# The changing architecture of financing

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The face of corporate finance will be going through a metamorphosis in the coming years given the changes that have taken place in the dynamics of the functioning of the financial markets. The changes are not just in the various challenges that have been posed to banks, NBFCs, debt markets etc. but also the evolving regulatory structures which have at their core strong proclivities towards an orderly development of all the segments which reduces underlying risk in the system.

The Indian way of financing has traditionally been banks where companies have had a strong legacy relationship with these institutions as this was the only part of the system which had an open-door policy. As banking is about 'relationship transactions' it has worked very well for years and was easily able to assimilate the activities of the DFIs which were traditionally the institutions that provided long term capital for investment purposes. With universal banking becoming the norm banks took on the role of the DFI and financed long term requirements. This did however develop a different set of contradictions.

However there were two problems. The first is that they all did not have the expertise for the same and hence credit risk assessment was always a challenge. Second banks ran serious asset liability mismatches where funds were typically in the form of deposits for period of up to 3 years while lending could stretch to well over 15 years. Deposits tend to be rolled over which was a safe assumption to make. However while there was no apparent problem in terms of matching of funds banks ran the risk in pricing as there were no available benchmarks.

The problem erupted when the irregularities in policies in the political regime prior to 2014 led to several projects being implemented that could not be completed especially in the areas of telecom, mining, power, metals etc. which led to the build-up of NPAs when the RBI brought in the Asset Quality Recognition process. The sudden recognition of such assets which was spread to over two years led to higher provisions being made which affected profits and fed back into the reduction or erosion of net worth and put pressure on the capital adequacy ratio. This has in turn made banks less willing to lend for investment purposes and directed them to other modes of finance like debt market and NBFCs.

The issue with debt market is that while all companies can raise funds the level of success depends on the credit rating. In general the market is for 'AA' and above ratings while 'A' rating can also evince some interest. The reason is that investors are still not willing to take a call on lower rated paper which creates the fundamental mismatch in demand and supply for lower rated paper. For any market to thrive there needs to be adequate demand and supply of instruments. Debt by its very nature is unique as unlike equity share which has a singular identity, the bond value varies with maturity as a 10-year bond when issued ceases to be of this tenure once a year passes which makes it hard to understand and hence escapes the attention of investors. RBI and SEBI have tried all options to open the window to evince interest of buyers and sellers of debt paper and the progress though slow is encouraging.

Companies have looked also at the NBFCs for finance which filled the gap considerably during the NPA crisis and did provide funds to corporates though there was some concentration in the real estate sector. In fact post demonetization NBFCs played a remarkable role in channeling funds especially for SME, retail and infra. The recent upheaval with some NBFCs has again brought to light the ALM mismatch and a fundamental anomaly in the models being pursued. Therefore there is some introspection that is in progress with the government and regulators trying to unclog the system.

Last, the ECB market has been an option for companies to borrow in international markets. Here too there is an open system though practically speaking the credit rating again is important to have access to this market and invariably the larger companies have a distinct advantage here. The considerations are rating, cost of borrowing (where the RBI fixes the upper level of interest that can be reckoned), exchange rate environment, cost of hedging, term of borrowing etc.

Against this background the regulators have taken certain steps to move borrowers to the corporate debt market and FY20 is the first year when the norms fully kick in. SEBI for instance has mandated that all companies with long term borrowing of above Rs 100 cr should borrow 25% of incremental debt through the bond market if they have a rating of AA and above. Failure to do so would involve a penalty at a future date as this will be observed closely for the first two years. The RBI has the large exposure norms which again mandate companies with overall debt of above Rs 10,000 cr borrowing incrementally from the bond market. Therefore companies will have to be mindful of these regulation when they plan their borrowings that are required to match their funding requirements. A nudge has definitely been provided to move companies away from banks.

The question is when will all this work? The focus so far has been on clearing impediments to borrowing from other sources and RBI and SEBI have worked hard on easing access to both the bond market and ECBs. The nudge to the bond market is being done in a gradual manner starting with higher rated companies which will then trickle down to the lower rated ones too in course of time. Market structures are to be constructed and made active in this regard. For example the CDS market has to work so that there is an insurance provided to the ultimate lender. As the RBI is also talking of having a secondary market for loans, it may be expected that the CDS can develop if bank loans are added to the overall array of eligible instruments. Credit enhancements have been there and need to be made effective so that lower rated bonds become attractive. In short, when we move away from banks which bear the risk (NPAs) to the market, a kind of insurance is a must to attract potential investors.

The ECB market looks attractive as the cost is benchmarked with LIBOR and hence makes sense for companies. However, there have been considerations that have come in the way of this becoming a general route for borrowing. While the cost is lower, one has to buffer for the following. First, the country rating of BBB becomes a kind of a ceiling for a company borrowing in the international market. While there can be some top-ups if there are forex flows for the company, an AAA rated company will never cross the country ceiling by more than two notches. And companies that have a lower domestic rating would walk precariously along the sub-investment edge. Second, a CDS has to be written here for cover which can push up the cost further by 100-200 bps. Third, there is a forex risk to contend with at the time of repayment as well as interest servicing. This concern has been voiced by the RBI often. Therefore, the cost has to be weighed carefully before really opting for such a source of funding.

NBFCs would continue to be an important source of funding and while their operational models will change and adapt to the evolving conditions, there will be more regulation that can in a way make their operations more structured. The government has in the budget made an announcement of a partial guarantee being given to loans of NBFCs purchased by PSBs to the extent of 10% of total for the first six months. Also the possibility of some of them turning into banks cannot be ruled out as even in the past we have had some of them applying for banking licenses. Therefore the route taken by these institutions has to be watched quite keenly.

On the periphery we have already seen that the FinTech companies have been involved with lending especially to the SMEs and there are also new payments banks and small finance banks which have entered the fray. The RBI has floated a paper some time back on peer-to-peer lending which also has the potential to take off. Therefore lending of smaller magnitude may just migrate to these more informal structures that do not have presently regulatory oversight. Others which work within the regulatory structure like small and payments banks will be carving a niche for themselves and it may not be surprising in case the structure follows a three tiered path. The bond market will be the one catering to long term investment requirements. Banks and NBFCs in a modified form will look more at working capital requirements and the niche banks and FinTech companies at small ticket lending.

Also one may expect securitization business to pick up which is quite mature when it comes to retail assets but will expand along the way. While regulation will be important to ensure that progress is orderly the 'originate and distribute' model would be one of the channels used especially for large size loans pertaining to infrastructure.

The future of corporate finance will hence be more focused with all channels being used in conjunction with accompanying regulation. Borrowers and lenders will have to weigh the possibilities as these segments evolve with different sets of regulation. Above all the regulatory processes would have to be dovetailed to ensure that the evolution is orderly. The challenge is it has to always be ahead of the curve to ensure that there is no major disruption.

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