Challenges in NBFC sector and development of Securitization market

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Since September 2018 IL&FS default, we have seen a series of unfavourable developments unfold in the debt capital market. Nearly Rs. 7.5 trillion of private sector debt (accounting for ~25% of outstanding debt) have been downgraded since September 2018. A handful of them have seen steep downgrades in a very short span of time while a select few have been de-rated to the default category. A part of corporate India, particularly promoter entities with higher leverage is also facing the stress (such as the issue of ZEE loan against shares).

The entire Non-Banking Financial Entities (NBFEs) issues stemmed up due to three prime reasons, a) In a bid to chase the profit growth, the entities ignored the significant asset-liability mismatch in their balance-sheet, b) As the banks were constrained in terms of their lending and risk taking capability, select NBFEs took significant risky exposure in their balance-sheet leading to significant concentration of risk in the NBFC sector and c) NBFEs suffer from the organic challenge of less sticky liability base and refinancing risk.

The system needs both near-term and long-term structural measures to address the on-going credit challenges.

In the near term, the policy makers can address the issue by cutting policy rate and massive liquidity injection. The benign inflationary environment and favourable inflation outlook for 2019 offers space to run an accommodative monetary policy. The central bank has already taken the lead on that. In the current easing cycle (commenced since February 2019), we have seen 75bps of cumulative rate cut. Additional 50bps of cut cannot be ruled out. The transmission of monetary easing can only happen in the environment of easy liquidity and on those lines, the central bank has been consciously working to keep the liquidity comfortable. Nearly Rs. 900 billion of permanent liquidity has been injected during April-June 2019 via FX and OMO purchases. Inter-bank liquidity (as measured by Net LAF) has turned into surplus since June. The RBI needs to ensure that the liquidity stays in surplus on a sustainable basis to enable financial market investors to lend out on a relatively longer-term basis and help to lower cost of funds.

US adopted Troubled Asset Relief Program (TARP) and Term Asset-Backed Securities Loan Facility (TALF) during 2008 crisis wherein the government purchased toxic assets and equity from the financial institutions to strengthen the financial sector. Similarly, the Eurozone had longer-term refinancing options (LTRO) which enabled cheaper funds to financial institutions by keeping these troubled assets as collateral. India too needs to think fast and bold and provide some sort of backstop arrangement for these troubled assets. In the final FY20 Union budget, the government announced partial credit enhancement for PSU banks against their purchase of asset pools from financially sound NBFC/HFC. This will help to unlock the liquidity issues for some of the NBFCs. However, weaker Non-banking financial entities also need resolutions immediately (bringing another promoter) as fear about some of these entities is leading to a general environment of risk-aversion.

While some entities would have to go under (such as Lehman in US), others would have to be taken over by the bigger and stronger entities (such as Goldman Sachs in US was saved by allotting preference shares to Warren Buffet, capital was in AIG and CITI by the government of US).

Recently, the RBI has released draft liquidity management guidelines for NBFCs which aims to introduce the Liquidity Coverage Ratio for NBFCs as well (currently only applicable for banks in India) and restricting the ALM mismatches across the maturity buckets. The RBI also aims to adopt liquidity risk monitoring tools/ metrics to capture strains in liquidity positions. These measures will help to address some of the above mentioned issues which led to the entire stress in the NBFC space. The budget also moved regulation and supervision of HFCs from NHB to RBI. This will be positive and should lead to greater confidence among investors. Given the size of HFCs and systemic importance, an asset quality review (AQR) is pertinent.

The other aspect of concentration of risk and a less reliable liability base can be partly addressed with developing and strengthening the securitization market in India.

NBFEs have displayed a stronger niche in credit origination, credit appraisals, risk assessment, and recovery. These players have built a network, systems and processes for origination, particularly in the unorganized sector. Also they are better in using technology and digital tools. The collection efficiencies of NBFEs have not dropped in any economic cycle or event related shocks thus far. Micro-finance institutions (MFIs) faced some problems right after demonetization, Kerala Flood event and Tamil Nadu Cyclone but they remained short-lived. On the contrary, the credit enhancements on the securitization pools get barely utilized.

The unorganized sector in India suffers from the lack of access to formal credit channels. The NBFEs have played a significant role in their financial inclusion. Learning from the western world clearly brings out the access to low cost credit is important to spur growth and job creation in any economy.

But the NBFEs face challenge on building a stable liability side. In the event of default, the lenders to NBFCs get cautious and reduce their exposure. Further, the refinancing options and the line of liquidity to them are not as strong as the banks, who can approach the central bank and other refinancing entities, pledge their government securities and various other refinancing entities. India's wholesale funding/ debt market has not grown in line with the size of the economy. On the other hand, large parts of the banking system, particularly the PSU banks have a very strong liability side.

To sum, while the banks benefit from cheap and relatively sticky liabilities base, the non-banking financial entities have displayed better expertise in reaching out to the unbanked individuals and entities. The policy makers need to capitalize on the differentiated skill set of both these entities. The development of securitization market can help achieve it. The assets originated by NBFCs/HFCs can be pooled together and subscribed to by banks, insurance, mutual fund and pension funds as per their risk taking ability. Globally, ABS/MBS are a very large market supporting the growth of the economy.

The securitization market in India is small despite an attractive performance history. It is the lack of familiarity with the instrument, which keep the investors at bay and prevent an active participation. In FY19, the pool of securitized assets doubled from Rs. 850 billion to Rs. 1.9 trillion. However, 65% of securitized assets were direct assignment to banks, where-in the rating agencies had to provide just one-time loss estimation at the time of assignment and not on-going surveillance. Today, public sector Banks prefer buying portfolios instead of PTCs which are rated as the later falls into the investment book of the banks, thus requiring mark-to-market valuations.

Having established the case for strengthening the securitization market in India, we now focus on how it can be done and the required infrastructure for the same. We can broadly classify them into a) Setting up of intermediating entity/ies which under-writes the securitized pool of assets, b) Necessary Regulations while buying the loans for the securitization, c) Creating the supporting market infrastructure, d) Actions to incentivize the demand for securitized assets, and e) Regulatory Oversight

a) Setting up of intermediating entity/ies which under-writes the securitized pool of assets

Taking a cue from the global experience, the first step to expanding the securitization market would be to set-up entities which will take the lead and buy the loans from various originating bodies like NBFCs and banks. These entities will have the technical know-how and create pools with various levels (in terms of seniority) of tranches, will get them rated by the credit rating agencies and down-sell such securities to potential investors who can invest in such tranches according to their risk appetite. These bodies will need to develop a thorough understanding of the duration and credit risk appetite of its investors and create the securitized tranches accordingly.

To start with, HUDCO or NHB in the housing sector and SIDBI in the MSME space can take the lead and set up a company/subsidiary that will play the above said role. But eventually, we need to ensure that these entities are privately held and listed, backed by an implicit guarantee from the Government of India. This will help to ensure that the entities operate with an independent management, enhanced transparency, checks and balances from shareholders, have a robust underwriting process built into the model aided by latest technology, and have a state-of-the art analytics framework. Focus should be on the development of an independent in-house underwriting team over time.

The implicit guarantee from the government will enable to reduce the cost of borrowing for these entities. Further, since they are not an originator of loans and will operate in the wholesale market, they stand to gain from reduced operating cost (since they do not deal with retail customers, they do not need to incur the cost of setting branches, and hiring the required manpower). Consequently, they can purchase the loans from the NBFCs at an attractive cost so that these lenders in turn can provide more loans to the qualified borrowers, and improve their profitability matrix. The securitization will not only help to spread the risk, but also reduce the cost of long-term funds for the NBFCs and enable higher credit growth in an under-leveraged Indian economy.

b) Necessary Regulations while buying the loans for the securitization

While listing of the entity and making them privately held will ensure certain checks and balances, the regulators can also impose additional guidelines for the above said entities with an objective to ensure that these entities maintain a healthy balance-sheet. Some of the plausible regulations include:

* Ability to take on leverage should be capped at, say ten times, compared to net worth so as to prevent the unwarranted rise in contingent liability and keep the balance-sheet of these financial entities intact
* The regulators can impose guidelines for the quality of loans that can be bought from the originators.
* It can be mandated that before a pool of loan becomes eligible for securitization, the asset pool should be serviced by the originator on its own book for a minimum period of six months or more
* The originator should be mandated to hold a minimum of 10% of the loan pool throughout the lifetime of such securitised assets and maintain at least 10% of the amount of assets sold under securitisation in the form

of bank FDs. These clauses will ensure that first-loss in the case of default will be borne by the originator and thus will help in keep a check on the underwriting process and quality

* The proposed entity should not hold more than a certain pre-specified % of assets securitized on its own balance sheet post expiry of six months from the date of securitisation, so that the ultimate risk correctly lies in the hands of the investor and free-up liquidity for further lending. The key objective of securitization is to spread/diversity the risk and not to transfer them from one balance-sheet to another.
* Over a period of time, these securitizing entities should categorise and create a 'Black list' of originators who have poor under-writing standards.

c) Creating the supporting market infrastructure

Apart from the proposed entity which buys loans and create securitisation, development of other necessary and supporting market infrastructure will also play a key role:

* An independent servicer company should be set up, which will create the required infrastructure and collection mechanism over time depending upon the asset class. Network of the existing Banks/ NBFCs can be leveraged against a commission. Servicer company will ensure that loan recovery doesn't depend solely on the capacity of loan originator.
* Over-time, RBI or NHB or any other entity can regularly publish high quality data on pool performance
* Rating agencies should not only rate these securitized papers, but also publish additional details on securitized assets. For instance, information and analytics should be available on the geographical spread of the loan portfolio, IRR distribution, LTV distribution, original and residual maturity of the loan, credit enhancement features, and first loss aspect (if any).
* NBFCs should be asked to show full details of all securitization and pool performance along with their quarterly results.
* Land titles should be digitized and a common data base of all the titles should be maintained.
* GST network data source can be utilized for credit appraisal of SMEs and MSMEs – Currently, lack of adequate documents/ information on small and medium enterprise makes the banks cautious in lending to these entities. Government can work with banks to work out the best way to utilize the data base while at the same time ensuring the data security and confidentiality.
* Actions are needed to develop the secondary market trading in securitized assets, maybe a concept of market makers with some special privilege.

d) Generation of Demand for Units of Securitised Assets

* Create a separate quota for Foreign Institutional Investors,
* Relaxation of rules pertaining to investment in all asset backed securitization (ABS) by NPS, provident funds and insurance companies.
* Banks can be provided with relaxation in SLR/ CRR ratios, lower risk weights for such loans. A portion of such securities can also be included as part of HQLA for calculation of LCR.

e) Regulatory Oversight

We need to ensure a strict regulatory oversight for such an institution in consultation with RBI, to ensure compliance with pre-defined policies and risk parameters.

Conclusion

India needs to build a vibrant securitization market. It will not only help to strengthen the India financial sector stability, but also percolate positively on the real economic growth. A growing, large economy actually needs an efficient risk sharing mechanism and not hyper concentration. Financial stability is more important than ever to keep growth trajectory right.