ICRA's knowledge report on NBFCs - Regulators as Enablers to Financial Lending Companies

JUNE 2024

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Shri Deepak Sood

Secretary General, ASSOCHAM

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Non-banking financial companies (NBFCs) and infrastructure financing have emerged as growth catalysts in India's dynamic financial landscape, spurring economic empowerment for small businesses and infrastructure finance. As the country aspires to be 'Viksit Bharat', the role of the NBFC sector will be more critical because it is playing an important part and becoming an integral member of the financial ecosystem, contributing to the stability, innovation, reach and profitability of the financial system. Thus, the challenges hindering the growth of NBFCs need a reassessment.

The Government's focus on providing relief and enhanced credit flow to the industry, particularly to small businesses, has resulted in a more positive macroeconomic outlook across industries including financial services. This focus is also supplementing national policies that target poverty reduction, women empowerment, assistance to vulnerable groups, and community development. These efforts are being supported and financed by NBFCs, microfinance institutions and infrastructure financing.

Given the highly dynamic nature of this segment, regulators and policymakers have worked to ensure that the regulations are commensurate with the risks. The regulators are cognisant of the balancing act required while devising regulations to ensure that the segment develops in an orderly manner without creating any challenges or risks for the overall financial system.

In this backdrop, ASSOCHAM is conducting its 10th National Summit on NBFCs and infrastructure financing.

Earlier editions of the ASSOCHAM National Summit on NBFCs and infrastructure financing had received an overwhelming response from the industry, creating a vibrant platform for encouraging dialogue between policymakers, regulators and industry stakeholders.

To set the tone for the 10th National Summit, ASSOCHAM and ICRA Limited have jointly prepared a comprehensive knowledge paper on 'Regulators as an Enabler of Financial Lending Companies'. We hope this report, along with the discussions during the summit, will help the regulators, market participants, government departments and research scholars develop financial services further.

I thank the knowledge partner for their valuable contribution and convey my best wishes for the summit's success.

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Karthik Srinivasan

Senior Vice President and Group Head,
Financial Sector Ratings, ICRA Limited

"The NBFCs registered a robust expansion in the last two financial years, boosting their position in the overall financial ecosystem. However, their improved systemic importance and higher interconnectedness, especially with the banking sector, have led to increased regulatory oversight and actions in the recent past.

The sector emerged relatively unscathed from the Covid-19 pandemic-related disruptions, thanks to the timely interventions of the Government of India (GoI) and the regulators. Entities built up capital and provision buffers during the pandemic, which, along with the calibrated growth, regulatory forbearances and funding support, helped them weather the adverse operating conditions that prevailed during that period.

Sizeable pent-up credit demand, after the pandemic, resulted in a sharp credit expansion, especially in the retail segments. During 2010-2020, NBFCs largely focussed on asset-backed lending and steadily built their franchises. Constant improvement in credit bureau data and better understanding of borrower cash flows helped them fine-tune their underwriting processes. This was further boosted by the digitalisation of their credit process, which started gathering pace from 2018-2019, and access to alternate borrower data that helped them widen their target borrower base and expand their credit offerings. As a result, personal and consumption loans increased sharply, especially after the pandemic, but this segment has emerged as another monitorable, attracting regulatory tightening. Losses in this segment would be higher than the conventional asset-backed lending of NBFCs. Thus, various internal control measures and early warning signals are key.

Entities in this space have a robust risk profile, supported by an adequate capital structure, comfortable asset quality and healthy earnings. However, headwinds remain with interest rates remaining elevated for longer periods, increasing competitive pressure from banks and concerns around loan quality in view of lower seasoning and higher borrower-level leverage.

NBFCs continue to focus largely on the credit-underserved or new-to-credit segments, which overlap with the priority sector exposures. Digitalisation has, in general, improved the overall loan cycle experience of the borrowers and is playing a key role in furthering financial inclusion in the country."

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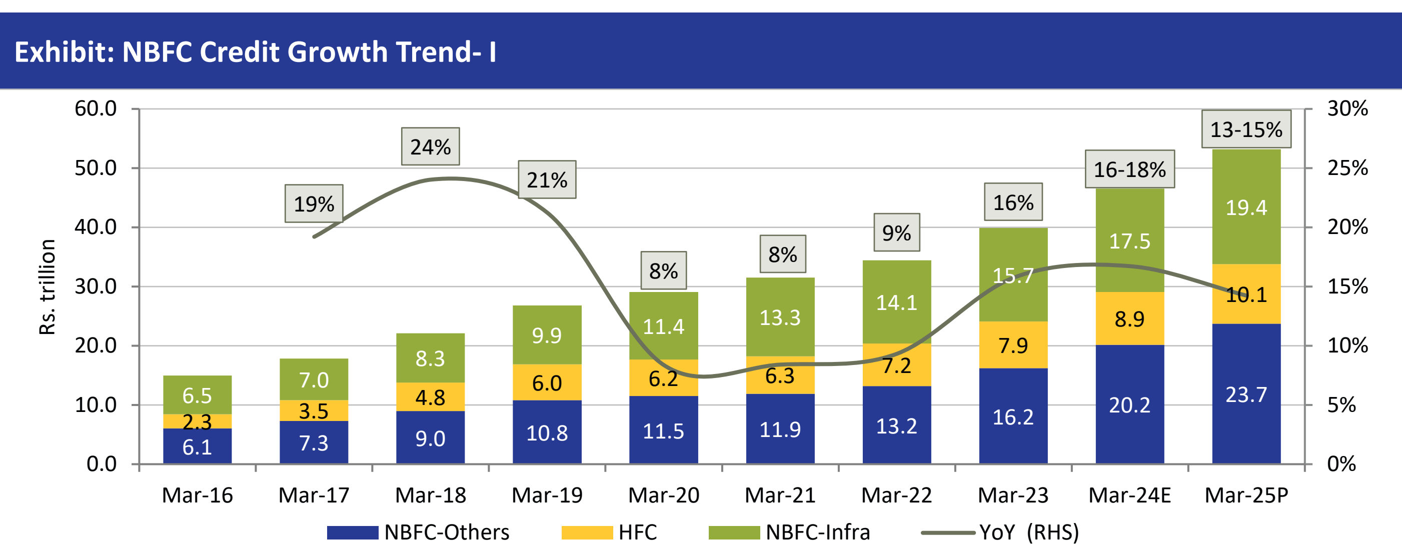
High Growth Catapults NBFCs' Systemic Importance

NBFC credit set to cross Rs. 50-trillion mark this fiscal

NBFCs[1] have weathered various hurdles in the past decade, emerging stronger in the process. The sector had faced numerous exogenous developments, which had briefly impacted their businesses and finances, before the significant disruption caused by the Covid-19 pandemic. NBFCs, however, braved all these hurdles and adequately augmented their resilience to provide confidence to various stakeholders on their ability to take up future challenges.

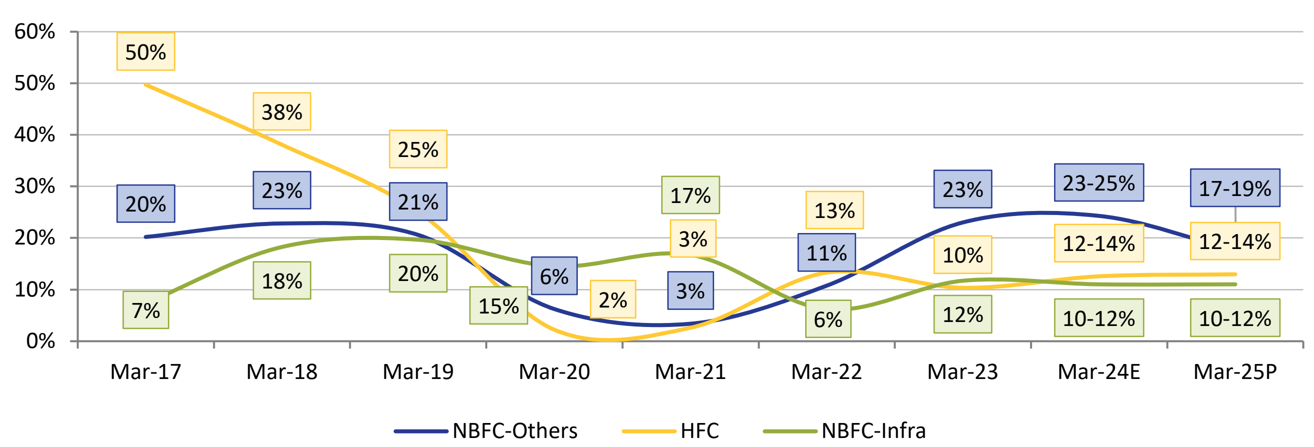
Emerging strongly from the pandemic impact, the sector growth revived in FY2023 and remain healthy in FY2024. While the growth remained lower than the historical highs, it was healthy considering the expanded base. NBFCs, excluding the HFCs and NBFC-Infra, shall continue to expand at a higher pace driven by the retail assets growth. Overall NBFC credit is set to cross the Rs.50 trillion mark (~Rs. 34 trillion excluding NBFC-Infra) in FY2025, even as growth rate is set to moderate, on an enlarged assets under management (AUM); access to commensurate funding however would remain key for meeting these growth projections, even as the target segments of NBFCs remain largely credit underserved.

Exhibit: NBFC Credit Growth Trend- I



Source: ICRA Research; E-Estimated, P-Projected; HFC data is excluding HDFC Limited for all the past period
Note: NBFC-Others exclude HFCs and NBFC-Infra AUMs

Exhibit: NBFC Credit Growth Trend - II



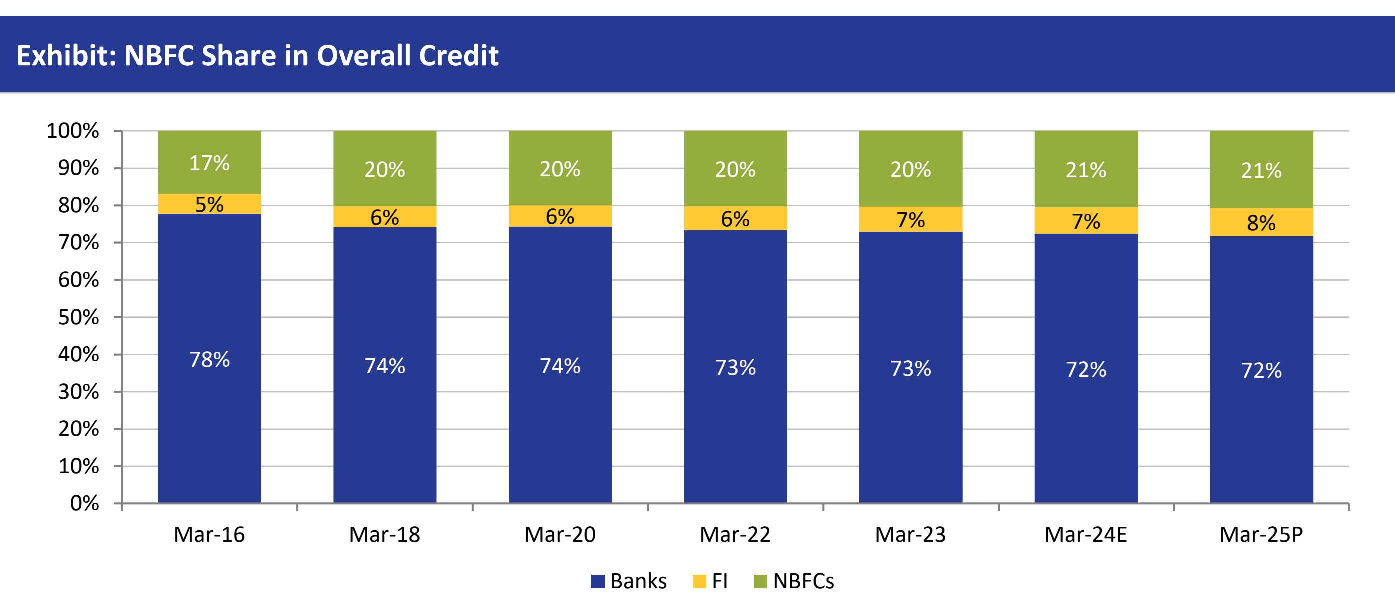
Source: ICRA Research

[1]*Including HFCs*

High portfolio growth and rising share of non-traditional products leading to increased regulatory oversight

NBFCs have steadily improved their market position by expanding at a healthy compound annual growth rate (CAGR) of ~15% during FY2017-FY2024[2] , while the loan book of banks recorded a CAGR of ~11% during this period. Overall, NBFC credit has tripled in the last eight years. Excluding NBFC-Infra, the sector's AUM increased at a CAGR of ~17% during the above-mentioned period.

Exhibit: NBFC Share in Overall Credit

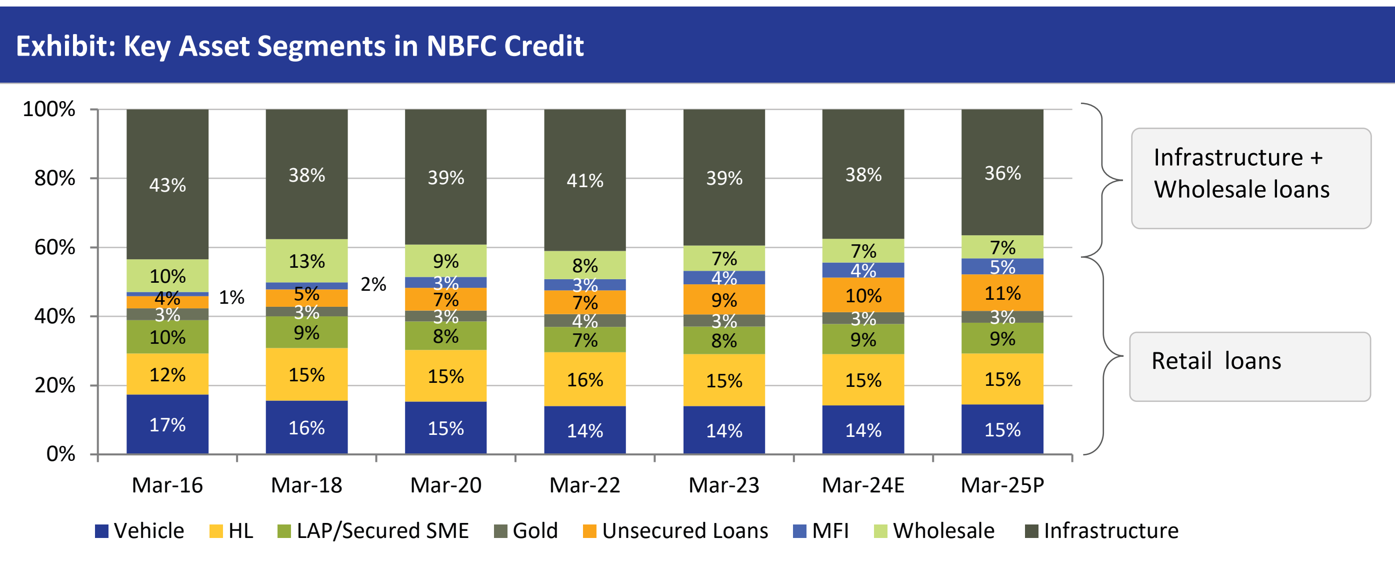


Source: RBI, ICRA Research; FI- All India Financial Institutions

Considerable growth in the AUM also warranted adequate regulatory evolution in view of the new products and services and the increased interlinkages between NBFCs and various financial sector entities. The sector also witnessed the emergence of new players operating in the non-traditional segments and the advent of technology, which revolutionised credit and product delivery and, led to a steep expansion in the borrower base.

[2] *March 2024 loan book data is estimated; HDFC loan book considered as part of bank credit for past periods*

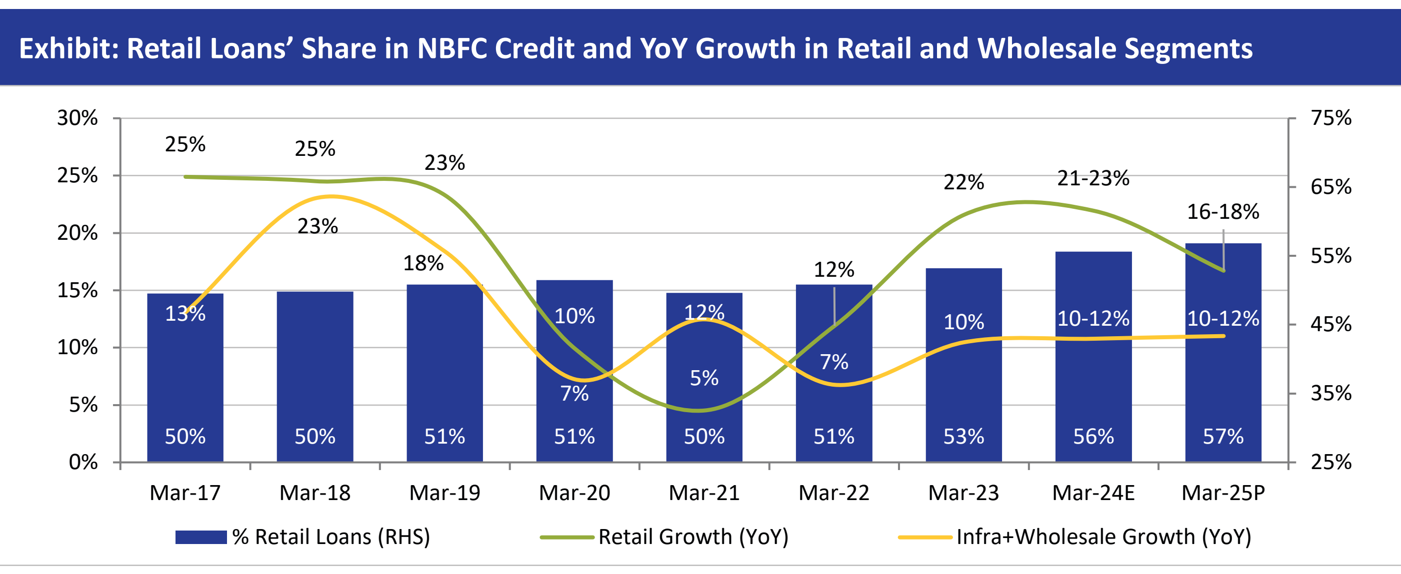
Exhibit: Key Asset Segments in NBFC Credit



Source: ICRA Research, MFIN Micrometer; MFI – Microfinance; Unsecured loans includes personal and consumption loans and unsecured business loans; HL – Home loans; LAP – Loan against property

Retail loans increased at a CAGR of 18% during FY2017-FY2024, driving the overall sectoral growth and leading to an increase in retail loan share in the overall NBFC credit. Retail loan growth was driven by unsecured loans (microfinance, personal and consumption loans and unsecured small and medium enterprise [SME] loans), which expanded at a higher pace.

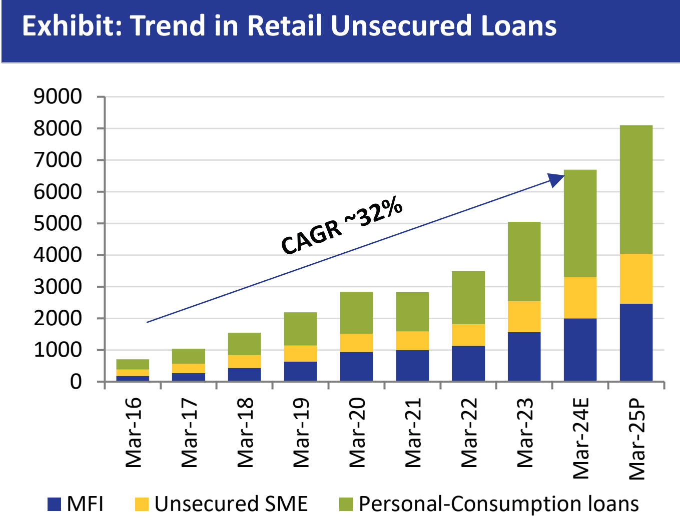
Exhibit: Retail Loans' Share in NBFC Credit and YoY Growth in Retail and Wholesale Segments



Source: ICRA Research

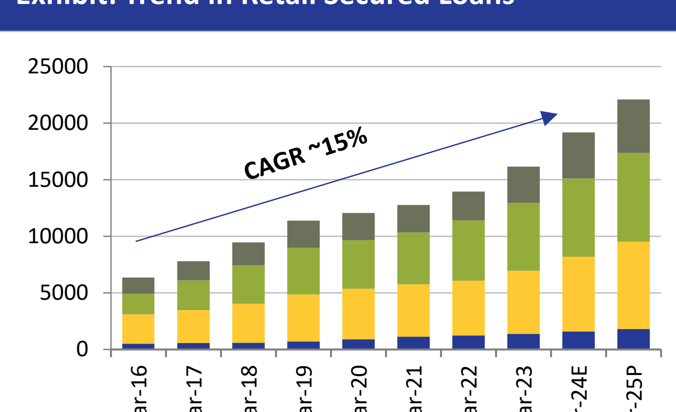
The share of unsecured retail loans is estimated to have increased to 14% of the overall NBFC credit (23%, excluding NBFC-Infra) in March 2024, up from 5% in March 2016. Unsecured loans expanded at a CAGR of about 32% during FY2017-FY2024, but on a lower base; this is double the growth rate of retail secured loans (vehicle, home loans (HLs), loan against property, gold, etc) during the same period.

Exhibit: Trend in Retail Unsecured Loans



Source: ICRA Research; Amount in Rs. billion

Exhibit: Trend in Retail Secured Loans



Source: ICRA Research; Amount in Rs. billion

Microfinance loans expanded at a CAGR of 35% during FY2017-FY2024. As a credit product, microfinance focusses on underserved borrowers, facilitating financial inclusion. The regulatory framework for this segment has also evolved proportionately in the past decade.

Personal and consumption loans, within the unsecured loans segment, expanded at a sharp pace in the last 2-3 years, rising at a CAGR of about 42% during FY2022-FY2024.

This was driven by two factors – cross-selling and digital lending. The cross-sell strategy is being adopted to strengthen the hold on the franchise by improving borrower engagement. This involves offering credit and other financial services to meet a borrower's various lifestyle and business requirements. For example, a borrower with an HL may require a personal loan or a consumer durable loan, etc, and may also need other financial services like insurance, investment, etc. NBFCs were increasingly offering pre-approved loans to meet such requirements of their credit-tested borrowers.

For product segments in which they have a limited track record or for diversifying their borrower base, NBFCs are relying on digital lending via co-lending/partnership arrangements. These arrangements are synergistic as fintechs/smaller NBFCs are able to improve their operating leverage, while larger partners are able to diversify their borrower and product segments.

Regulators have kept pace with the evolving nature of these loans and are considering the target borrower segment – new-to-credit and borrowers with modest credit profiles. The increase in the risk weights for consumption credit in November 2023 shall raise the capital requirements of NBFCs and would require them to recalibrate their growth plans. The Reserve Bank of India's (RBI) digital lending guidelines on increased disclosures and the focus on borrower protection and transparency are also targeted at driving responsible growth in this segment.

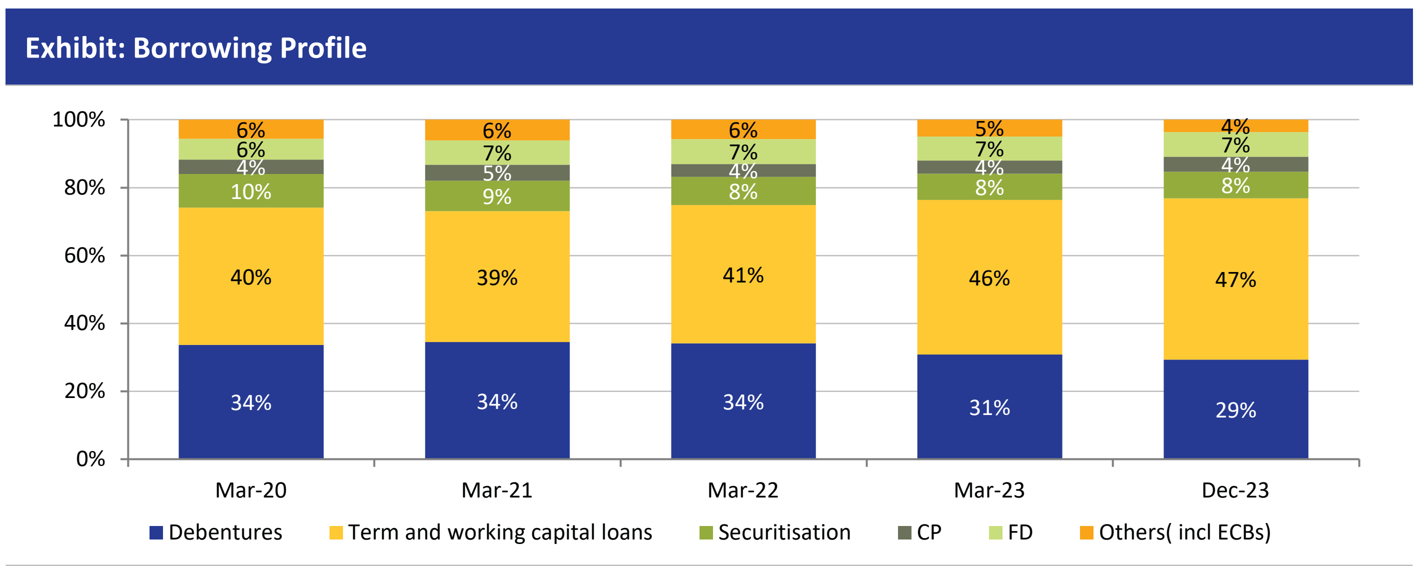
Technology adoption can improve credit delivery as well as borrower convenience. Taking this into consideration, the RBI has set up a regulatory sandbox to pilot programmes in a controlled environment to keep pace with the evolving technological landscape. The Reserve Bank Innovation Hub (RBIH) was set up to foster innovation in the fintech space.

Enhanced systemic importance and interconnectedness to financial ecosystem

NBFCs are the net borrowers of funds in the financial sector ecosystem. This, along with their high interconnectedness, could pose systemic challenges if their asset and/or liability-side risks are not addressed commensurately.

NBFCs' funding profile is characterised by long-term borrowings in the form of debentures and term loans, which account for the bulk of their total debt. The share of short-term borrowings, like commercial paper, has remained range bound in the last 3-4 years.

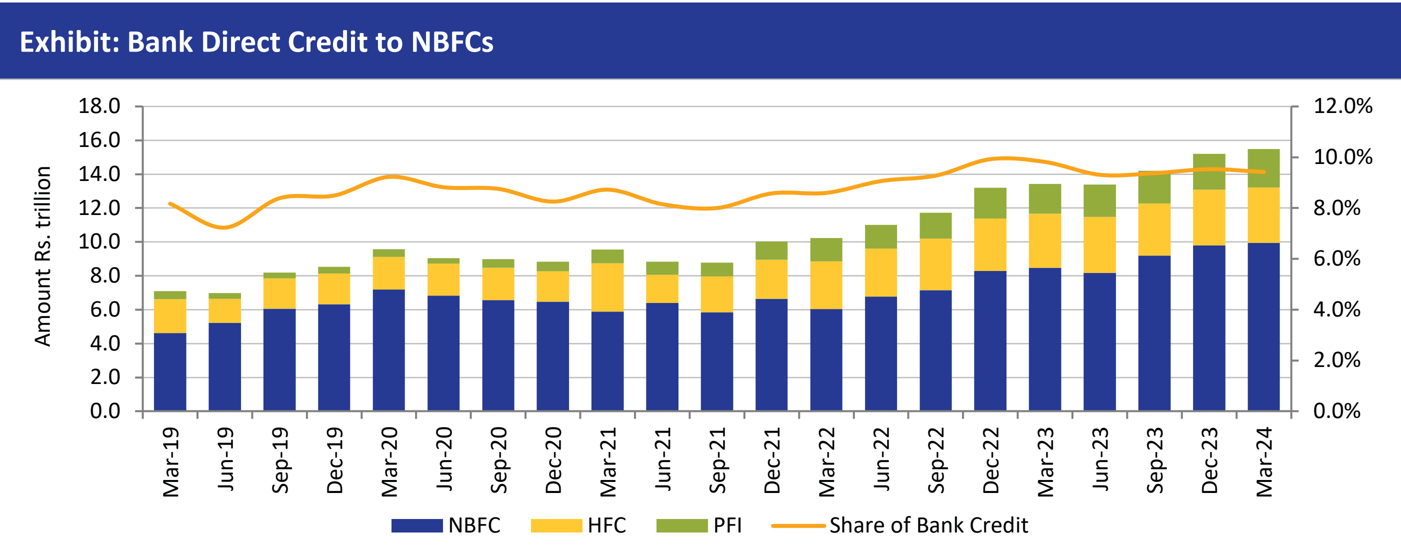
Exhibit: Borrowing Profile



Source: ICRA Research, ICRA sample of NBFC-Others and HFCs; the above sample set does not include NBFC-Infra

Banks are the largest lenders to the sector. Bank credit to NBFCs rose at a CAGR of 17% during FY2020-FY2024 vis-à-vis the overall bank credit growth of 13% during this period. As a result, bank credit to NBFCs increased to 9.5% by March 2024 from 8.0% in March 2019.

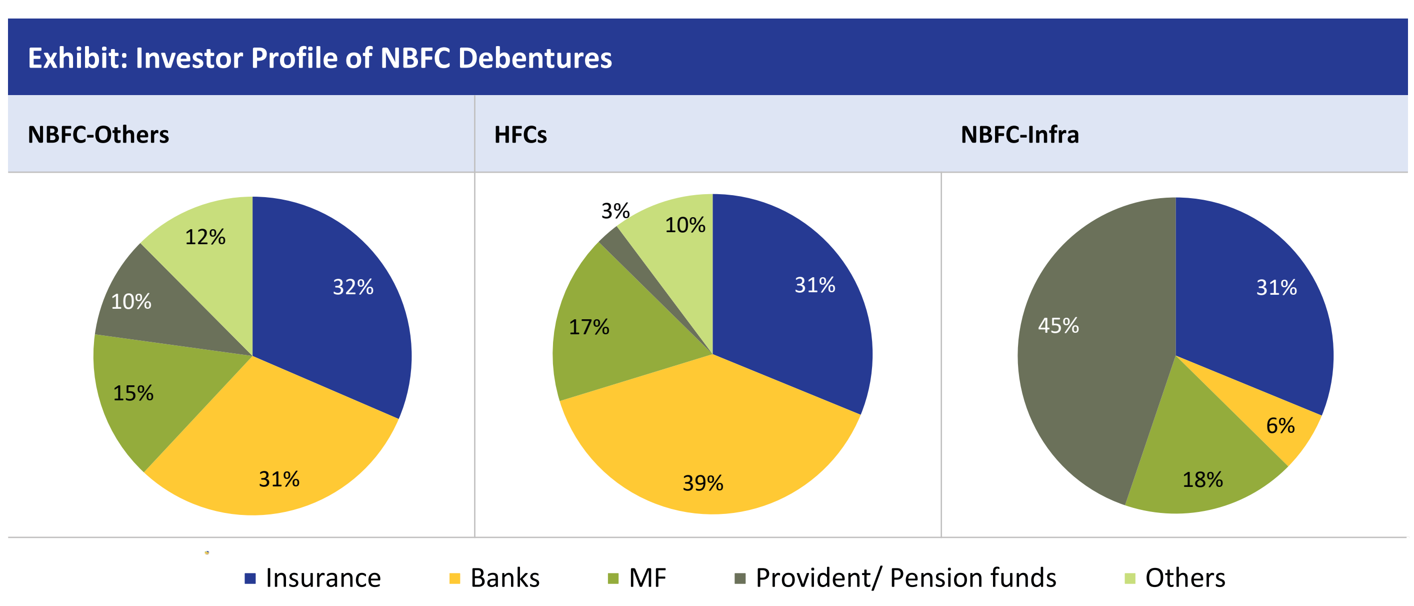
Exhibit: Bank Direct Credit to NBFCs



Source: RBI, ICRA Research

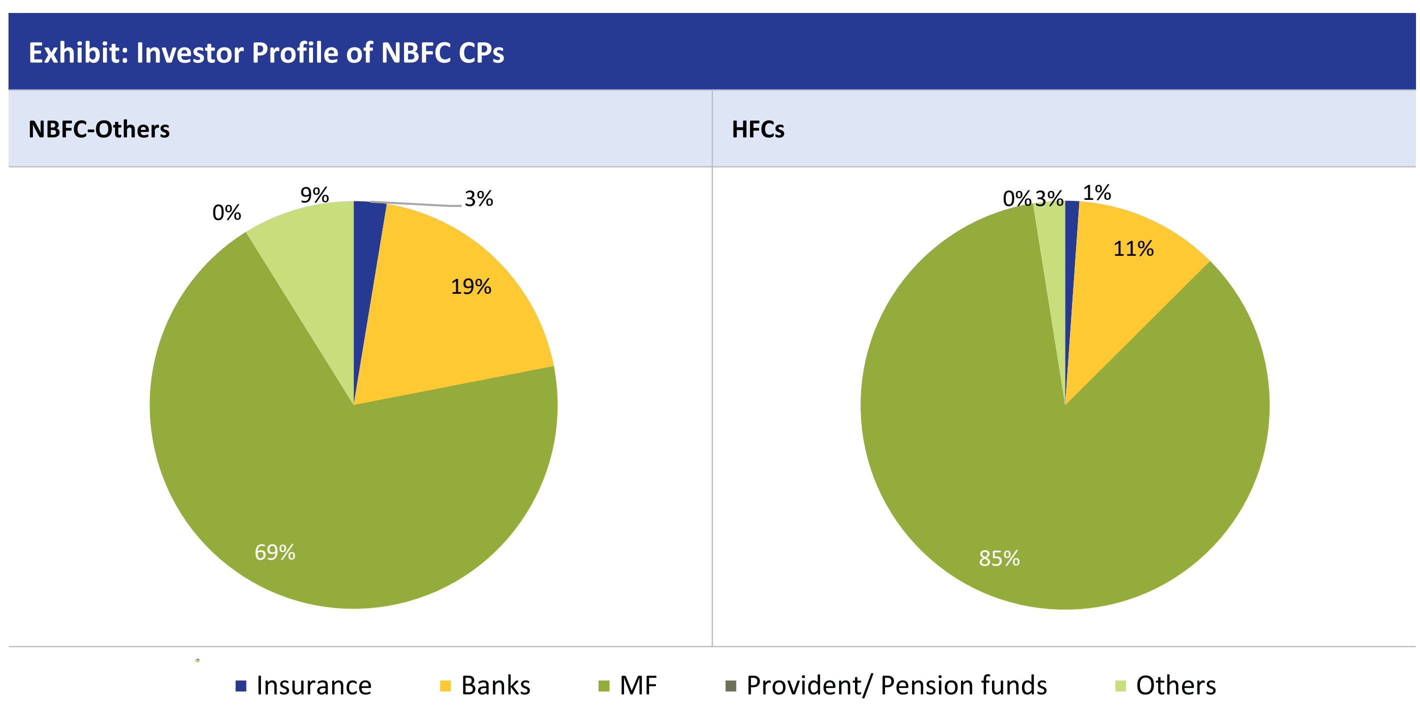
Banks also invest in various market debt instruments, especially long-term capital market debt, along with participating in securitisation and loan sell-down transactions.

Exhibit: Investor Profile of NBFC Debentures



Source: ICRA Research, data based on top 10 investors and as of September 2023

Exhibit: Investor Profile of NBFC CPs



Source: ICRA Research, data based on top 10 investors and as of September 2023; NBFC-Infra does not have sizeable CPs in the borrowing profile

As per ICRA's estimates, banks account for 2/3rd of the overall NBFC (excluding NBFC-Infra) liabilities. For NBFC-Infra entities, banking exposure (direct credit and via investments in various debt instruments) is about 30%.

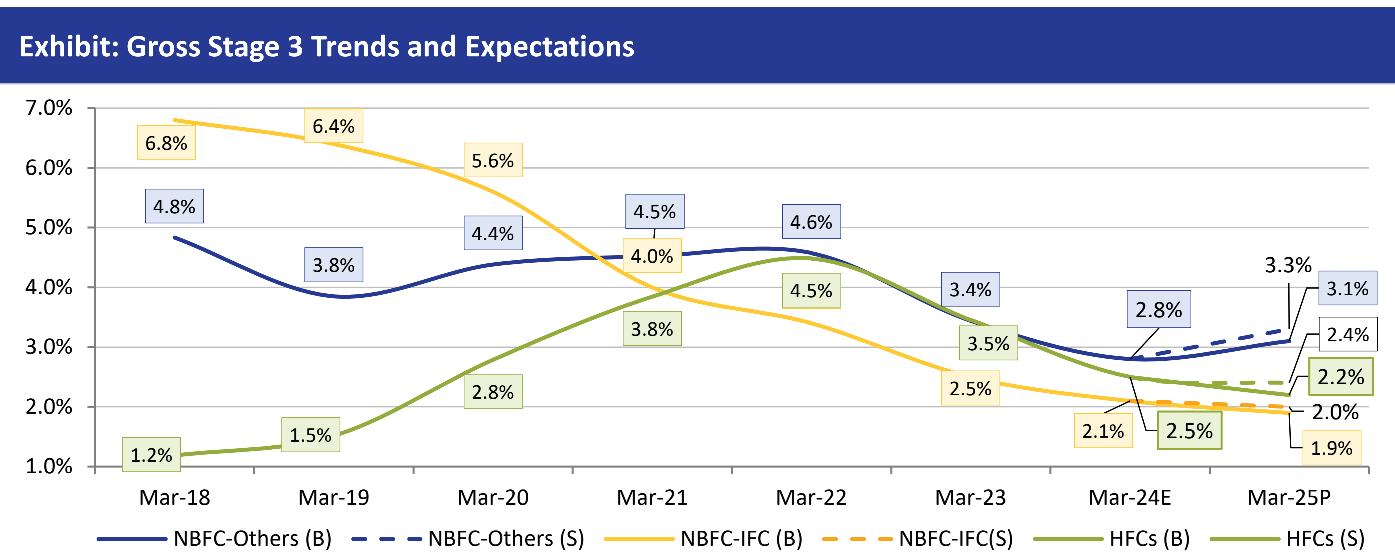
The RBI has taken note of the interlinkages with the banking sector and the increased dependence of NBFCs on banks in the recent past. Thus, the risk weights for bank credit to the sector was increased by 25 percentage points across the rating categories (AAA to A) in November 2023. The scale-based regulations and prompt corrective action (PCA) framework were also aimed at strengthening the regulatory structure in view of the increased systemic importance of the sector. The RBI has also harmonised some of the NBFC regulations vis-à-vis banks, in line with its approach towards regulations as per the nature of the risk rather than the nature of the entity.

Strengthened risk profiles fortify resilience against impact of regulatory actions

The asset quality has been on an improving trend over the last two fiscals. The unwinding of the provisions created during the pandemic and better risk profiles supported the headline asset quality numbers in FY2023 and FY2024. ICRA expects asset quality headwinds to crop up in the near term due to the seasoning impact of the sharp credit growth in the recent past, the increase in the share of riskier asset segments and concerns regarding borrower-level overleveraging.

Base estimates suggest an increase of 30 basis points (bps) in the NBFC-Others category. As this segment would be most impacted if the growth slows and the funding tightens, the jump could be marginally higher than the above levels in a stressed case scenario. The asset quality of HFCs and NBFC-Infra is expected to improve as recoveries would continue and fresh slippages are expected to be limited.

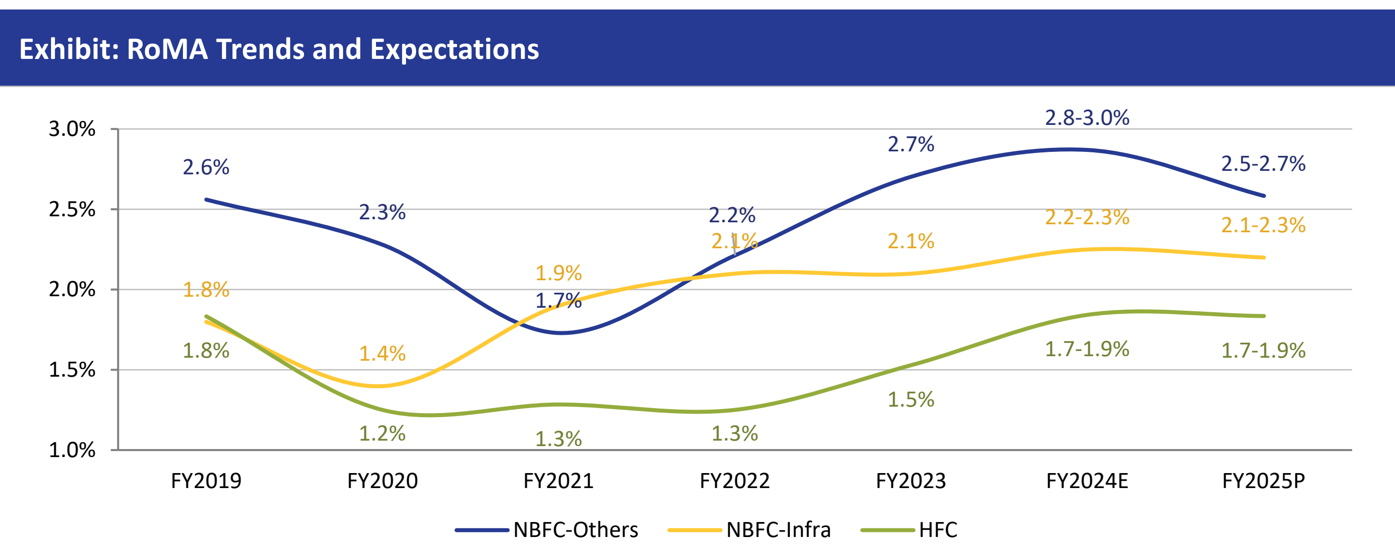
Exhibit: Gross Stage 3 Trends and Expectations



Source: ICRA Research; Data based on ICRA sample set of entities; B – Base case, S – Stressed case
NBFC-IFC - NBFC - Infrastructure Finance Companies

Profitability shall remain healthy in the current fiscal, notwithstanding the funding cost pressure and the impact of the moderation in the growth trends, especially for NBFC-Others. The return on managed assets (RoMA) shall largely remain stable for HFCs and NBFC-Infra.

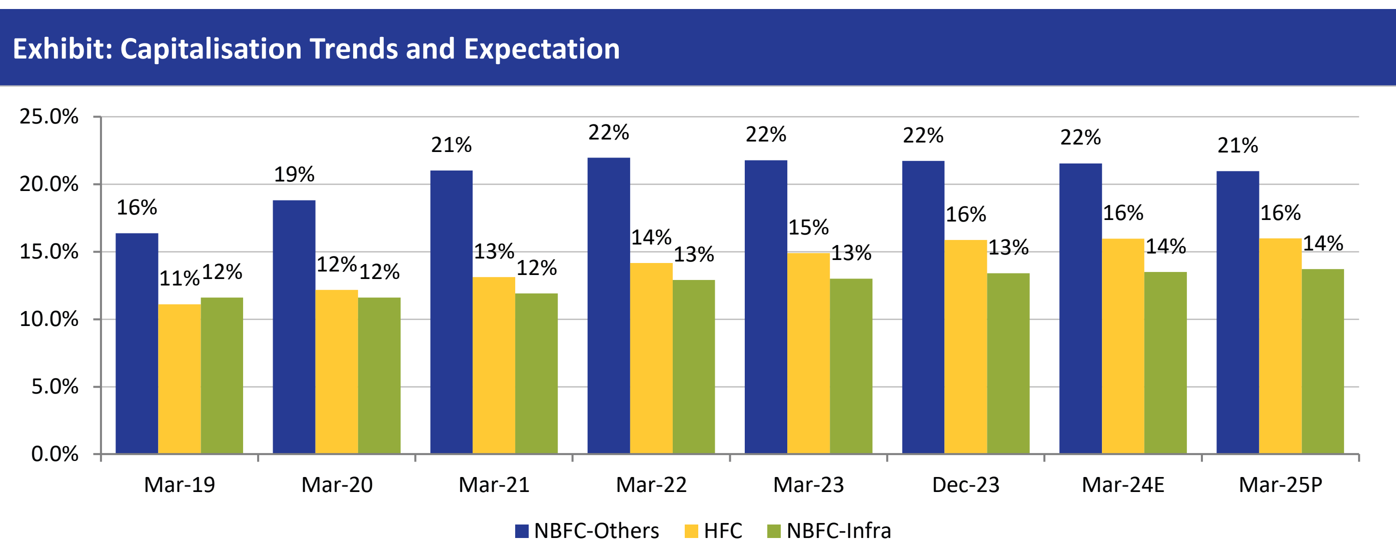
Exhibit: RoMA Trends and Expectations



Source: ICRA Research; past data based on ICRA sample set of entities

The capital profile is the key mitigant against the risks of weakening loan quality and moderating earnings, especially for NBFC-Others. NBFC-Infra, however, faces the risk of credit concentration, considering the high loan ticket sizes in the infrastructure space. The capital profile of all the key NBFC segments has improved over the past five years as internal generation remained good in relation to capital consumption, especially during the pandemic-hit years when growth had slowed down. Further, some entities raised capital to mitigate the risks visible on account of the pandemic. Currently, the capital profile of the sector is quite adequate in relation to the risks.

Exhibit: Capitalisation Trends and Expectation



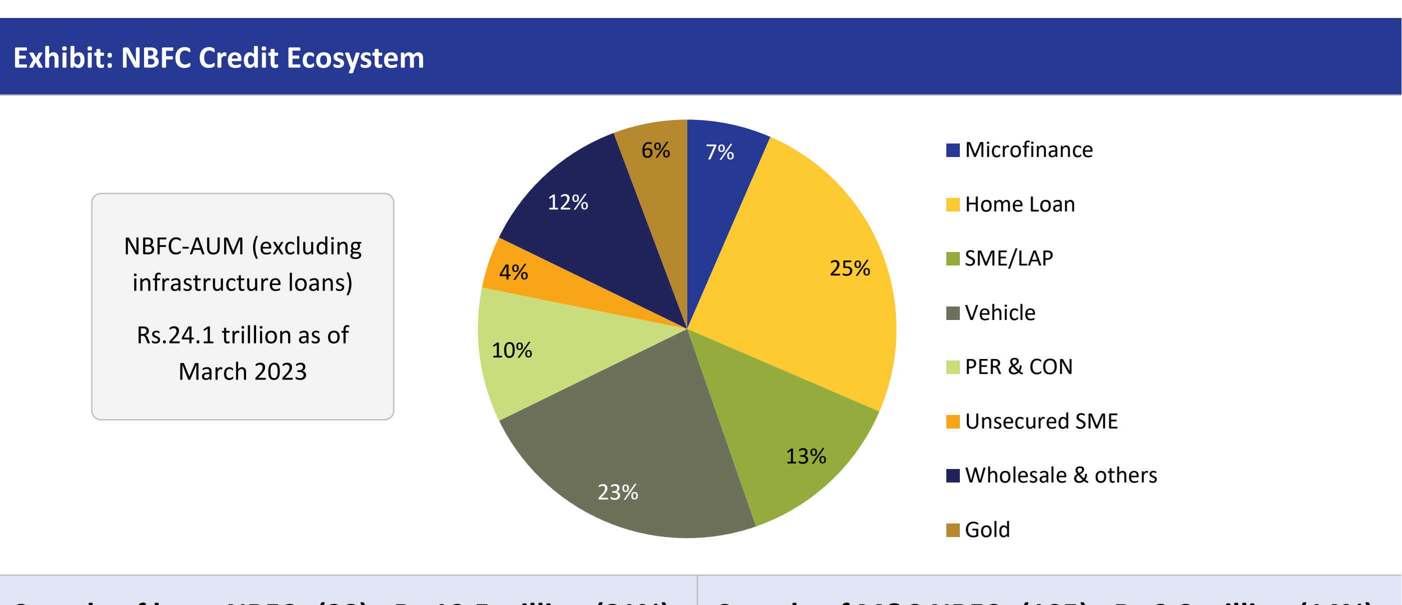
Source: ICRA Research; past data based on ICRA sample set of entities

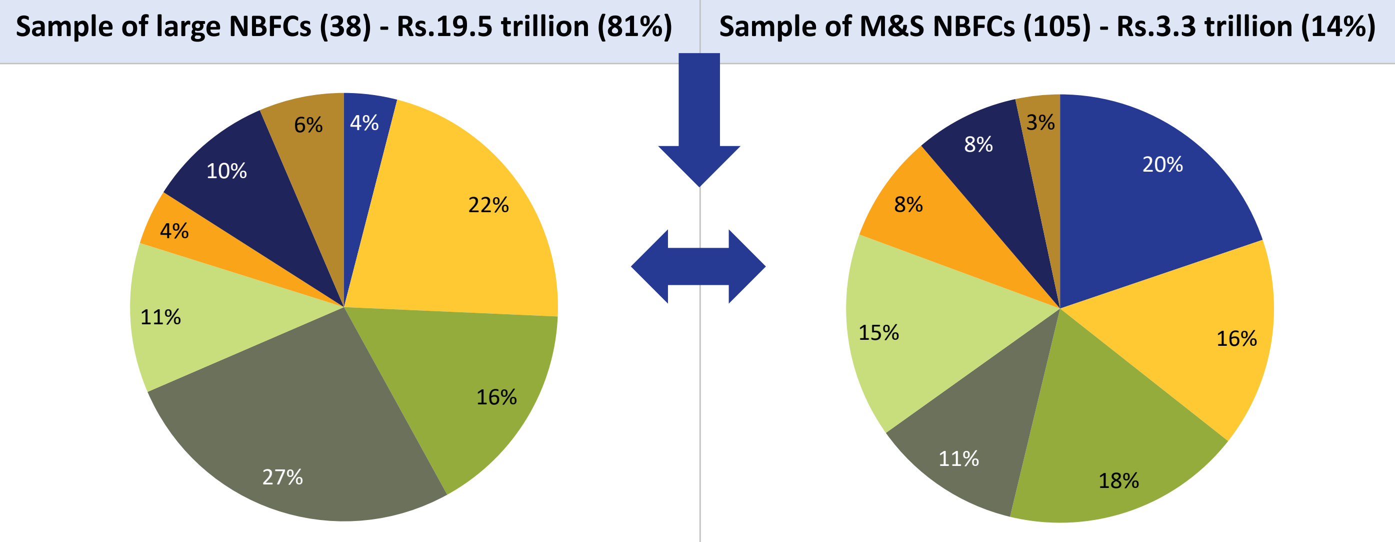
NBFCs foster credit ecosystem for underserved borrowers

NBFCs channel credit flow to traditionally underserved segments

The NBFC space is quite concentrated, with large entities accounting for the lion's share. These players have longer vintage or are a part of a corporate group, which provides them with access to commensurate funding for meeting their growth requirements.

Exhibit: NBFC Credit Ecosystem





Medium and small (M&S) NBFCs defined as entities with AUM of up to ~Rs. 100 billion as of March 2023
Source: ICRA Research; PER &CON- Personal and consumption loans

Large NBFCs[3] are generally focussed on the traditional asset segments, namely vehicle loans, HLs and small business loans, which together account for 2/3rd of the overall NBFC AUM (excluding infra loans). Unsecured loans (including microfinance) constituted about ~20% of the AUM of these entities vis-à-vis ~43% for mid and small (M&S) NBFCs.

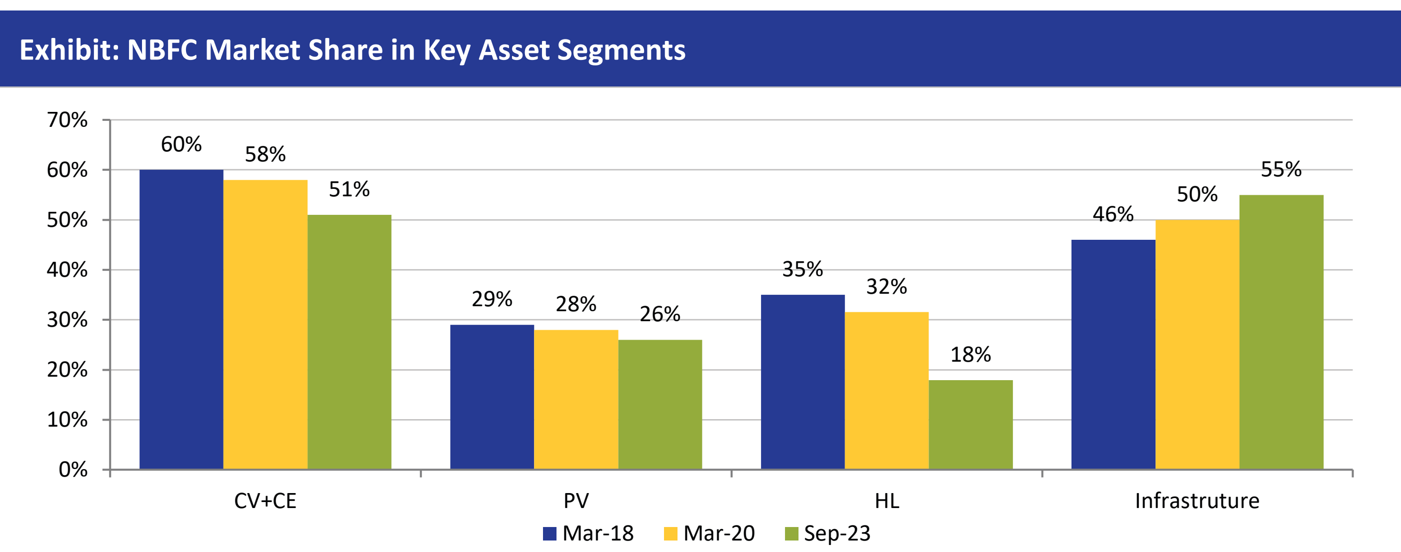
[3]*Larger NBFCs – 38 entities, which contributed 81% to the industry (excluding NBFC-Infra)*

M&S NBFCs are expected to expand at a faster pace with a CAGR of 26-28% during FY2024-FY2025 vis-à-vis the large NBFC (excluding NBFC-Infra) CAGR of 18-20%. Large NBFCs would continue to constitute about 80% of the total NBFC AUM (excluding NBFC-Infra) in March 2025.

Large NBFCs compete with banks in some traditional lending businesses. These NBFCs, especially in the vehicle finance and mortgage businesses, have carved out a space for themselves. However, increasing competition from banks, especially in the retail segments, has affected their market position.

NBFC-Infra however continued to increase their share in infrastructure loans as banks slowed down.

Exhibit: NBFC Market Share in Key Asset Segments



Source: ICRA Research; CV/CE – Commercial vehicle/Construction equipment; PV – Passenger vehicle, HL – Home loans; HL share has dropped sharply, post the merger of HDFC Limited with HDFC Bank in Q2 FY2024

NBFCs have carved out a space for themselves through their differentiated and customised credit offerings and by targeting borrower segments, which have generally been overlooked or are underserved by banks. Be it microfinance, used vehicle financing, affordable housing finance, small business loans or consumer finance, NBFCs have been on the forefront and have been early movers, thereby creating a unique franchise. Further, with their feet-on-street approach, NBFCs have been a key contributor to the financial inclusion drive in the country.

As they have created a franchise and managed their credit quality performance in challenging operating environments in the recent past, namely demonetisation, NBFC crisis and the pandemic, NBFCs are in a relatively better position to address the evolving credit requirements, powered by digitalisation, access to better borrower-level data, and innovative underwriting models. NBFCs are moving towards a borrower-focussed approach of credit delivery instead of the earlier product-focussed approach. This is also evidenced by the increase in unsecured credit observed in the recent past with NBFCs extending additional loans to its existing borrowers to meet their various credit requirements.

Used vehicle, affordable housing and business loans are focus segments

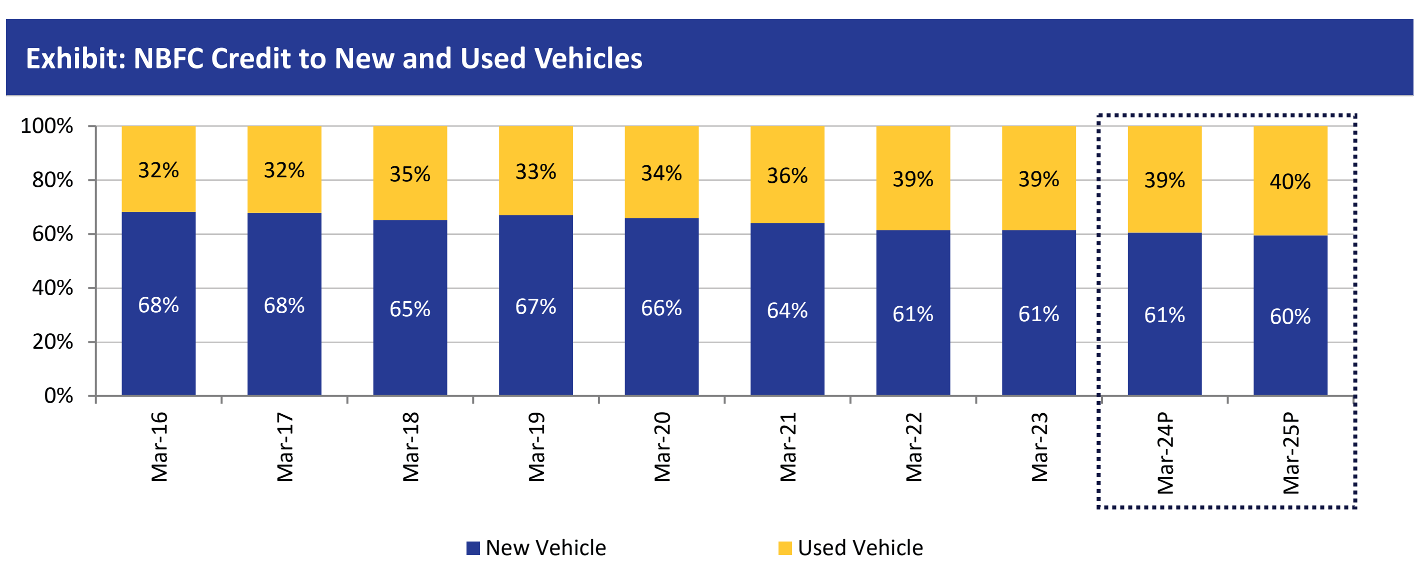
Vehicle loans and HLs constitute the bulk of the NBFC AUM (excluding NBFC-Infra), accounting for about 45-48%. Higher interest rates and competitive pressure from banks in the new vehicle loans segment and for credit to the salaried/prime borrowers in the HL space have resulted in the entities focussing on used vehicles and lower-ticket HLs in the affordable housing segment.

Within the vehicle assets space, commercial equipment (CV)/construction equipment (CE) and passenger vehicle (PV) together accounted for the bulk of the NBFC vehicle AUM at ~80% as of March 2024. CV/CE AUM is projected to expand by 12-14% in FY2025, while PV is estimated to grow by 21-23%. Overall NBFC vehicle loans are projected to grow by 15-17% in FY2025.

Banks have essentially taken up share in the new vehicle financing segment in the recent past, while NBFCs continue to dominate in the used vehicle segment. Financial penetration in used asset financing, which is a large market, is low. The share of used assets in the overall NBFC vehicle book is, therefore, projected to expand to 40% by March 2025 from about 35% in March 2020. Used vehicle loans are expected to rise at a CAGR of 19-21% during FY2024-FY2025 while new vehicle assets AUM growth is projected at 15-17%.

The increasing share of used vehicles augurs well for financial inclusion as it facilitates credit to the last mile borrowers, who are usually not catered by the banks.

Exhibit: NBFC Credit to New and Used Vehicles

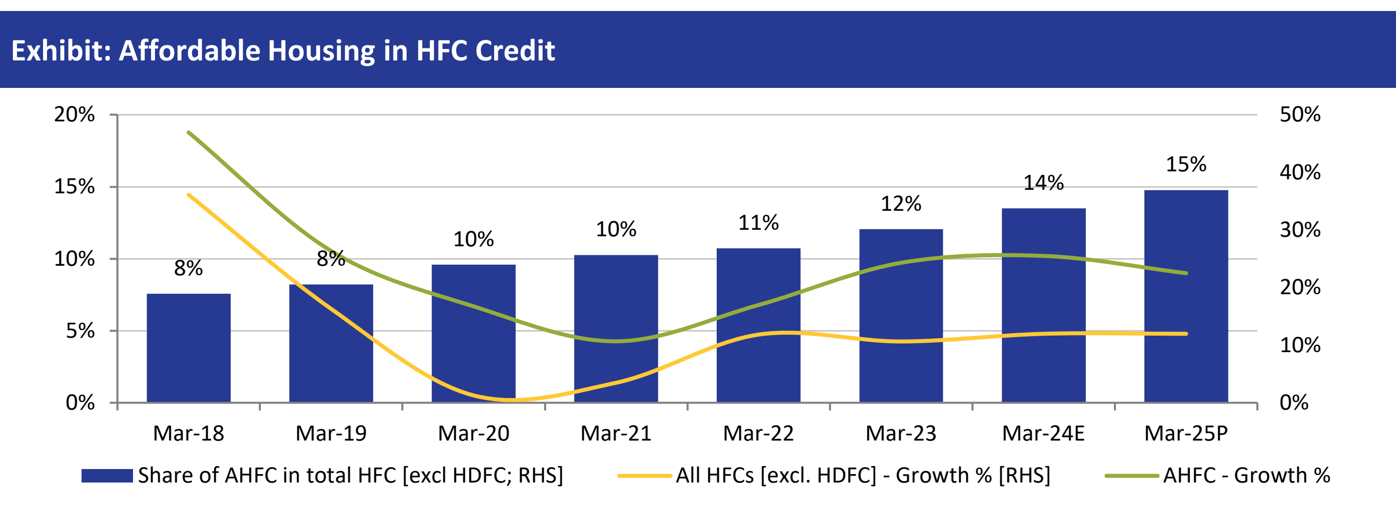


Source: ICRA Research; Vehicle – CV/CE/PV/Two-wheelers/Three-wheelers/Tractors

HLs are highly interest rate sensitive products, leading to more competition. HFCs, over a period, have steadily increased their share of loans to the self-employed category of borrowers, wherein banks have a limited presence. Further, they are largely focussing on smaller-ticket HLs, i.e. affordable housing loans.

Affordable housing loans expanded at a CAGR of ~20% during FY2018-FY2024 vis-à-vis the traditional housing loans growth of ~8% during this period. Affordable housing loans crossed the Rs. 1-trillion mark in December 2023.

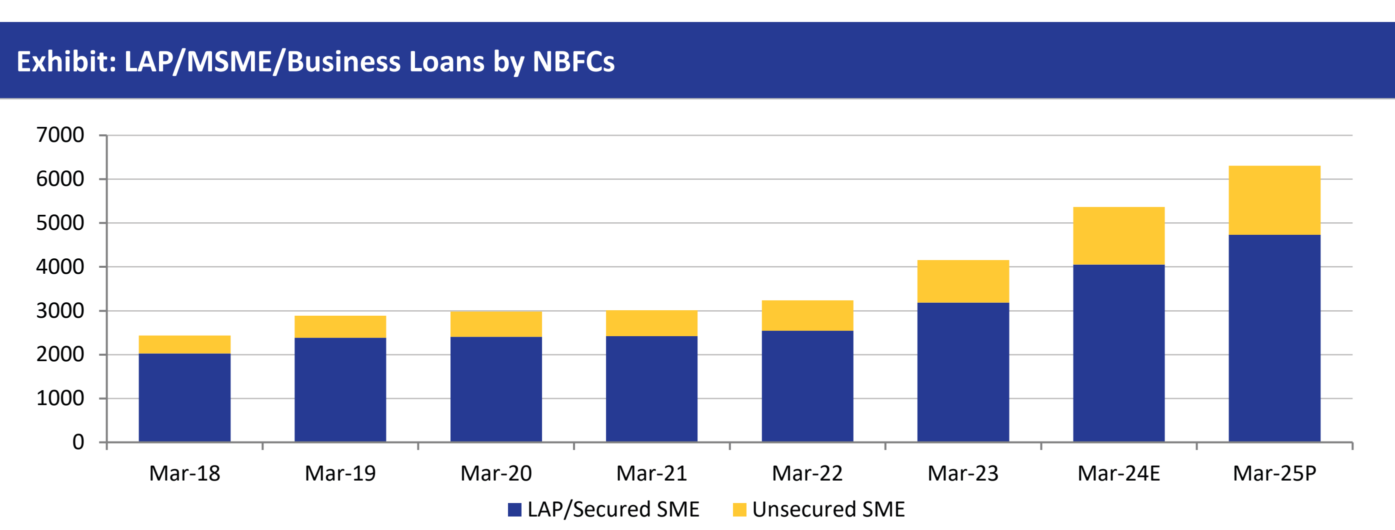
Exhibit: Affordable Housing in HFC Credit



Source: ICRA Research

NBFCs have emerged as the key lenders in the micro, small and medium enterprise (MSME) space. The classification of retail and wholesale trade as MSME from June 2021 further expanded the NBFC base in this segment. This segment has seen a sharp revival post the pandemic with the waning of the asset quality related concerns, which had impacted growth till FY2020. The NBFC credit to MSME segment expanded at a CAGR of 22% during FY2022-FY2024.

Exhibit: LAP/MSME/Business Loans by NBFCs

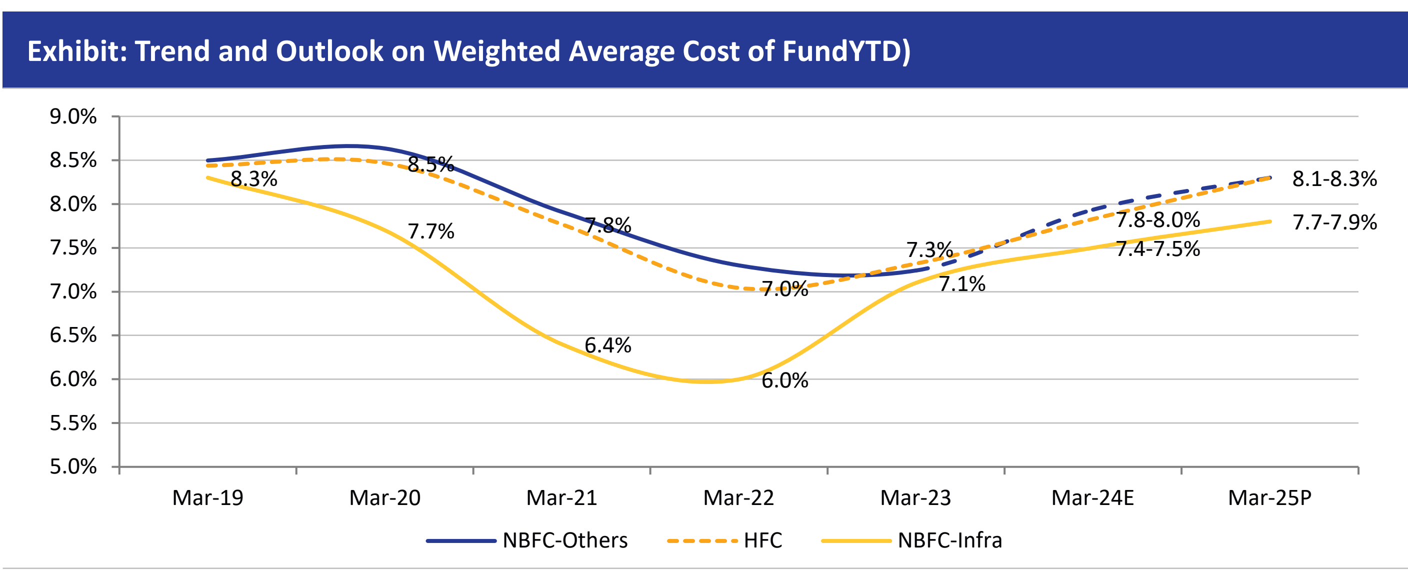


Source: ICRA Research; Amount in Rs. billion

Access to commensurate funding crucial for achieving envisaged growth

Increasing systemic interest rates can potentially erode the competitive position of NBFCs vis-à-vis banks, which have access to cheaper sources of funds, even after adjusting the impact of the various statutory liquidity requirements applicable for them.

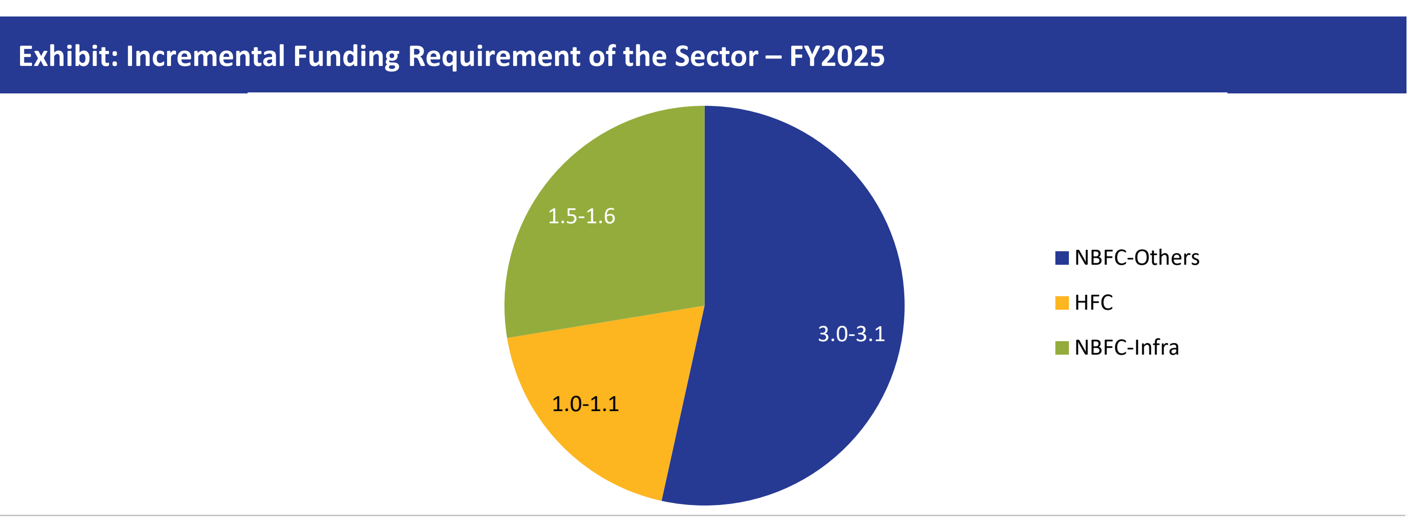
Exhibit: Trend and Outlook on Weighted Average Cost of FundYTD)



Source: ICRA Research

Bank credit to the sector moderated in the last few months of FY2024. Over the last 3-4 years, private sector banks, within the banking group, expanded their share in the overall bank exposures to the NBFC sector. Tighter liquidity, higher competition for deposit mobilisation and the requirement to improve the credit-deposit ratio shall impact the participation of private sector banks in the same manner over the near term at least. This shall have a cascading effect on credit flow to the NBFC sector unless public sector banks increase their exposure/appetite.

Exhibit: Incremental Funding Requirement of the Sector – FY2025



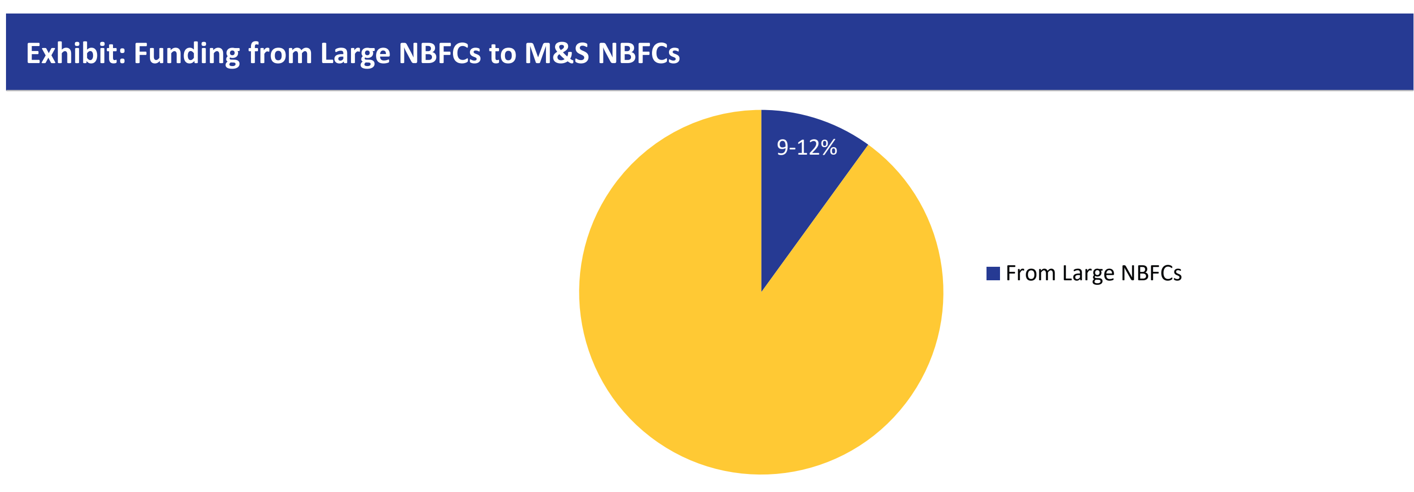
Source: ICRA Research; Amount in Rs. trillion

Further, banks would be more constrained in raising the share of their exposure to the NBFC sector, given their internal sectoral limits and the recent increase in risk weights by the RBI for bank exposure to NBFCs. Further, bank credit is expected to grow by 11.7-12.6% in FY2025, lower than the robust growth of about 16.3% in FY2024.

Thus, assuming that banks continue to maintain their share of credit to the sector (as a percentage of their overall credit) at the current level (9.4%), incremental direct lending from banks could be constrained at Rs. 1.8-1.9 trillion in FY2025. This would be about 33% of the total base case incremental funding requirements of the sector (Rs. 5.6-5.8 trillion) in FY2025.

Large entities have created a symbiotic relationship with smaller peers via co-lending and other business arrangements. Some also extend credit to smaller peers and/or invest in their debt securities.

Exhibit: Funding from Large NBFCs to M&S NBFCs



Source: ICRA Research

Increased supervision of NBFC-UL entities

Based on the regulator's intent regarding the proportionate application of regulations and considering the increasing scale and complexity of NBFC operations and their growing interconnectedness with the financial system, the RBI implemented scale-based regulations. As per the RBI, 15 NBFCs were in the upper layers (UL), constituting about 23% of the total assets of NBFCs in September 2023.

Upper layer NBFCs (NBFC-UL) are subjected to enhanced regulations regarding exposure norms, governance, disclosure and equity listing. They could also be subjected to tighter capital and leverage requirements in future. While most of the applicable requirements are being implemented by entities without much difficulty, equity listing could be an onerous process. NBFCs, which are a part of a larger corporate group or have a complex structure, are going through an organisation restructuring to ensure an optimal structure for business valuation before going ahead with the listing. Listing would involve increased disclosures, which are a concern

for closely-held entities. A stipulated listing timeline, post classification of the UL category, can restrict the NBFC's ability to secure the expected valuation for its shareholders.

While the RBI has raised the regulatory requirements for the sector as a whole, NBFCs still have some arbitrage in their favour, namely no cash reserve ratio (CRR)/statutory liquidity ratio (SLR) requirements, no minimum priority sector credit exposures and limited operational restrictions like branch expansion and requirements for meeting the minimum number of branches in unbanked rural centres etc. Overall, higher regulatory oversight and disclosures are only credit positives as they would boost investor/lender confidence.

NBFCs have sizeable exposure to priority sector eligible assets

Priority sector lending (PSL) is a banking requirement to facilitate credit to the underserved segments of society for ensuring a more equitable flow of credit for economic empowerment and employment generation. The concept of PSL was envisioned in the 1960s and the target segments and their composition within this have evolved in line with economic reality and requirements.

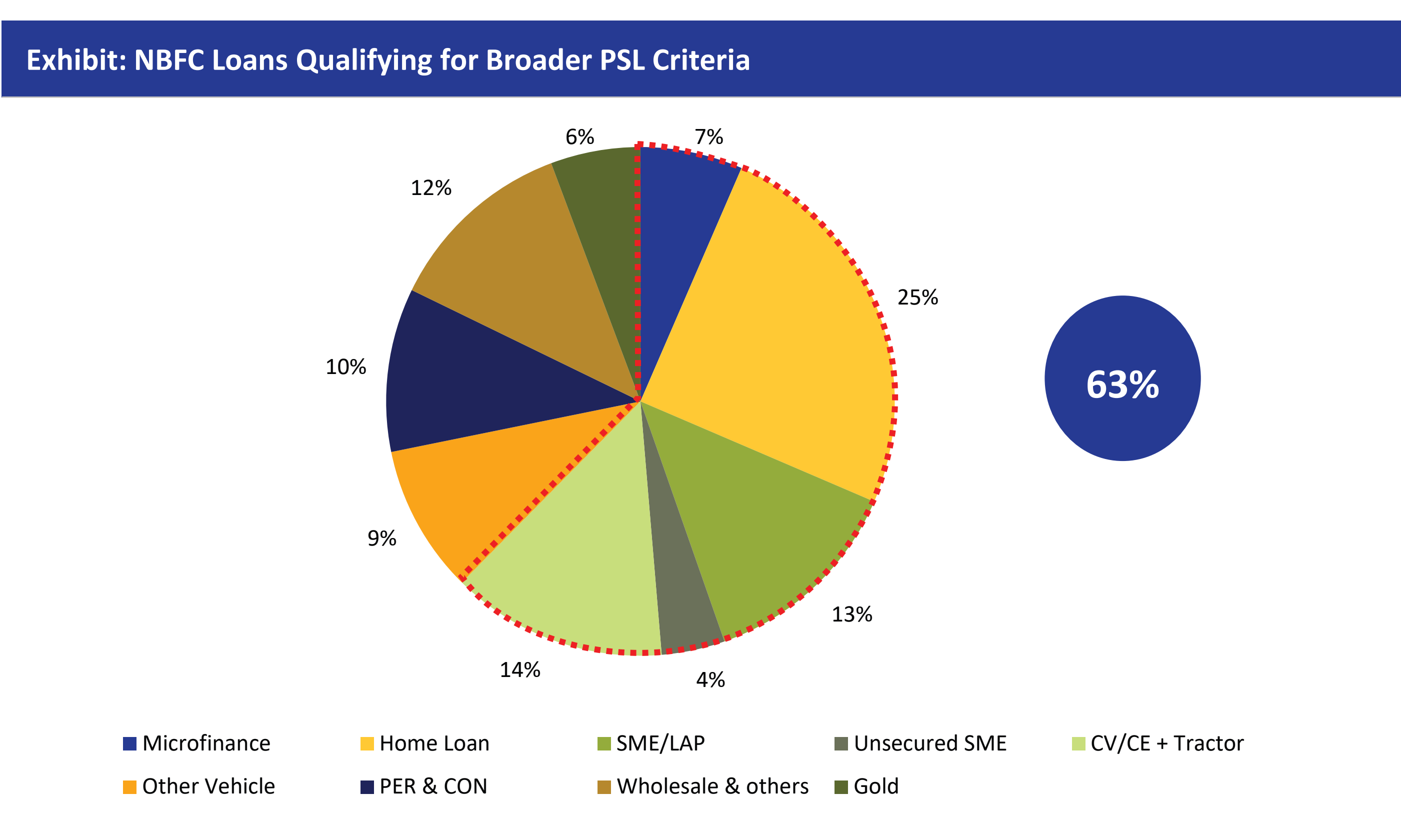
There are sub-targets within the overall PSL target aimed at agriculture, MSME, weaker sections, etc. The segments currently covered under this include agriculture, MSMEs, renewable energy, social infrastructure, housing, education, etc. The banking system met the priority sector target of 40% in March 2024. However, considering the sizeable unmet demand and credit gaps, the rate of credit growth to this segment would have to sustainably exceed the overall bank credit growth to steadily reduce this gap.

NBFCs play an important role in furthering credit reach to underserved segments. Considering their role, the RBI brought bank lending to NBFCs for on-lending for specific end uses, i.e. agriculture, MSME and housing loans, under the PSL umbrella. Further, loans to microfinance institutions (MFIs) for on-lending are eligible for the PSL tag.

The RBI's co-lending guidelines, also aimed at the PSL segment, are making NBFCs key stakeholders for furthering sustainable finance to these segments.

A sizeable share, i.e. more than 60% of the overall NBFC credit, shall qualify for the broader PSL criteria applicable for banks, considering the target borrower segments. Ensuring the same meets the loan ticket size and the applicable end use as required for the PSL tag however, shall remain key.

Exhibit: NBFC Loans Qualifying for Broader PSL Criteria

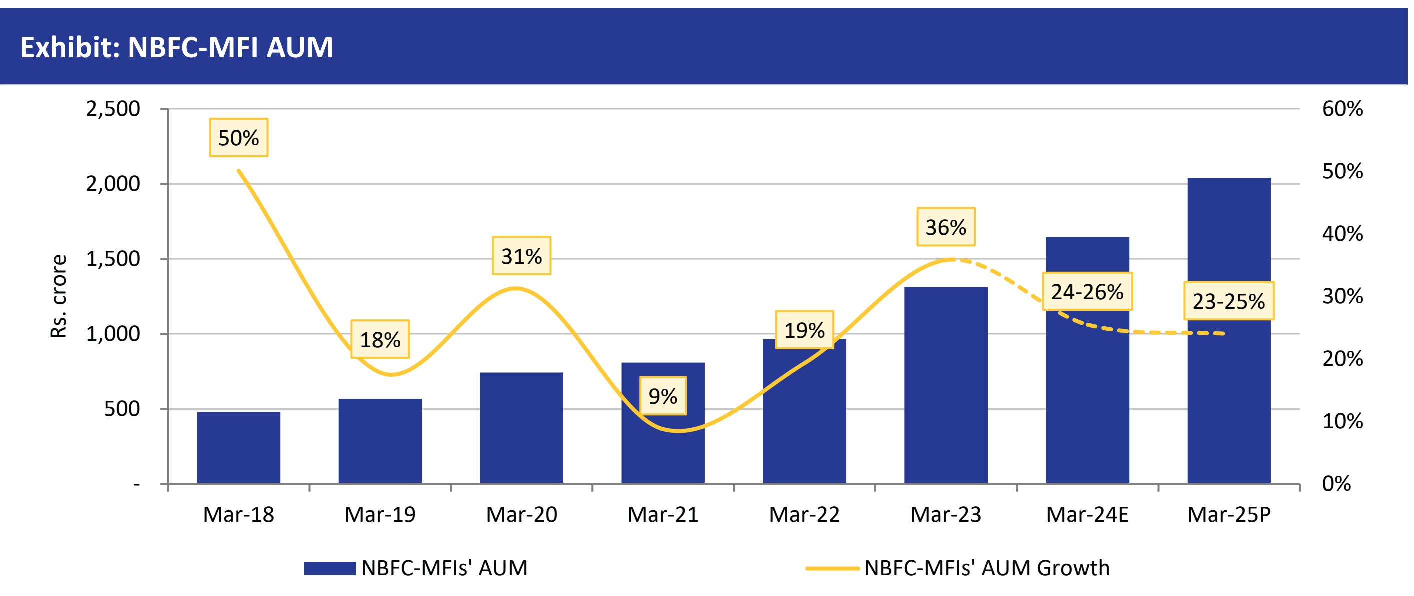


Source: ICRA Research

High growth in key priority sector assets; refinancing to NBFCs, however, remains modest

The overall microfinance (including banks, small finance banks (SFBs), etc) sector had a unique borrower base of more than 74 million as of December 2023, of which NBFC-MFIs have a unique borrower base of about 37 million. Correspondingly, NBFC-MFIs account for close to 39% of the overall microfinance AUM (Excluding SHG-Bank linkage) as of December 2023. NBFC-MFI AUM expanded at a CAGR of 23% during FY2019-FY2024. NBFC-MFIs continue to depend on bank credit, which accounts for the bulk of their borrowings (58% as of December 2023) while refinance from financial institutions constituted only about 10.5% of their total borrowings.

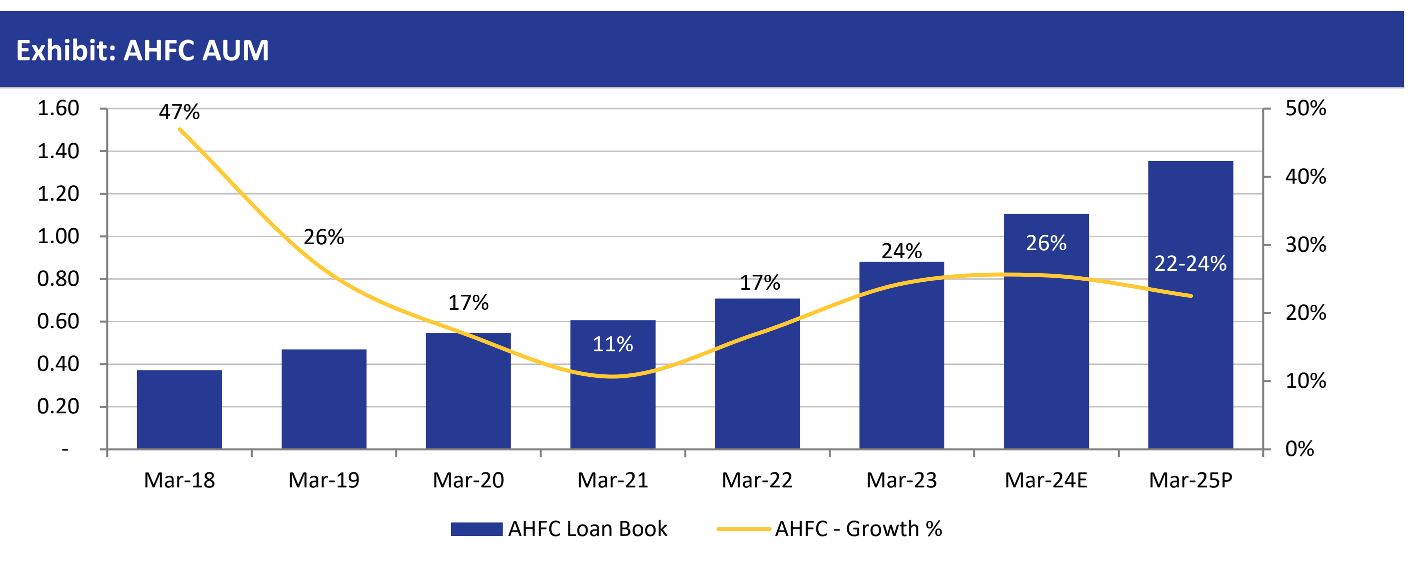
Exhibit: NBFC-MFI AUM



Source: MFIN, ICRA Research; Amount in Rs. billion

The growth rate of affordable housing finance companies (AHFCs) remained higher than the overall HFC segment. The total on-book portfolio was estimated above Rs. 980 billion as on September 30, 2023 and above Rs. 1 trillion as on December 31, 2023. As per ICRA's estimates, the share of AHFCs in the HFC pie (excluding HDFC Limited) was 13% as on December 31, 2023. The underpenetrated market and the Government's thrust on 'housing for all' have been supporting the growth over the years.

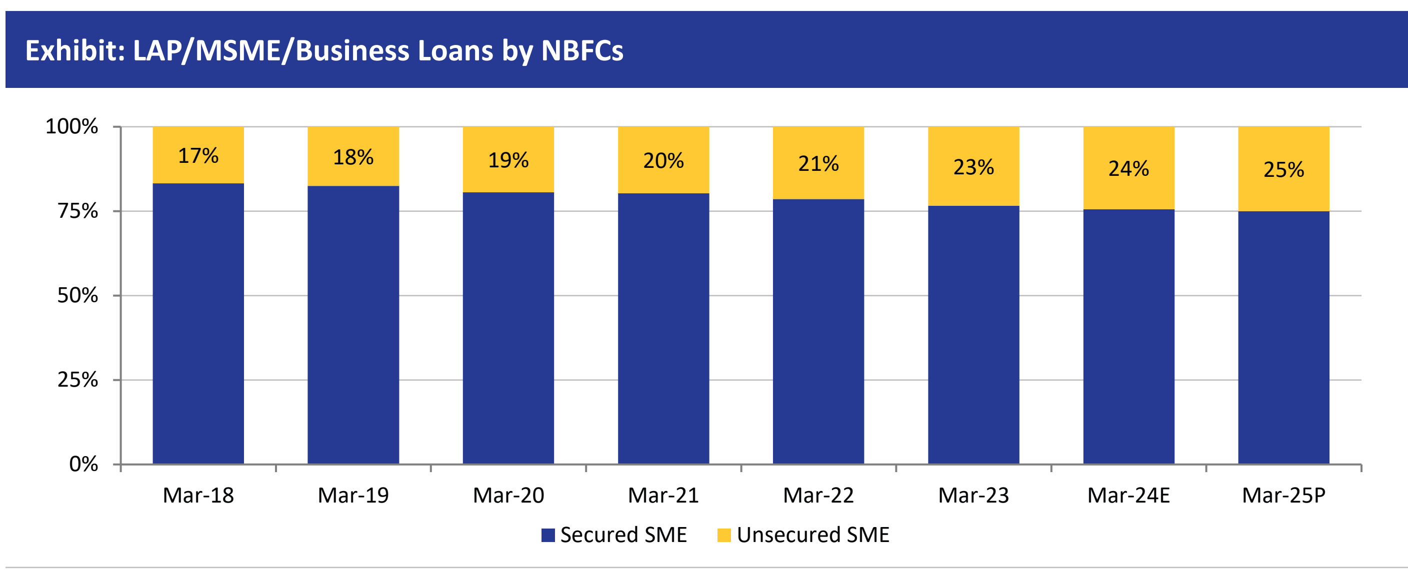
Exhibit: AHFC AUM



Source: ICRA Research; Amount in Rs. trillion

Within the small business loans segment, entities are steadily increasing the share of unsecured loans, which is again driven by access to borrower-level cash flow data and other credit models created by them for cash flow estimation. Unsecured SME loans rose at a CAGR of 21%, albeit on a lower base, vis-à-vis the secured loan growth of 12% during FY2019-FY2024.

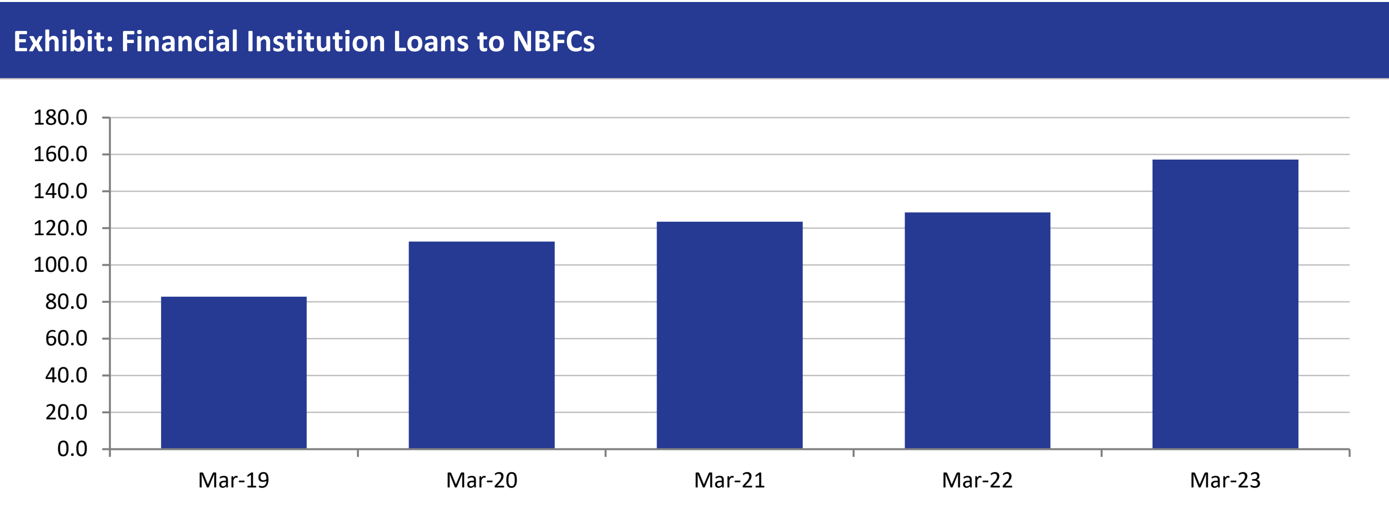
Exhibit: LAP/MSME/Business Loans by NBFCs



Source: ICRA Research

Refinance from All India Financial Institutions (AIFIs) to NBFCs increased at a healthy CAGR of 17% during FY2020-FY2023 though this segment's share in the overall borrowings remained quite modest at about 5% of the NBFCs' (excluding NBFC-Infra) borrowings.

Exhibit: Financial Institution Loans to NBFCs

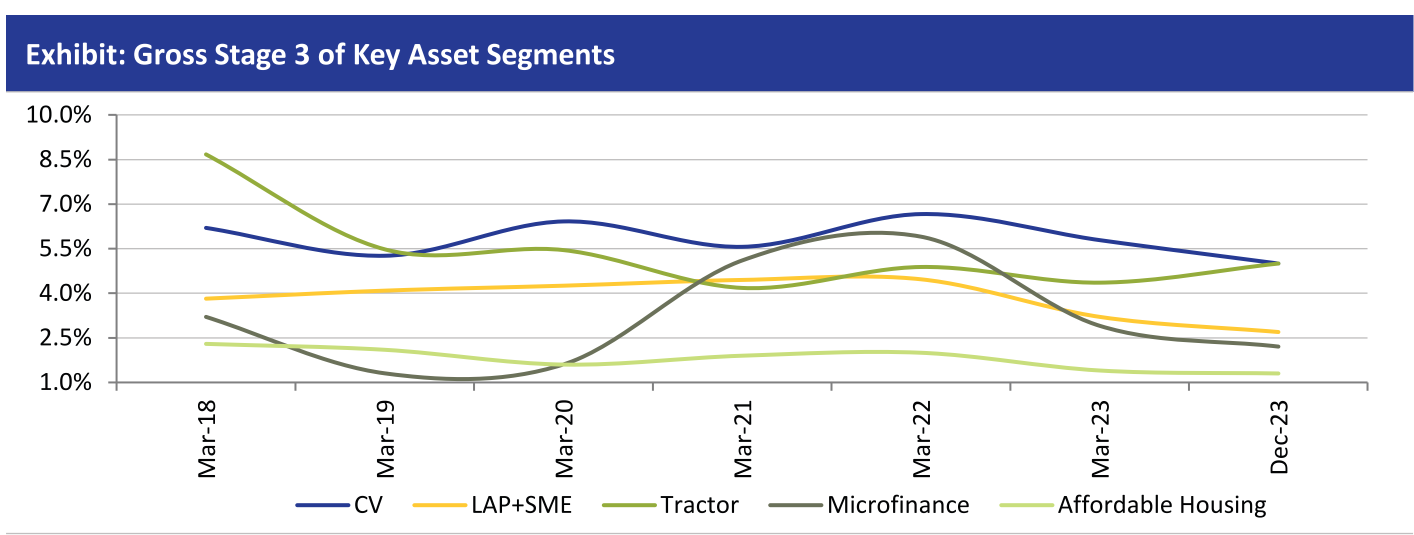


Source: RBI, ICRA Research; Amount in Rs. billion

Credit guarantee schemes emerge as key risk mitigant

The asset quality of key asset segments, while on an improving trend of late, has had a volatile profile in the past. Although NBFCs have augmented their business and operations to keep their credit losses under control, access to credit guarantee schemes shall ensure adequate risk support.

Exhibit: Gross Stage 3 of Key Asset Segments



Source: ICRA Research; Based on ICRA' sample set

Guarantee schemes also facilitate channel credit flow to borrowers who were underserved on account of non-availability of collateral. Assessing borrower cash flows to estimate credit eligibility rather than reliance on collateral, supported by risk mitigation in the form of the credit guarantee, shall increase the credit expansion to small businesses. Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) and Credit Guarantee Fund for Micro Units (CGFMU) are the two most prominent credit guarantee schemes availed by NBFCs. As per public data, the CGTMSE-guaranteed amount exceeded Rs. 1.5 trillion in FY2024, registering a 50% increase over FY2023.

Regulations pave the way for evolution of digital lending

Evolving regulatory landscape

The impact of technology on the financial services space and its accelerated adoption in the recent past have been driven by the sharp increase in telecom subscribers and internet users. This, combined with the ease of payments via Unified Payments Interface (UPI), revolutionised the fintech space. The strong bedrock of bank account penetration and the unique identification, i.e. Aadhar, supported the above. Fintechs facilitate financial inclusion by widening the access of financial services to rural, low-income borrowers and small businesses. This also helps in the efficient and effective implementation of various Government initiatives for the socially and economically weaker borrower segments.

Exhibit: Fintech Ecosystem

01
Customers
Retail customers acquired digitally by the LSP

Customer sourcing

02
LSP
Fintech entity with origination/ underwriting

Scenario 1

03
RE
NBFC/bank, etc, acting as on-B/S lender

Scenario 2

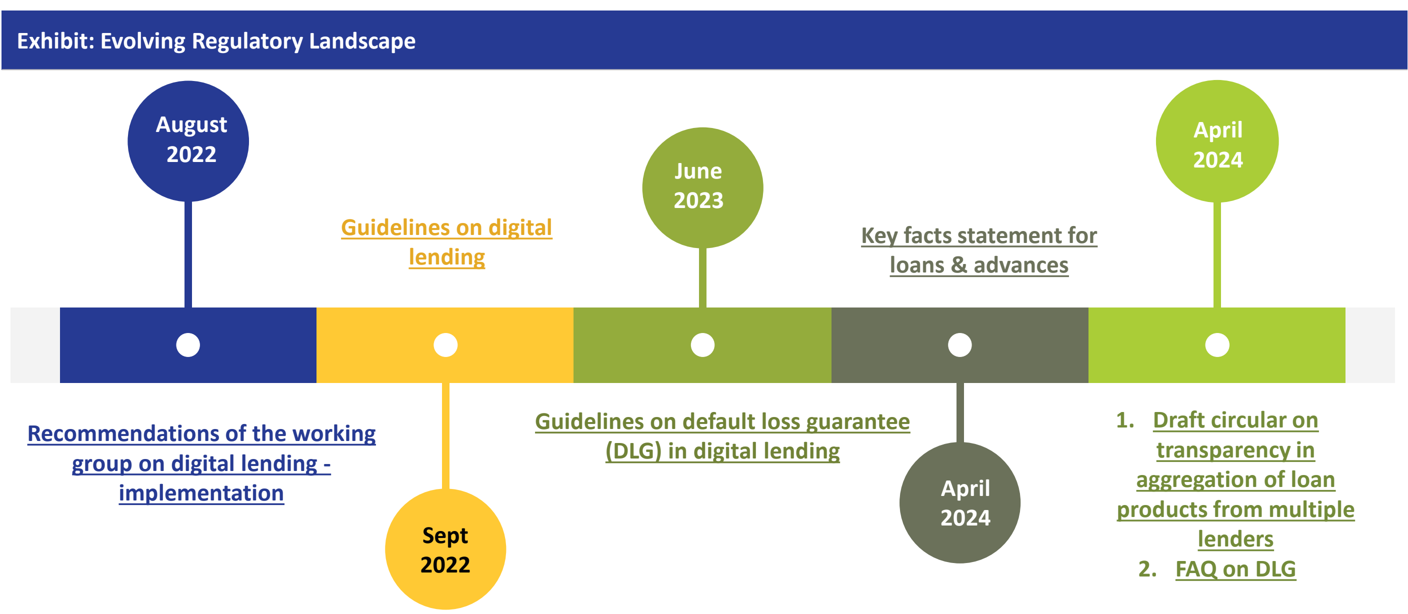
04
RE 1

05
RE 2

Source: ICRA Research

The fintech ecosystem in India has tremendously improved the delivery of financial services by making them faster, cheaper, efficient and more accessible. However, like any other new credit product, teething issues were visible even in the digital lending space, mainly due to some of the business practices like low transparency in lending rates, unethical recovery processes, data privacy related concerns, etc, thereby warranting regulatory intervention. Further, the rapid growth of digital financial services makes the financial system prone to various risks, including data security, cybersecurity, etc.

Exhibit: Evolving Regulatory Landscape

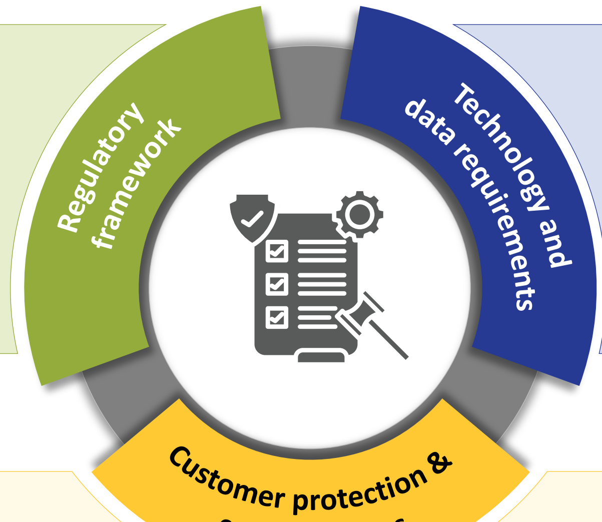


Source: ICRA Research

Regulators and policymakers have also kept up pace, considering the highly dynamic nature of this segment, to ensure that the regulations are commensurate with the risks. The regulators are cognisant of the balancing act required while devising regulations to ensure that the segment develops in an orderly manner without creating any challenges or risks to the overall financial system.

In view of the above, the RBI released a discussion paper in August 2022, followed by digital lending guidelines in September 2022. The focus was to identify the key stakeholders in digital lending, improve borrower protection and data privacy, and set the standards of operations and technology requirements. In its June 2023 guidelines and FAQ of April 2024, the RBI provided directions and clarity regarding the usage of the first loss default guarantee (FLDG), which is currently capped at 5% of the loan disbursed. In ICRA's view, this is likely to result in clear risk-sharing between fintech entities {also called lending service providers (LSPs)} and on-balance sheet (on-B/S) lenders (i.e. regulated entities; REs).

Exhibit: Building Blocks of Regulatory Environment



Regulatory framework

- Compulsory reporting to credit information companies
- FLDG

Technology and data requirements

- Policy on technology standards, data storage and server locations
- Data security and privacy while sharing data with third parties

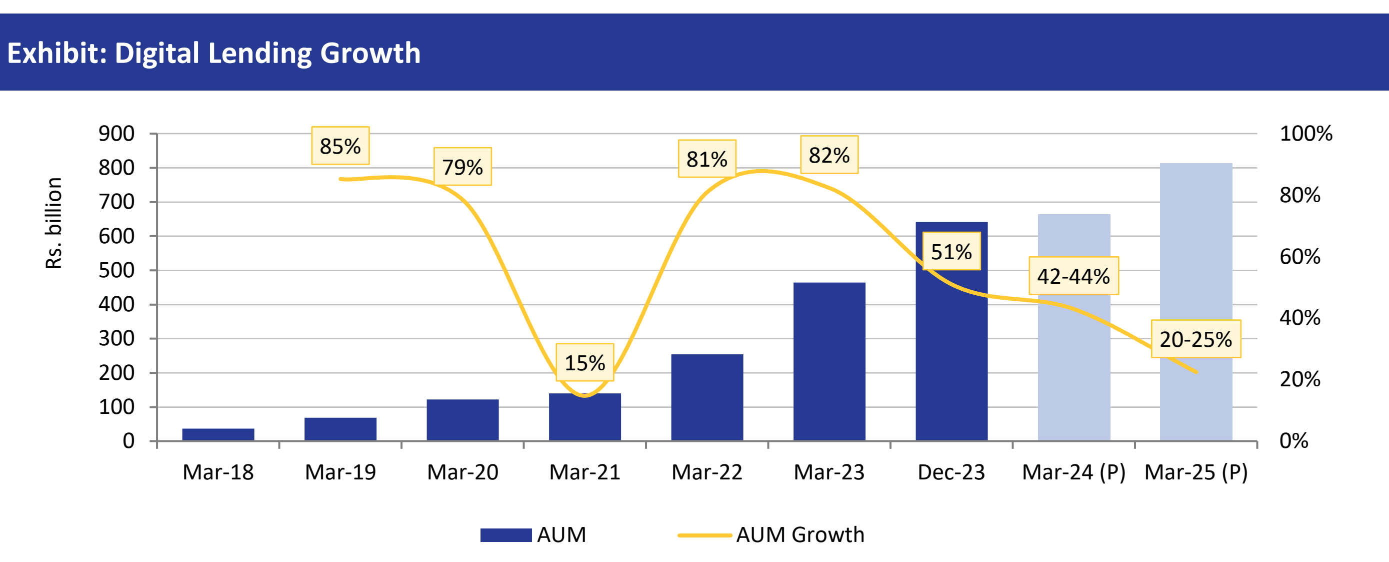
Customer protection & conduct issues

- Disbursement and loan servicing into bank account of borrowers/lenders
- Borrower disclosure – Annual percentage rate (APR) and key fact statements
- Grievance redressal and cooling period
- Due diligence and review of and service providers by lenders

Digital lenders recalibrate for orderly expansion

Digital lending has seen exponential growth, albeit on a lower base. The AUM of ICRA's sample set of entities stood at ~Rs. 650 billion as of December 2023, increasing at a CAGR of 60% in the last five years. ICRA expects AUM growth to expand in an orderly manner going forward, in view of the regulatory actions and guidelines. Further tightening of funding and capital conditions shall weigh on the segment's growth. As per ICRA's estimates, AUM growth is expected at around 42-44% YoY in FY2024, which would slow down further to 20-25% YoY in FY2025.

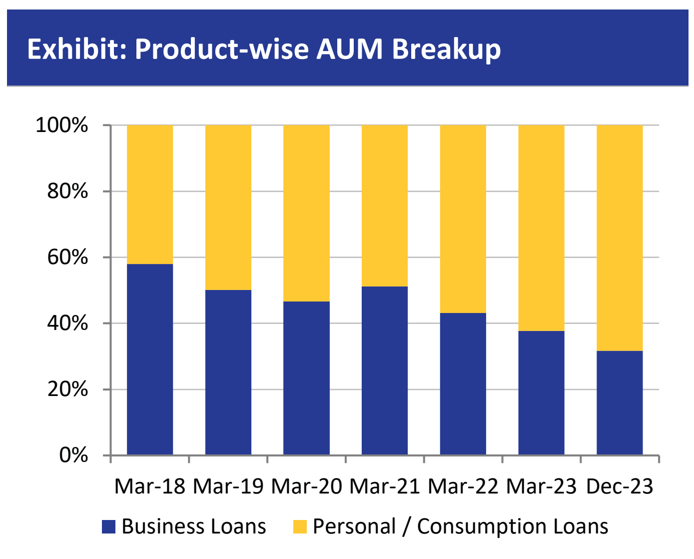
Exhibit: Digital Lending Growth



Source: Based on sample set, ICRA Research; AUM pertains to the loans of the digital lending NBFCs and the loans originated through the same digital mode for the partner NBFCs/banks

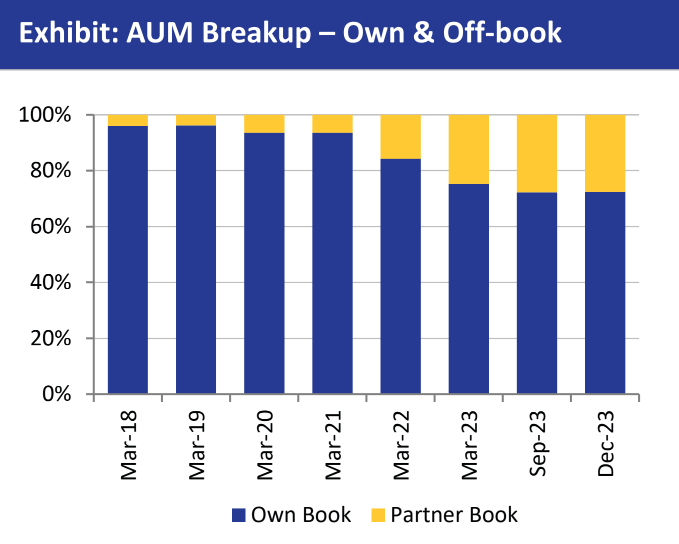
Digital lenders are predominantly focussed on unsecured, small-ticket and small-tenor loans in the consumer (including personal loans) and small business loan segments. The share of consumer loans has been increasing steadily over the years. However, the AUM growth in the consumer loans space was significantly higher at a CAGR of ~70% during the period FY2019-FY2024 compared to ~40% for business loans. As a result, consumer loans accounted for more than 2/3 of the digital lending AUM as of December 2023.

Exhibit: Product-wise AUM Breakup



Source: Based on sample set, ICRA Research

Exhibit: AUM Breakup – Own & Off-book



Source: Based on sample set, ICRA Research

Given the start-up nature of digital lenders and their modest balance sheets, funding high growth rates is a key constraint. Digital lenders have developed various innovative partnership models, whereby they partner with larger NBFCs or banks for AUM growth by leveraging the partners' balance sheets.

These partnerships have also been beneficial for larger NBFCs and banks, which previously had a limited presence in the segments targeted by digital lenders. The share of such off-balance sheet (off-b/s) partnership-based AUM growth has been steadily increasing over the last few years. Currently, around 30% of the digital lenders' AUM is funded via their partners. Additionally, with the regulator increasing constraints on direct lending by banks to NBFCs by raising the risk weights, it is likely that digital lenders would rely more on partnerships as a sustainable avenue for AUM growth.

Loan quality and profitability to remain key focus areas as business scales up

Exhibit: 90+ Dpd

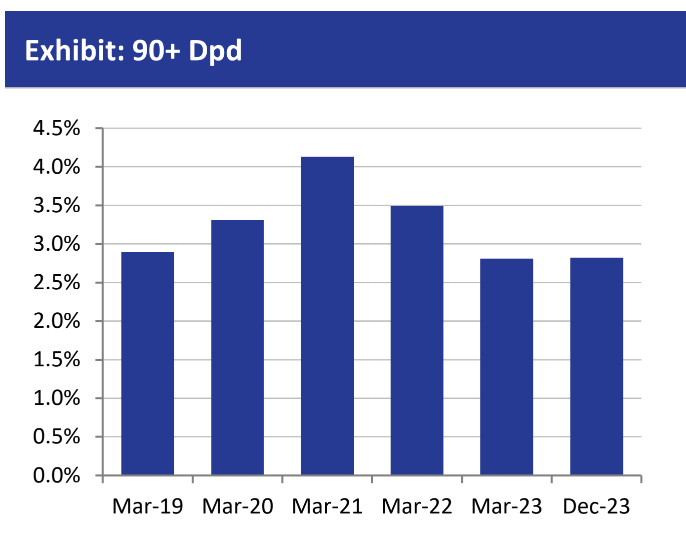
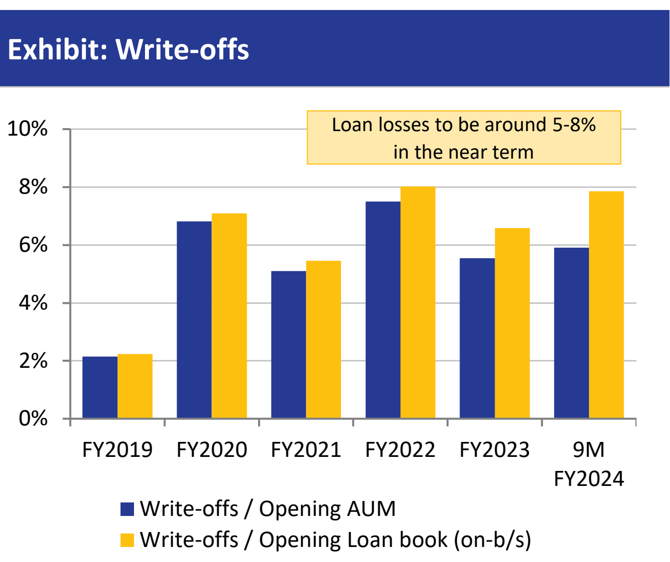
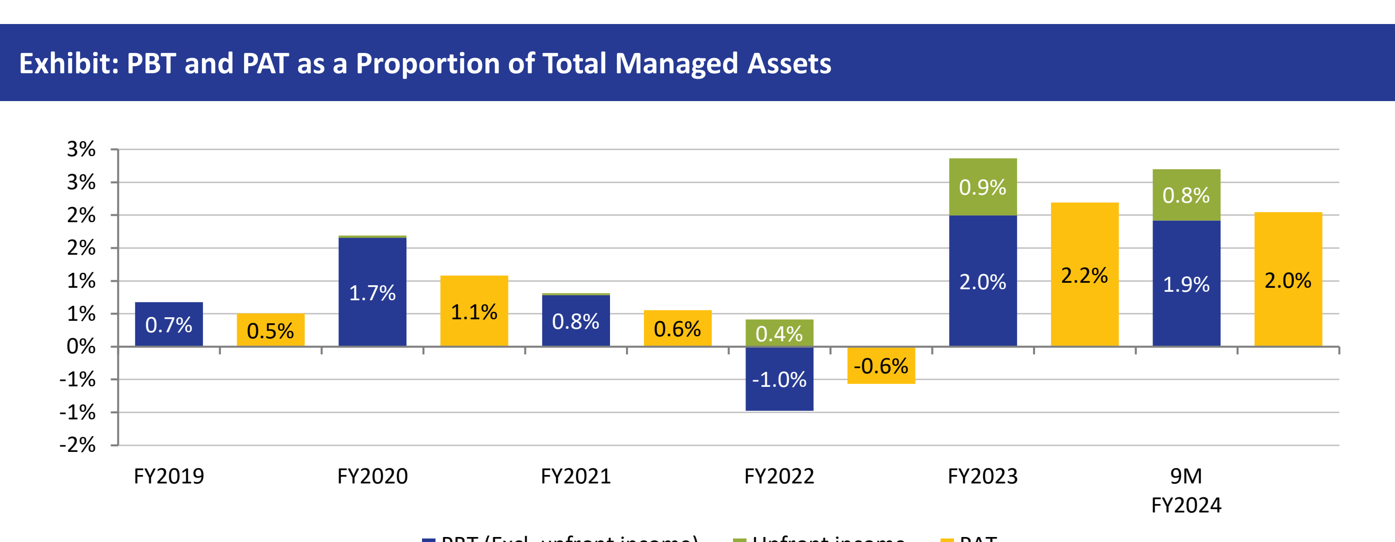


Exhibit: Write-offs



Source: Based on sample set, ICRA Research

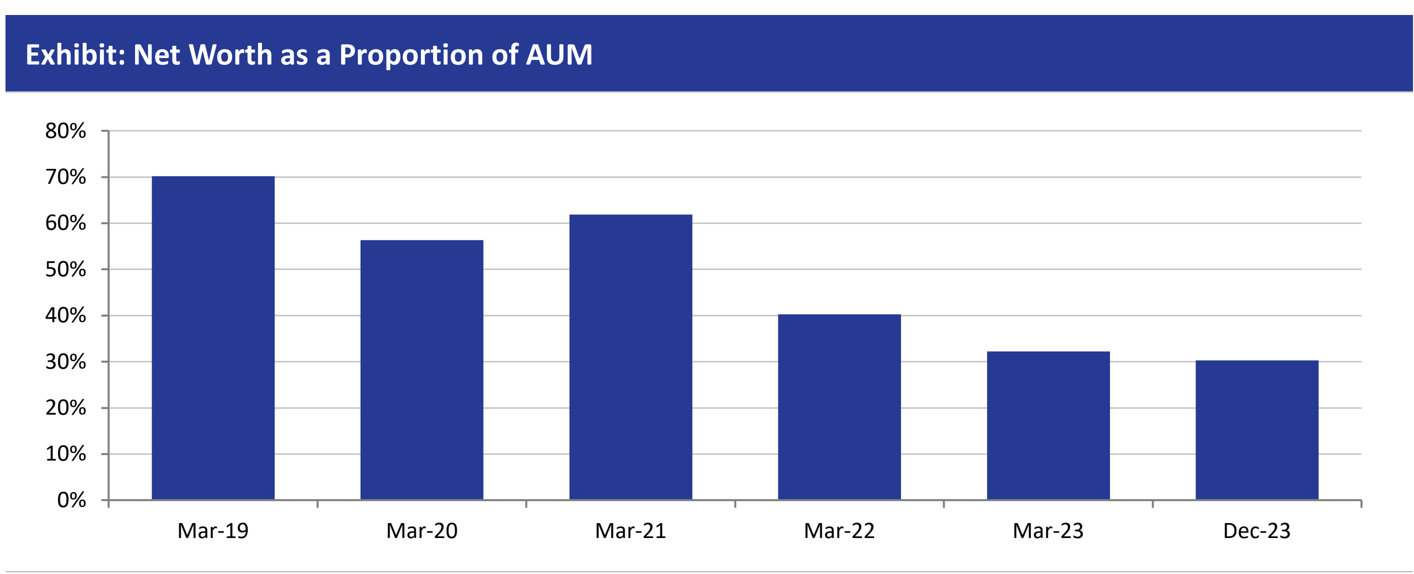
Given the modest credit risk profiles of the target consumer segment as well as the pandemic-related impact, digital lenders had faced higher delinquencies and write-offs over the last few years. Underwriting remains key as digital lenders have limited field presence and the collection infrastructure is in the scale-up mode at present. Delinquencies have remained range-bound, but elevated, as entities have been prudent in writing off loans (typically within 180-360 days) within accelerated timeframes, considering the target borrower segment. Loan losses had increased steeply during the pandemic but had declined in FY2023. However, some deterioration was witnessed again in 9M FY2024. The asset quality implications of borrower overleveraging have started becoming more visible for smaller-ticket consumer credit, credit cards, etc. ICRA expects loan losses for digital lenders in the range of ~5-8% on a cohort basis in the near term.



Source: ICRA Research; Based on sample set

High operating and credit costs have been a significant drag on the net profitability of digital lenders in the past. The sustainability of the performance remains to be seen as the entities scale up, especially with respect to their ability to keep the credit costs under control. Nevertheless, digital lenders have typically enjoyed a significant quantum of non-interest income (in the form of processing fee/commission income), which helped offset the impact of the elevated operating and credit costs, supporting the net profitability to a significant extent. They have also been realising upfront gains from their off-b/s portfolio transactions.

Adequate capitalisation at present



Source: Based on sample set

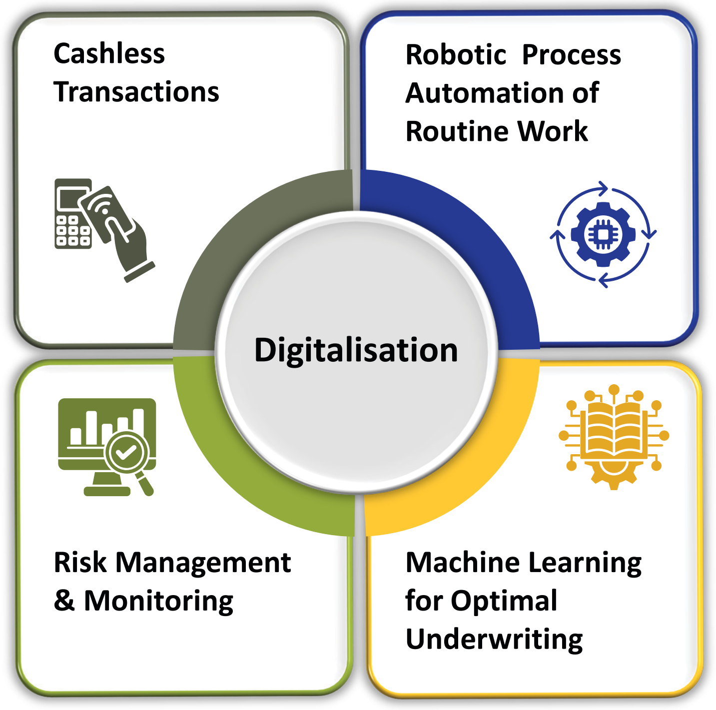
Digital lenders have largely relied on equity funding support from investors to fund their strong growth. This has been especially critical as internal accruals have remained weak. Usual lenders to this segment would be NBFCs, high-net-worth individuals (HNIs), smaller banks, etc. Managing AUM growth via partnerships has been key in the recent past. However, as lenders have slowly gained confidence on the back of their increasing track record in this segment, their exposures have also grown steadily. This has led to a steady increase in the leverage over the last three years. The impact of the regulatory tightening on funding to NBFCs from banks remains to be seen in the near term. Further, any adverse regulatory development in the partnership arrangements can affect the fund flow to the entities.

Adoption of technology by NBFCs

Process digitalisation improves efficiency

The evolution of new technologies has influenced the way business is being done in the financial sector. Financial institutions are adopting various tools either directly or via partnerships with tech-enabled entities for undertaking different key functions, including client assessment and onboarding, loan monitoring, and risk management, and for the delivery of several financial services. The consummation of key financial transactions via the digital mode has not only optimised the cost of operations of financial institutions but has also improved borrower/customer experience.

Exhibit: Digitalisation of Processes

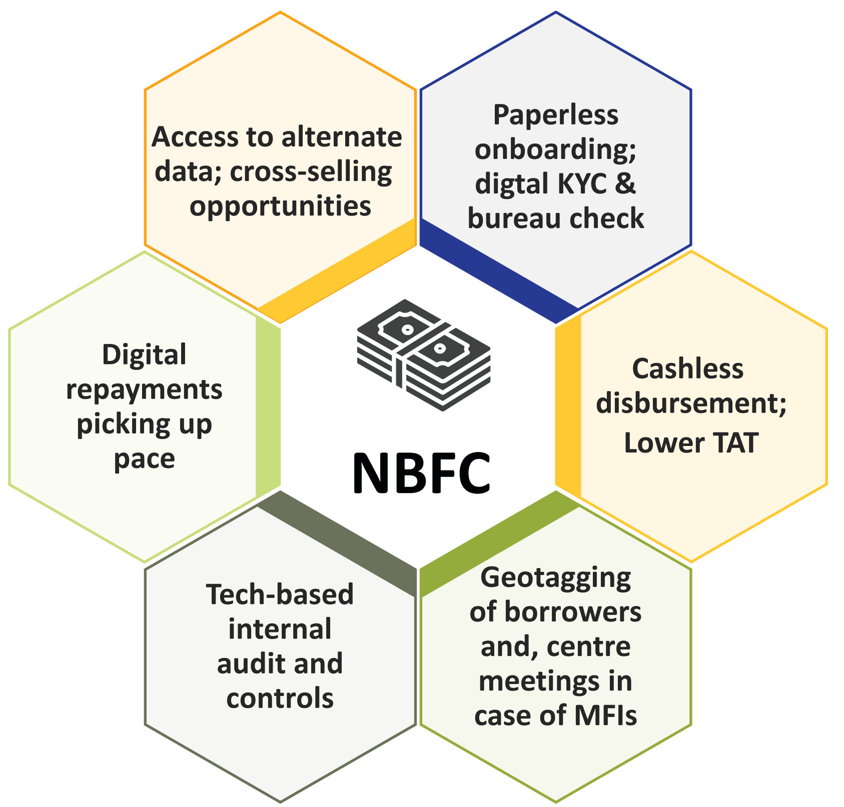


Source: ICRA Research

Routine processes are largely automated to limit manual intervention and transactions are being moved to the digital mode. Digitalisation of tax returns and other business filings has enabled the assessment of borrower creditworthiness based on cash flows vis-à-vis the asset cover in the past. NBFCs can now access alternate borrower information, providing them with lifestyle insights, which is crucial for assessing new-to-credit borrowers. The digitalisation of financial services has, in general, improved the turnaround time (TAT) and has widened the borrower catchment for a financial institution. On one hand, the overall borrower loan cycle experience has improved while, on the other hand, lenders are able to price their risk more appropriately and are able to monitor credit for any early warning signals. Further, the widening of the borrower base and the ability to offer multiple loan/financial products have helped NBFCs strengthen their franchises. Entities are increasingly augmenting their omnichannel presence to get a 360-degree assessment of their ecosystem and systematically widen their operations.

NBFC-MFIs have largely moved to the cashless disbursement of loans. They have also made sizeable strides in moving towards collections via the digital mode with plans to increase the share of the same, going forward. Microfinance is a high-touch business, requiring automation of routine work while ensuring enhanced borrower engagement and monitoring levels. Automated borrower onboarding, cashless disbursements and geotagging of the centres have helped improve TAT and optimisation of the field-level resources. Further, sizeable advancements are being made towards digitalising the internal audit processes. Entities are applying various predictive tools, like machine learning (ML) and generative artificial intelligence (AI), to optimise their underwriting processes.

Exhibit: Digitalisation of Credit Cycle



Source: ICRA Research

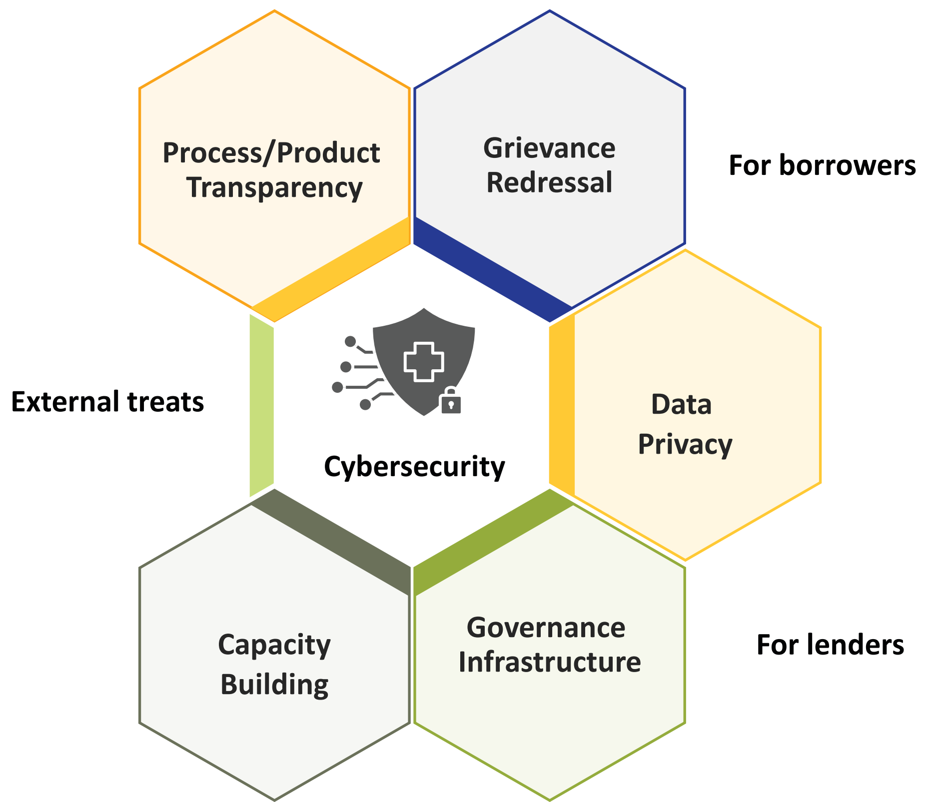
HFCs are moving towards a completely digital loan cycle approach with an end-to end digital journey for their borrowers. Entities are leveraging technology to generate leads from non-traditional channels. They have also developed apps to directly onboard prospective borrowers and/or connect with the lead generators (direct selling agents (DSAs), connectors, builders, etc). AI and ML are being deployed for optimising the credit scorecards created for various prospective borrower segments and for post-underwriting risk assessment.

Responsible application and commensurate controls required

The growing role of technology also requires lenders to deploy additional measures towards building customer confidence in the processes deployed by ensuring robust data and cybersecurity, transparency of the terms and conditions of the financial product, and setting up of customer grievances redressal mechanisms.

Algorithm-based models for credit assessment would have to ensure that the use of non-traditional data, especially for the assessment of marginal borrowers, is rigorous and continually upscaled. Ensuring adequate transaction capacity in relation to growth plans, commensurate software development and deployment and data privacy would be key.

Exhibit: Monitorables in Digital Environment



New technologies can entail unforeseen challenges. Thus, NBFCs would have to develop a comprehensive risk and governance framework for addressing the same.

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About ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency. Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

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The Associated Chambers of Commerce & Industry of India (ASSOCHAM) is the country's oldest apex chamber. It brings in actionable insights to strengthen the Indian ecosystem, leveraging its network of more than 4,50,000 members, of which MSMEs represent a large segment. With a strong presence in states, and key cities globally, ASSOCHAM also has more than 400 associations, federations and regional chambers in its fold.

Aligned with the vision of creating a New India, ASSOCHAM works as a conduit between the industry and the Government. The Chamber is an agile and forwardlooking institution, leading various initiatives to enhance the global competitiveness of the Indian industry, while strengthening the domestic ecosystem.

With more than 100 national and regional sector councils, ASSOCHAM is an impactful representative of the Indian industry. These Councils are led by wellknown industry leaders, academicians, economists and independent professionals. The Chamber focuses on aligning critical needs and interests of the industry with the growth aspirations of the nation.

ASSOCHAM is driving four strategic priorities - Sustainability, Empowerment, Entrepreneurship and Digitisation. The Chamber believes that affirmative action in these areas would help drive an inclusive and sustainable socio-economic growth for the country.

ASSOCHAM is working hand in hand with the government, regulators and national and international think tanks to contribute to the policy making process and share vital feedback on implementation of decisions of far-reaching consequences. In line with its focus on being future-ready, the Chamber is building a strong network of knowledge architects. Thus, ASSOCHAM is all set to redefine the dynamics of growth and development in the technology-driven 'Knowledge-Based Economy. The Chamber aims to empower stakeholders in the Indian economy by inculcating knowledge that will be the catalyst of growth in the dynamic global environment.

The Chamber also supports civil society through citizenship programmes, to drive inclusive development. ASSOCHAM's member network leads initiatives in various segments such as empowerment, healthcare, education and skilling, hygiene, affirmative action, road safety, livelihood, life skills, sustainability, to name a few.

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