

Indian NBFC Sector

A review post global credit crisis

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Introduction

NBFC sector faced significant stresses on asset quality, liquidity and funding costs due to the global economic slowdown & its impact on the domestic economy. While all the NBFCs were affected, the impact varied according to the structural features of each NBFC. Asset-liability maturity (ALM) profiles, type of assets financed and origination / collection models followed were the primary differentiators within NBFCs. The support provided by the Reserve Bank of India (RBI) highlighted the explicit acceptance of the systemic importance of the sector. FY10 was marked by re-aligning of the liability profiles, tightening of lending norms coupled with closing down of many of the unsecured loan segments. On a structural basis, the sector is now more robust due to the lessons learned by NBFCs from this crisis. Profitability is expected to be lower than historical levels due to conservative ALM management, higher provisioning and avoidance of high yielding unsecured loan segments. However profits are at the same time expected to be much more stable & less susceptible to liquidity related pressures going forward. CARE has an overall positive outlook on the sector due to the better ALM position, focus on relatively safer asset classes and the demonstrated acceptance of the sector as systemically important by the regulator.

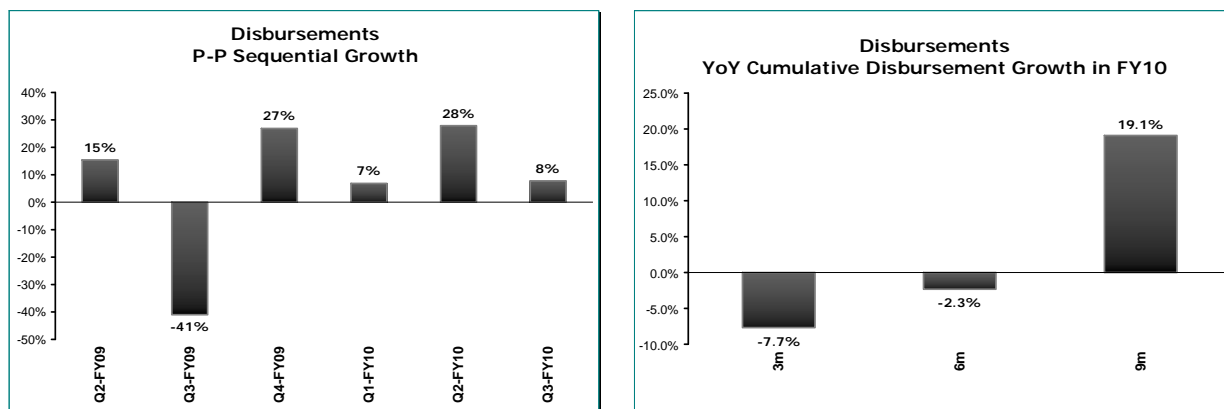
Background

The global economy was hit by a severe credit crisis beginning in 2008 which converted into a recession for many countries across the world. Indian economy was also affected by the same due to its global linkages. However it recovered much faster than the global economy and the impact was also not as severe as that of developed countries.

During September 2008 the crisis led to a liquidity crunch in financial markets and impacted the financial institutions in India. This review considers the impact on NBFC sector, its current position and presents an outlook on the same. The data is for 19 CARE rated NBFCs which cover more than 40% of the entire NBFC sector (excluding development financial institutions, brokers and microfinance institutions).

Disbursements - Sharp fall during the crisis with the trend continuing till H1-F10, pickup in Q3-FY10

Graph1: Disbursements Trend for CARE rated NBFC's



Source: CARE Ratings

Disbursements were clearly hit during the crisis as is visible from Graph 1. Sequential P-o-P data shows a sharp fall in disbursements in the third quarter of FY09 which coincides with the peak of the global crisis. Primary reason for this initial fall was lack of supply of funds after the market liquidity dried up. Impact however differed depending on the capital structure of the company, with NBFCs having larger ALM mismatches and those which had more dependence on mutual funds for funding were affected more severely as mutual funds themselves faced redemption pressure on their short term schemes. To support the sector, RBI undertook several measures to improve the

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liquidity flow to the NBFC sector (refer Box 1). This was a significant development as the regulator highlighted the systemic importance of the sector.

Box 1: RBI measures to improve liquidity of NBFCs

- The systemically important non-deposit taking non-banking financial companies (NBFCs-ND-SI) were permitted to raise short-term foreign currency borrowings.
- Allowed banks to avail liquidity support under the LAF for the purpose of meeting the funding requirements of NBFCs through relaxation in the maintenance of SLR up to 1.5 per cent of their NDTL.
- Risk weights on banks' exposures to claims on NBFCs-NDSI were reduced to 100 per cent from 150 per cent.
- Setting up of a special purpose vehicle (SPV) for addressing the temporary liquidity constraints of systemically important non-deposit taking non-banking financial companies (NBFCs-ND-SI).
- Deferring the higher CAR norms for NBFCs-ND-SI by 1 year.

While liquidity conditions started improving from Q4 FY09, disbursements growth remained subdued for the sector till the first half of FY10. On a y-o-y basis the cumulative disbursements showed a fall during Q1 FY10 and H1 FY10. This period saw deterioration in asset quality of most NBFCs, which was especially high in their unsecured loan portfolios. Lower disbursements were mainly because of the pull back of NBFCs out of unsecured lending segments. On a cumulative basis 9ME FY10 disbursements increased by more than 19%. Even if we consider the low base effect of Q3FY09 disbursements, there is clear indication of pick up in disbursements and a positive outlook for the sector. With improvement in overall economic activity and higher thrust on infrastructure financing by the government, the scenario is expected to improve further in FY11.

Cost of Funding - Shot up during the crisis due to short tenure borrowings, stabilized now & expected to be less volatile due to larger proportion of long term funding

Many NBFCs took advantage of the lower interest rate regime at the shorter end of the yield curve by borrowing short term funds (3months – 1 year) at lower rates and lending for maturities ranging from 3-4 years at higher rates. However the level of mismatches

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differed between NBFCs and those with higher mismatch faced not only liquidity pressure, but their cost of funding also increased during this period due to inverting of the yield curve and a general rise in interest rates. Average borrowings costs¹ (on an aggregate basis for CARE rated NBFCs) increased from around 9.5-10.0% in FY08 to 11.5-12.0% in FY09. This shows the severity of the impact as financial crisis affected funding costs in the second half of FY09 and led to a 200 bps increase for the entire year. The response by NBFCs was to gradually replace short term funding with long term sources. This is a significant structural change in the borrowing profiles that will bring more stability in profitability of the sector. However spreads will also be lower compared to historical levels due to this change.

During the 9ME FY10 cost of borrowing reduced from the average of 11.5-12.0% of FY09 to 10.2-10.5% for the 9 month period and is expected to remain around these levels for FY10. This however is still higher than the FY08 levels due to the structural move towards longer term borrowings.

Asset Quality – Deteriorated more due to unsecured loans which is now virtually stopped by most players, provisioning has improved & asset quality expected not to worsen further

Asset quality for the sector deteriorated significantly during the crisis. Aggregate Gross NPA ratio² trended from around 1.1% for FY08 to around 2.1% in FY09. While there was deterioration in all asset classes, unsecured asset classes (Personal Loans, Unsecured SME loans) showed the maximum deterioration and were the key drivers for overall increase in NPAs. Apart from the asset-type financed, another differentiator between asset qualities was the origination & collection model followed. NBFC's which originated majority of their portfolio through branches & own employees showed better asset quality performance than those which used the DSA model.

Aggregate Gross NPA ratio has further worsened to 3.0% at the end of 9M FY10, however it is close to peaking out. De-growth in unsecured portfolio segment has also lowered the portfolio outstanding growth thereby leading to a 'base effect' on the Gross NPA ratio and adding to the rise in reported numbers.

Provision coverage has increased from around 50% for FY09 to around 60% at the end of 9MFY10 as players have become more conservative. Unsecured lending has virtually

¹ Computed as sum of interest expense / sum of average advances for sample NBFCs

² Computed as sum of reported gross NPA / sum of gross Advances for the sample NBFCs

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stopped for many NBFCs and underwriting norms have also been tightened in general for other asset classes. These developments indicate positive structural changes.

Outlook

Ratings of the NBFCs whose profitability and asset quality was affected due to the crisis were supported by their strong parentage. Based on the parental strength some players have raised further equity and also managed to re-align their business models while maintaining their solvency. CARE has an overall positive outlook on the sector due to the better ALM position, focus on relatively safer asset classes and the demonstrated acceptance of the sector as systemically important by the regulator. The crisis has imposed an overall sense of 'caution' even for the newer entrants in the market. Also going forward higher capital adequacy norms will put a fairly conservative cap on the leverage of the sector thereby improving the credit profile of many entities (NBFC-ND-SI).

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