NBFCs will have to diversify funding sources in 2024

Issuances of commercial paper and bonds by non-bank lenders have started gathering pace

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Non-bank lenders that borrow heavily from commercial banks to lend further may need to diversify their funding sources in the year ahead, given the rising competition for bank credit, and higher risk weights on loans to these lenders, experts said.

In fact, issuances of commercial paper, a short-term debt instrument, and bonds have already started gathering pace, they said.

In November, the Reserve Bank of India (RBI) increased risk weights on bank loans to non-banking financial companies (NBFCs) and also on unsecured loans that NBFCs disburse to their borrowers, by 25 percentage points each. This move will make loans more expensive as it requires them to set aside more capital as a safety measure, likely prompting them to pass on the increase in credit cost to customers.

"Increased competitive pressures, margin compression on account of funding cost increases, and asset quality performance would be the key trend to monitor in the next year. Entities would diversify their funding profiles going forward, which shall be the key differentiator," said A. M. Karthik, senior vice-president and co-group head, financial sector ratings, Icra Ltd.

Rapid credit expansion in general, and specifically in the unsecured consumption and digital lending in the recent past, prompted the banking regulator to institute a series of precautionary measures, Karthik said. He characterized 2023 as a year of regulatory actions aimed at facilitating an orderly and manageable credit expansion for the NBFC sector.

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14-17%
AUM expansion of NBFCs expected in FY25, as per Crisil

An analysis in RBI's September bulletin found that domestic non-bank financiers, especially those from the upper-layer category, have become more reliant on bank borrowings compared to other funding sources. Under RBI's scale-based regulations, NBFCs are divided into four layers according to their size, activity, and perceived risks. The lowest, or base layer, is followed by middle, upper and top layers. In September, the regulator released a list of 15 NBFCs including Tata Sons, Shriram Finance and LIC Housing Finance that are part of the upper layer.

A section of non-bank lenders hope the RBI reviews the risk weight guidelines and differentiates between NBFCs that lend for consumption and those that lend to productive sectors of the economy.

"The idea is to improve funding access to productive sectors, but the regulations can lead to customers paying more and make NBFC loans less affordable," said K.V. Srinivasan, chief executive officer of Profectus Capital, an NBFC that lends to small businesses.

Srinivasan sees growth continuing in the coming calendar year as well, and expects little slowdown during the months leading to the upcoming general elections. A stable government, Srinivasan said, would allow infrastructure spending to continue next year, and boost small businesses and lenders alike.

Rating agency Crisil expects assets under management (AUM) of NBFCs to expand 14-17% in FY25, helped by a continued strong credit demand across retail loan segments. However, Crisil believes growth may be moderately lower than 16-18% expected in the current fiscal (FY24), since unsecured retail loans — the fastest growing segment in the NBFC AUM pie so far — are likely to slow down following the RBI's risk weight guidelines.

25-27%
NBFC AUM is made of home loans and vehicle finance

"The two largest traditional segments of home loans and vehicle finance now comprise 25-27% each of the NBFC AUM. Both segments are expected to report steady growth," said Ajit Velonie, senior director, Crisil Ratings Ltd.

Velonie said that when it comes to tapping funding avenues other than banks, both debt capital markets and securitisation have already seen a rebound. Issuances of commercial paper have increased and are at nearly pre-covid levels, he said, adding that bond issuances are also gathering pace and Crisil has seen a rising share of mid-sized NBFCs in issuances of non-convertible debentures.

Non-bank lenders also said they are looking at more co-lending arrangements with banks. Shachindra Nath, founder and managing director of U GRO Capital, an NBFC focussed on small businesses, said that he expects to soon add a few private sector banks in its co-lending funnel and get some of its "innovative products" approved for co-lending. Under RBI norms, banks can co-originate loans with non-banks, provided NBFCs have at least 20% exposure in the joint loan.

"...in the next 12 months, we will expand our reach through our multiple channels to provide cash flow-based lending products such as retailer financing, revenue-based financing, close-loop sales invoice discounting, and app-based credit platforms," said Nath.

Although banks continue to be a primary source of funding for NBFCs, at U Gro, they account for 38% of the overall liability mix, he said. "We have diversified our lender base between banks, large NBFCs, capital market, and high-quality development financial institutions and impact funds," Nath said.