Challenges in the NBFC Sector and Development of Securitisation Market

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The fast growing NBFC Sector is an integral and important segment of the country's financial landscape. Not being as tightly regulated as banks it offers scope for innovative customized products and processes to deliver last mile credit to unbanked and underbanked sectors and geographies, thereby deepening financial inclusion. Some NBFCs efficiently carved out niche markets like commercial vehicle financing, pre- owned vehicle financing, asset financing and then diversified to cover retail, SME and commercial sectors, becoming almost like banks.

As on January 2021, 9507 NBFCs were registered with RBI. RBI has classified them into 12 categories based on the activities they undertake, which are as varied as account aggregators, P2P platforms, Mortgage Guarantee Cos., Infrastructure Development Funds, etc. The focus of this article is the NBFC- Investment and Credit Companies (ICC), NBFC- Micro Finance Institutions (MFI) and NBFC- Housing Finance Companies (HFC) which are essentially in the business of lending in retail, MSME and commercial sectors.

Bank borrowings and non-convertible debentures constitute the main sources of funding for this group, with some short term resources raised through CPs. NBFCs credit to GDP has been steadily increasing and currently stands between 11-12%. Over the years, NBFCs have assumed systemic importance due to their interlinkages with banks and capital market.

The lockdown of 2020 and consequent slowdown of economic activity imposed a heavy burden on NBFCs, worst affected being MFIs. NBFCs had to face the challenge of declining collections, resulting in a liquidity crises and stressed asset scenario. The impact was felt on profitability. Market started differentiating between highly rated well governed NBFCs and others, with funding becoming difficult for the latter. Some liquidity measures and regulatory forbearance by RBI enabled them to weather the storm, but the full impact of the pandemic on asset quality will only become evident over time. Some estimates place the stressed book (GNPA + restructured) at a high 9.5-11% as on September last year.

The regional lockdowns during the 2nd COVID wave impacted both urban and rural areas and fresh disbursals slowed down. The loss of livelihoods and closure of small businesses adversely impacted debt servicing capabilities as also demand. Even some well established NBFCs saw a doubling of bad loans in Q1 FY22. Vehicle financiers are likely to see the steepest decline in collections due to lower utilizations of commercial vehicles, school and tourist buses and taxi operator services. While housing segment should be resilient, certain sectors in SME segment, particularly service oriented sectors, will witness increased delinquencies. Short term challenges are immense. The uncertainty of a 3rd or even a 4th wave looms large. Much would depend on the speed with which the economic revival takes place, the severity of any future wave of the pandemic and the speed of vaccinations.

To shore up capital and resources, large NBFCs with good ratings accessed the market for adequate liquidity buffer. But smaller NBFCs face a challenge due to higher provisioning, adverse impact on profitability and on credit ratings. We may see some consolidation and restructuring in the sector. Big established players are expected to improve market share.

NBFCs, other than HFCs, do not have any recourse to refinance facilities. Over the years, to free up capital and increase capital efficiency, as also for liquidity and asset risk management, NBFCs increasingly resorted to securitisation and assignment of pools of standard assets to banks. During FY2019 and 2020 close to Rs 2 lakh crore securitisation volumes each year were seen. Banks participated in these to meet the shortfalls in their priority sector targets, to diversify risks and to grow at a fast pace. Assignment, through bilateral deeds, is the more popular route, being less complex, and is a significant part of the business model of NBFCs and MFIs. Both securitisation and loan assignment enables NBFCs to capitalize on their core strengths of : (1) Origination - given their flexibility, customized products and customer proximity; and (2) Collections – as they earn a fee through collections and servicing of the underlying loans.

Typically, securitisation is done for standard assets by issue of pass through certificates (PTCs) through a Special Purpose Entity (SPE). Securitisation through non- convertible debentures is yet to take off. Securitisation through PTCs is mostly seen in housing loans and other mortgage backed securities, vehicle loans and micro finance loans. SPEs are bankruptcy remote, with transferred assets beyond reach of originator or its creditors and securitisation is required to be done on a "true sale" basis with little recourse to originator. It involves credit tranching, wherein the 1st tranche (junior tranche) is held by the originator. Credit enhancements

are available to the investor through bank guarantees, cash collateral, over-collateralisation, etc. While PTCs are expected to make loans liquid, by becoming tradable, unfortunately the lack of a vibrant secondary market for such securities has resulted in most PTCs being privately placed to pre- identified investors. To enlarge the investor base, the regulator recently permitted FPIs to invest in unlisted PTCs.

Recognizing that the securitisation and co-lending market and sale of loan pools through assignment play a significant role in the growth and development of NBFCs, RBI released two draft guidelines, namely, a Draft Framework for Securitisation of Standard Assets and a Draft Comprehensive Framework for Sale of Loan Exposures on 8th June 2020. For brevity's sake we will refer to them as Securitization Framework and Loans Framework. The final guidelines are awaited as on date. It is evident that RBI is keen to develop the securitisation market and to strike a balance between flexibility (important for financial inclusion) and tighter regulations. To create a level playing field for NBFCs-MFIs and to improve their competitiveness, RBI issued a Consultative document on 14th June 2021 proposing a common definition of microfinance loans applicable to all regulated entities.

The Securitisation Framework defines "securitization" as:

"The set of transactions or scheme wherein credit risk associated with eligible exposure is tranched and where payments in the set of transactions or scheme depend upon the performance of the specified underlying exposures as opposed to being derived from an obligation of the originator and the subordination of tranches determines the distribution of losses during the life of the set of transactions or scheme".

The draft directions require servicing of securitized assets to be on an arms length basis with no obligation on servicer to pay the cash flows in case of shortfall of collections. Payment priorities have been detailed and appropriate legal comfort provided regarding their enforceability.

The Framework addresses a number of issues:

- It seeks to increase the participant base by permitting a wider range of entities (like mutual funds) to invest in these securities and by making public offering (listing) mandatory whenever residential mortgage backed securities (RMBS) exceed Rs 500 crores. This limit should be reduced to Rs 100 crores for wider impact.
- It includes securitisation of operating lease receivables and trade receivables.
- It proposes to do away with the current restriction applicable to assets purchased from other entities.
- In recognition of the fact that RMBS carry lower risk and have longer tenors, the framework has carve-outs for minimum retention requirement (MRR) and minimum holding period (MHP) and has provision for reset of credit enhancements. The MRR has been reduced to 5% (from 5%-10%) and the MHP has been reduced to 6 months or 6 instalments, whichever is later, from 12. The regulator should also consider nil MRR for certain class of residential mortgages.
- It permits single asset securitisation – relevant for longer tenor loans to be securitised in full or in part.
- It permits securitisation of bullet payment loans, provided instalments of either interest or principal are paid.
- Replenishment structures, defined as "process of using cash flows from securitized assets to acquire more eligible assets which will continue for a pre-announced replenishment period" should help securitise shorter tenor consumer and micro finance loans.
- It introduces an STC (Simple, Transparent & Comparable) framework for NBFCs with lower risk weights - External Ratings Based Approach (ERBA), in line with Basel III. The STC framework also includes clarity on homogeneity of a pool.

The attempt of the regulator is to move the market towards greater securitisation, to deepen the secondary loan tradable market and to align it with Basel III requirements. Exemptions are few, namely, revolving credit facilities (like cash credit, credit card receivables), loans with bullet repayments of both principal and interest and synthetic securitisation.

The Loans Framework proposes major changes by doing away with minimum retention requirement, price discovery process and resale of loans. This would motivate larger NBFCs to purchase loans from smaller players, consolidate them and resell to banks, thus promoting the growth of small financial intermediaries and thereby financial inclusion.

The Securitisation Framework lays importance on detailed disclosures and provides for appropriate legal comfort, in line with the market practices prevalent in jurisdictions which have well developed secondary markets. It seeks to address the numerous shortcomings and challenges in this market and we look forward to a new vibrancy when the final guidelines are implemented.