use of multi-lingual apps to attract customers. Subsequently, rapid digitization aided by agile and light core technology systems allowed new customer acquisition for unsecured loans.

The current phase will focus on both new and existing customers through an assisted-digital model for secured and asset backed loans. Thereby assisting drop-offs through a seamless handoff across channels to provide an omnichannel experience. The same has been validated through the EY-FICCI Business Confidence Survey for the NBFC sector – 2020, where the respondents have mentioned that an omnichannel presence (Physical + Digital) will be a differentiating element in credit distribution and customer sourcing for non-bank lenders.

Digital first approach adopted by non-bank lenders is as illustrated below:



Whether it is a consumer durable finance, vehicle finance or a small personal loan, non-bank lenders are transforming the value chain by making loan acquisition faster and easier through digitization. The potential digital lending value chain for a SME is as illustrated below;



Case study – Product digitization

A leading non-bank lender to revamped their customer facing platforms at physical stores and web. This improved the overall customer experience and brought out conversational interfaces. Customer journeys for personal and home loans were also revamped as part of this by partnering with FinTechs.

Key highlights include enabling pre-approved offers based on propensity models, real time underwriting, effective marketing decisions and enhancing collection efficiencies.

70%
higher customer engagement

25%
of personal loan customers engaged using bots

3 lakh
customer interactions during 1st week of launch

7.2 Analytics driven decision making to prioritize custome use cases

Digitalization has allowed easy capturing and access of multiple customer data points across financial, non-financial and demographic profiles, thereby assisting in defining multiple use cases for business analytics. Analytics, which was used for need-based analysis by non-bank lenders, is now integrated into the value chain with multiple use cases thereby providing data-driven and real time insights. This led to data-driven actioning on key performance indicators across the value chain.

Value Chain							KPIs Impacted
Customer Insights	Customer Retention	Customer Segmentation	Social Network Analytics	Customer Profitability	Lifetime Value Estimation	Customer win back	Product Per Customer
Product, Sales & Acquisition	Cross/Up Sell (incl Banca Partner & Group Companies)	Customer Segmentation	Campaign analytics	Product Profitability	Sales incentive analytics	Sales Volume Forecasting	Revenue per customer Cost Per Acquisition
Channel Management	Channel migration to digital	Channel Allocation	Branch Optimization	Lead estimation model – Digital channel	Channel performance analytics	Contact Centre Analytics	Branch Cost
Portfolio & Performance Management	Portfolio Dashboards	CXO Dashboards	Balance build up strategy	Portfolio review analytics	Trigger & Life Event Marketing	Revenue Forecast Modelling	Profitability NPS
Productivity, Service & Process	Agent Productivity	Agent fitment analytics	Agent retention analytics	Automated insights for sales enablement	Process Optimization TAT analytics	Customer Feedback – Text & Voice	Digital Penetration
Operations & Support	Employee performance analytics	Employee retention analytics	Employee compensation analytics	Next best action analysis	Geolocation based analytics	Virtual MIS assistant	Agent productivity

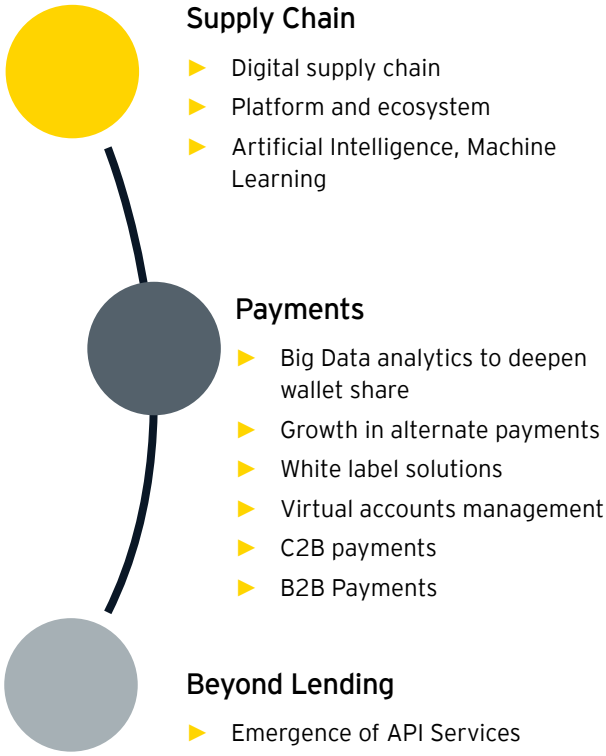
7.3 Leverage partner driven ecosystem and collaborations to drive growth

Ability to offer products in an efficient and intuitive manner is now an important go-to-market lever for non-bank lenders. This is bringing a noticeable shift from having purpose-built systems and applications, which are largely functional, to having custom journeys and seamless customer experiences.

FinTech solutions are gaining prominence in this context as they supplement capabilities of non-bank lenders over a range of areas through their modular approach. They are known to have solutions which connect the value chain, enable digital transactions and provide a lens to look beyond.

> Non-bank lenders should collaborate with FinTechs. Many process optimizations are already available with FinTechs to be readily utilized
>
> **MD & CEO of a diversified non-bank lender**



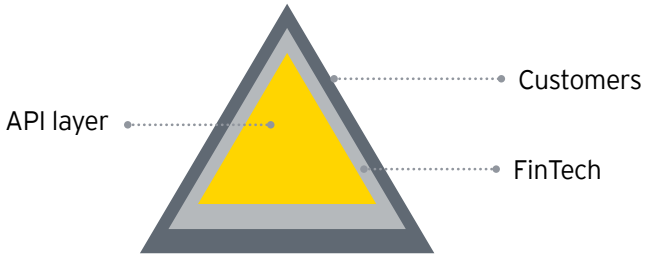


These solutions offered by FinTechs are characterized by their API based services which allow non-bank lenders to offer a host of value-added services. They allow to:

(i) Leverage the financial ecosystem to provide APIs as products to third party developers

(ii) Generate revenues by turning APIs into products

(iii) Manage customer relationships through FinTech solutions



Case study – Achievement of operational excellence through end to end digital journey

A leading non-bank lender launched a mobile application offering an end to end digital journey for personal loans in India.

The mobile application allows having disbursements in under 10 minutes coupled with FinTech solutions to allow real time underwriting, automation and collaborate with other managed service providers.

In process, it built a large partner network to gain scale and offer a range of product suites across personal loan, car loan and two-wheeler loan segments.

3- minute
process, from application to disbursal

100% online
using smartphone based application and assisted model

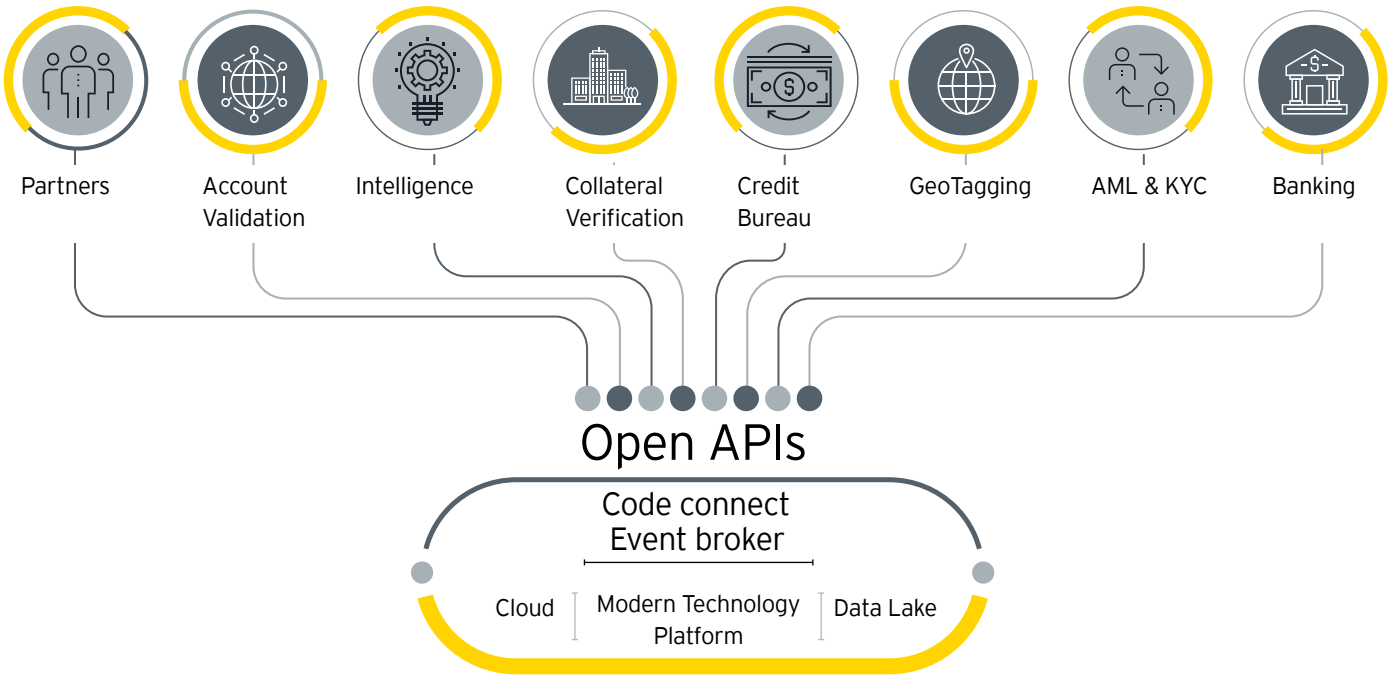
e-KYC
based identification and form completion

Paperless
sanction

7.4 Technology enablement using innovative platform

Non-bank lenders are increasingly focusing on optimizing the value chain through automation and real time, event driven triggers. Technology is playing a key role in this transformation and is becoming a source of competitive advantage. This is largely attributed to digitization, analytical capabilities and agile technology components. With cost optimization being among the key priorities for 75% of the non-bank lenders in the next 2 to 3 years as per EY-FICCI Business Confidence Survey for the NBFC sector, focus on technology to render operational excellence is gaining prominence.

> We are reducing cost through a combination of digital, automation and centralization. This will help us scale faster in the interior locations without a significant increase in manpower
>
> **MD & CEO of a mid-sized housing finance company**



Lead Generation

- Omni Channel User Experience
- Digital Marketing
- Contact Center
- CRM

Customer Onboarding

- ICR/OCR
- RPA
- Analytics & Insight
- Onboarding

Underwriting & Loan Sanction

- NLG on Financial Statements
- AI/ML based lending platform
- Human Decisioning
- CRM

Documentation & Disbursement

- Cognitive based Bespoke Contract Creation
- Human Decisioning
- Document management

Servicing & Collections

- Payment System
- CRM
- Contact/ Collections Center
- AI based Early Warning Signal and Monitoring System

7.5 Maintain tight risk management controls

Risk management priorities are changing rapidly as the business and ecosystem evolves. The biggest challenge is managing the speed of business change while aligning risk expectations. While regulator has taken a step in the right direction by mandating CRO for non-bank lenders having asset size greater than INR 5000 crores, the focus must be on establishing a robust risk management framework with risk governance at the core. The regulator has also introduced the liquidity risk management framework effective December 2020 to enable non-bank lenders to manage liquidity better.

We propose a risk management framework for non-bank lenders that could encompass emerging risks such as reputational risk, ESG risk, regulatory risk in their risk management framework along with operational, credit and liquidity risk. The framework could facilitate:

- Better decision making through well-defined risk appetite statement
- Proactive assessment impact of all material risk across the Lines of Business across earnings, reputation, capital and people,
- Aggregated view of risk and have mitigation plans in place
- Proactive monitoring of key risk drivers to identify the adverse movements and take necessary action in time to avoid surprises
- Clear risk roles and responsibilities, communication, reporting and escalation

Building robust technology infrastructure in risk management should be part of future roadmap to enable alignment, convergence and efficiencies across the three lines of defence.

7.6 Attract, retain and grow the best talent

The growth trends of the non-banking finance sector are closely aligned with the growth of the financial services sector. As per the Future of Jobs in India report by NASSCOM, FICCI and EY, FinTechs are witnessing traction and as the non-banking finance sector evolves, ~15% increase in hiring is anticipated, primarily stemming from increased adoption of technology across the sector. While niche skills are important, the demand for a multi-skilled workforce is also on the rise. Accordingly, the sector is also seeing an increased demand for technology professionals with understanding of Finance and/or business operations. As with other sectors, technology and digital advancements are likely to have an impact on workforce skills, expectations and talent management practices. Further, the COVID-19 pandemic has also forced organizations to adapt their workforce models to the rapidly evolving situation as illustrated.

Creation of talent hubs

Non-bank lenders are looking to create talent hubs and microsites across the country – mainly in Tier 2 or 3 cities, to enhance workforce resilience. This provides an opportunity to run critical processes from back-up locations in case of disruptions and reduce cost of talent acquisition and other expenditure

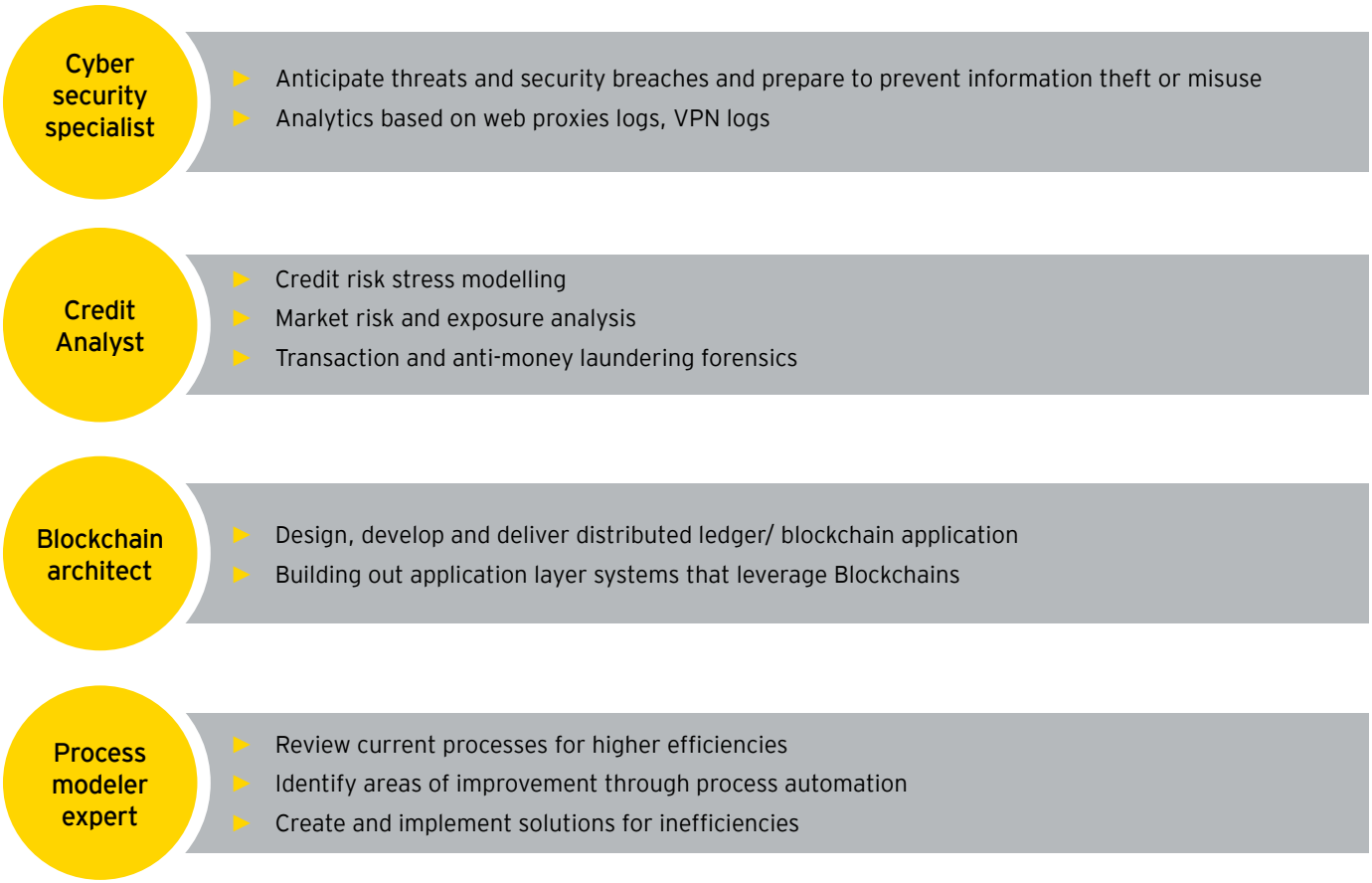
Building employer brand

Reduced cost of talent acquisition can create an opportunity to spend towards value additions such as for building the employer brand

Restructuring of the workforce

A review of the existing talent pool will build a case for more diverse teams – creating a hybrid model with a combination of full-time and flexible/gig workforce

Non-bank lenders will need to articulate their unique value offering to both prospective hires and existing employees – opportunities for career advancement, enhanced learning and collaboration will need to become more competitive than the traditional perquisites and benefits. Using social media as a tool for micro-level targeting of candidates will need to become a norms. Accordingly, some of the major recruitment trends and job roles in the non-banking finance sector are going to evolve around:



Growth, Retention and Enablement: Once the best talent has been identified and acquired, non-bank lenders will also need to look at creating opportunities for growth internally. New age talent not only seeks a challenging and intellectually stimulating job role, but also a culture of growth in the organization. Non-bank lenders would need to create an inherent sense of purpose among the workforce. Empowering the workforce with tablets/ tools, continuous and personalized training, and career planning interventions will drive a culture of innovation and set the tone for digital transformation.

Further, enhanced focus would be required on continuous and personalized learning. Abundant opportunities and platforms for skilling, re-skilling and re-purposing would have to be created, with clear linkage to business outcomes. These platforms help integrate content from various sources and create individual learning journeys to meet specific role requirements for both the current roles and from a future succession planning perspective. Lastly, as customer experience is becoming a key business driver, non-bank lenders will need to build in a basic risk appetite with a view to encouraging a culture of innovation.

8

Conclusion



The non-banking finance sector was facing an unprecedented liquidity challenge during the last two years. As the sector was recovering, the COVID-19 pandemic has disrupted the global economy. The liquidity crisis has brought to fore inherent drawbacks in the non-banking finance sector and has given it an opportunity to correct its course. The crisis also helped non-bank lenders withstand the pandemic despite a sharp reduction in business and collections.

After a prolonged lockdown, businesses and non-bank lenders alike are gradually bouncing back to normalcy. The sector witnessed support from multiple quarters during the pandemic, including the regulator and the government, in the form of stimulus packages. As the sector looks beyond the pandemic, the regulator, through policy measures, should ensure that both banks and non-bank lenders are able to leverage their respective inherent strengths and be complementary to each other. A financial ecosystem built on the foundation of robust distribution capabilities of non-bank lenders and sound balance sheets of banks is the need of the hour. This will ensure existence of resilient non-bank lenders and seamless transmission of credit.

Further, the post COVID-19 new normal is expected to see accelerated digital adoption by non-bank lenders across the value chain owing a conscious effort of non-bank lenders and customers alike. Non-bank lenders should grasp this opportunity to build a robust digital franchise.

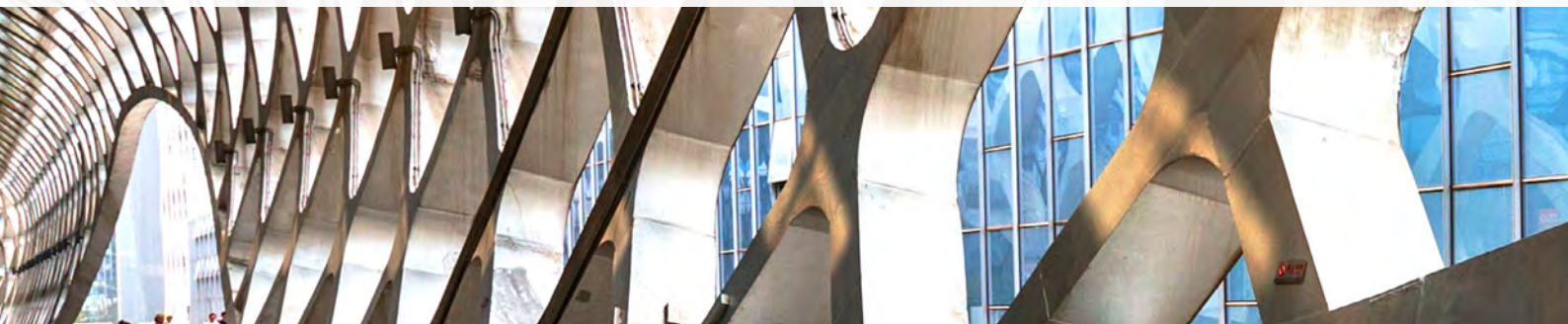
In conclusion, the non-bank lenders are a significant part of the credit ecosystem of the country and are presently undergoing a change in their business model. This requires due support for the banking community to provide them timely leverage. The non-bank lenders on their part need to recapitalise themselves, build in the required governance and explore alternate forms of finance. The regulator needs to look at governing large non-bank lenders akin to banks and at the same time consider regulations around short term liquidity support in addition to providing them with a path to becoming a universal or differentiated bank.



Glossary of Terms

Abbreviation	Full form
ALM	Asset Liability Management
APF	Approved Project Funding
AQR	Asset Quality Review
CD	Certificate of Deposit
CP	Commercial Paper
CRE	Commercial Real Estate
CRILC	Central Repository of Information on Large Credits
CKYC	Central KYC
DaaS	Data as a Service
e-KYC	Electronic mode for Know Your Customer process
ECB	External Commercial Borrowings
EWS	Economically Weaker Section
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GECL	Guaranteed Emergency Credit Line
HFC	Housing Finance Company
IGAAP	Indian Generally Accepted Accounting Principles
Ind-AS	Indian Accounting Standard
KYC	Know Your Customer
LAP	Loan Against Property
LGD	Loss Given Default
LIG	Low Income Group
MCLR	Marginal Cost of Funds based Lending Rate
MFI	Microfinance Institution
MLI	Member Lending Institution

Abbreviation	Full form
MoF	Ministry of Finance
MSME	Micro, Small & Medium Enterprises
NABARD	National Bank for Agriculture & Rural Development
NBFC	Non-Banking Financial Company
NCGTC	National Credit Guarantee Trustee Company
NHB	National Housing Bank
NIM	Net Interest Margin
NoF	Net Owned Fund
NPA	Non-Performing Asset
NTC	New to Credit
OEM	Original Equipment Manufacturer
OVD	Officially Valid document
PCGS	Partial Credit Guarantee Scheme
PSL	Priority Sector Lending
RBI	Reserve Bank of India
RDDBFI	Recovery of Debts Due to Bank's & Financial Institutions Act
ROA	Return on Assets
SBI	State Bank of India
SLF	Special Liquidity Fund
SARFAESI	Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act
TAT	Turnaround Time
TLTRO	Targeted Long-Term Repo Operations
TReDS	Trade Receivables Discounting System
V-CIP	Video Customer Identification Process





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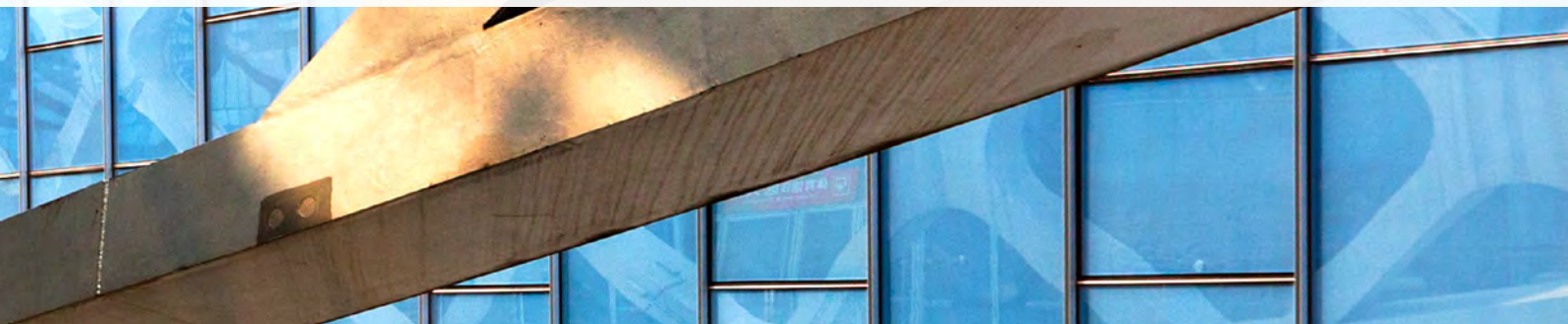
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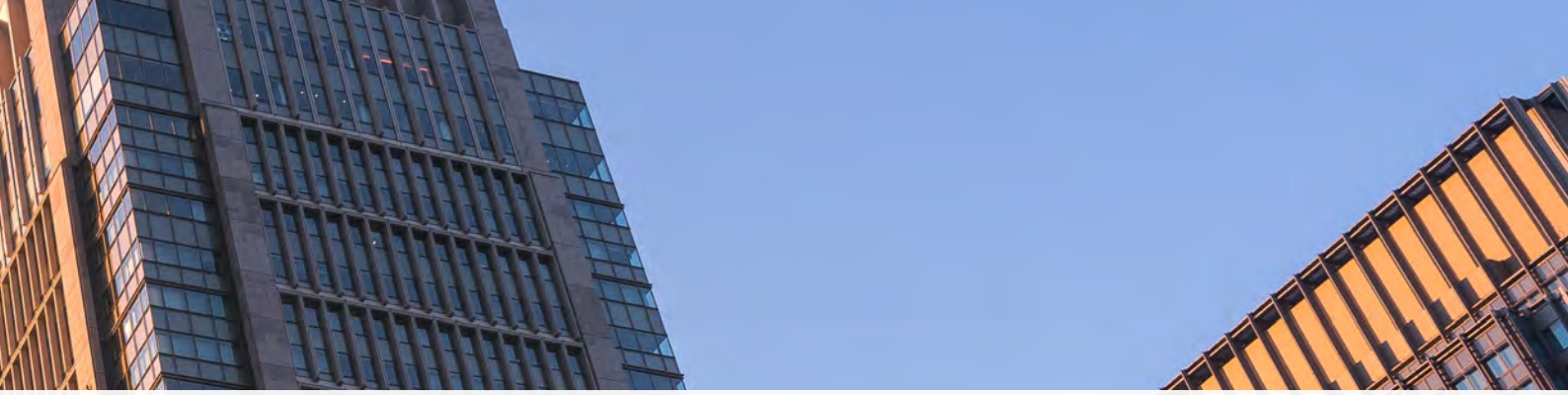
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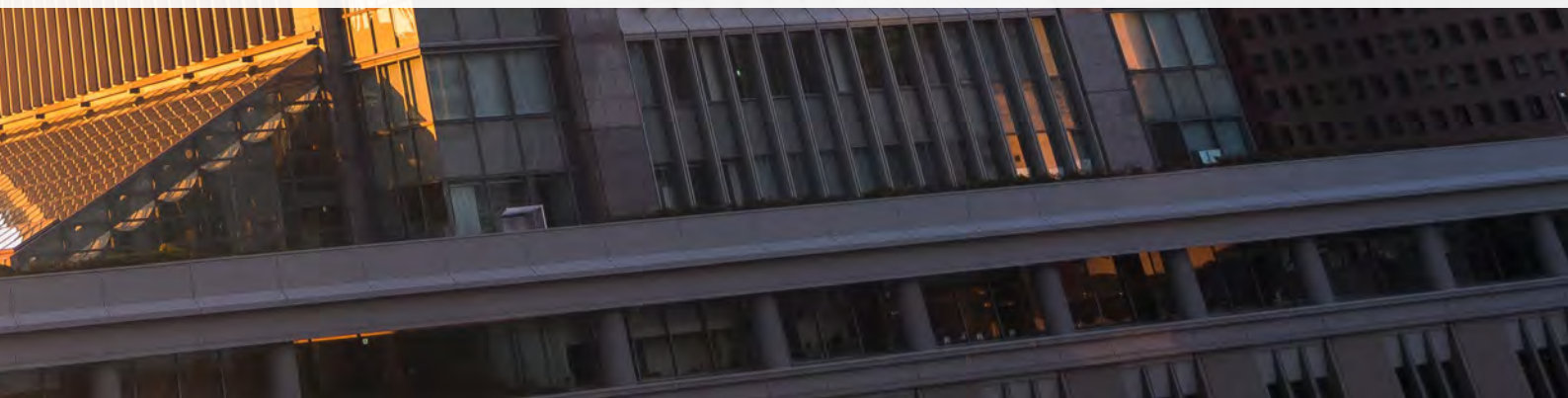
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