

NBFCs gearing up for growth



Analytical contacts

CRISIL Ratings

Krishnan Sitaraman

Senior Director and Deputy Chief Ratings Officer
krishnan.sitaraman@crisil.com

Ajit Velonie

Director
ajit.velonie@crisil.com

Subha Sri Narayanan

Director
subhasri.narayanan@crisil.com

Malvika Bhotika

Director
malvika.bhotika@crisil.com

Rahul Malik

Associate Director,
rahul.malik@crisil.com

Contents

Foreword.....	4
Executive summary	5
NBFCs: An important cog in the credit delivery wheel	6
HFCs: Refurbishing business models.....	12
Vehicle finance: On a fundamental drive	18
Digital lending: On the cusp of reorientation	23
Fiscal support and strengthened fundamentals augur well for infrastructure finance	29
Conclusion	34

Foreword



Shri Deepak Sood
Secretary General
ASSOCHAM

Non-banking financial companies (NBFCs), public and private banks, and financial institutions form the four broad constituents of the credit ecosystem of the Indian financial sector, with NBFCs being a key pillar therein. Over the past few decades, NBFCs have navigated several storms, some of them unprecedented.

After several challenging years, fiscal 2023 has brought growth back into focus for NBFCs. To be sure, NBFCs have demonstrated an innovative and resilient streak over the years, adapting efficiently, even during the Covid-19 pandemic, to an evolving credit landscape.

NBFCs are stronger and more resilient today, and better positioned in almost all operationally critical parameters. Provisioning levels have also increased in the past couple of years, as NBFCs created management overlays to provide for uncertainty pertaining to the pandemic. Overall, the sector has much stronger balance sheets today.

Through various policy announcements, the government has reinforced the stature of the infrastructure sector as a critical driver of economic growth and overall development. While the National Infrastructure Pipeline (NIP) introduced in 2019 will continue to push the infrastructure juggernaut forward, the PM Gati Shakti National Master Plan and National Logistics Policy announced in February 2022 and September 2022, respectively, will also further this cause.

Keeping this imperative in mind, ASSOCHAM is conducting its 9th Annual Summit on NBFCs and infrastructure financing. In this background, ASSOCHAM and CRISIL Ratings have jointly prepared a comprehensive knowledge paper on **NBFCs gearing up for growth**. We hope this report, along with discussions during the summit, will help the regulators, market participants, government departments, and research scholars develop the Indian financial services sector further.

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

Executive summary

After weathering countless challenges over the past three fiscals, exacerbated by the Covid-19 pandemic, fiscal 2023 has brought growth back into focus for NBFCs¹. This is expected to continue into fiscal 2024, with assets under management (AUM) of NBFCs projected to increase 13-14% vis-a-vis single-digit growth over the past three fiscals (2020-22). The acceleration will ride on improving economic activity, strengthened balance sheet buffers, and better asset quality metrics.

Indeed, NBFCs are critical to overall credit delivery in India, as indicated by exponential increase in AUM from Rs 3.6 lakh crore in fiscal 2008 to ~Rs 27 lakh crore at present. For a better understanding of their criticality in the credit space, NBFCs accounted for almost 16% share of overall credit in fiscal 2022.

Over the past three fiscals, NBFCs largely focussed on liquidity, capital and provisioning buffer. These, combined with the consistent improvement in economic activity, have put the sector in a better position today to capitalise on growth opportunities.

That said, two key monitorables remain. First, intensifying competition from banks, especially in the traditional retail segments of home loans and vehicle finance. Second, rising interest rates have increased the cost of borrowing for NBFCs, which is limiting their competitiveness in some asset classes.

To be sure, NBFCs are realigning their portfolio strategies to combat these challenges. Their focus is shifting towards non-traditional asset classes—unsecured loans; micro, small and medium enterprise (MSME) finance; and used vehicle finance—which are expected to post higher growth. Consequently, these segments are garnering higher share in incremental disbursements. While the traditional segments will also grow, the rate is unlikely to surpass the pre-pandemic levels.

As large NBFCs tap new segments, co-lending and partnerships with the emerging and mid-sized NBFCs will gain traction.

With this shift and NBFCs being able to pass on the increase in cost of borrowing to consumers, at least in incremental disbursements, gross spreads are likely to compress 40-60 basis points (bps) this fiscal.

However, improvement in asset quality will provide some cushion. NBFCs have created substantial management overlays in the past few fiscals, which will provide support going forward. In fact, NBFCs are expected to dip into previously created management overlays, which along with improving asset quality metrics should lower credit costs.

Net-net, the overall earnings profile for NBFCs is expected to remain stable.

¹ Including NBFCs and housing finance companies (HFCs) in the private sector, excluding government-owned entities



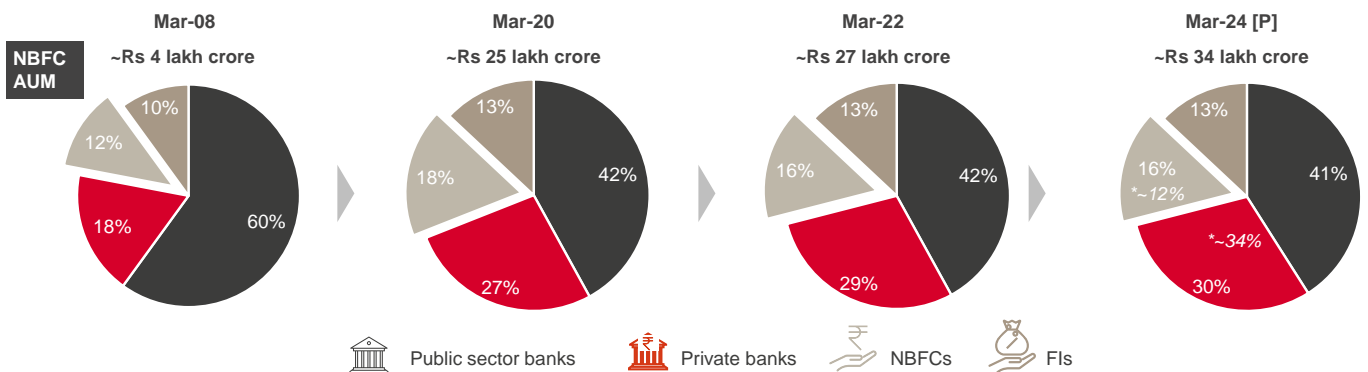
NBFCs: An important cog in the credit delivery wheel

After several challenging years, fiscal 2023 has brought growth back into focus for NBFCs². To be sure, NBFCs have demonstrated an innovative and resilient streak over the years, adapting efficiently, even during the Covid-19 pandemic, to an evolving credit landscape. Today, they are stronger, more resilient and well placed to tap growth opportunities.

NBFCs had steadily increased their market share till recent years, with AUM accounting for as much as 18% of the overall credit pie in March 2019, up from 12% in March 2008. Several challenges over the past three fiscals lowered their share to 16% in fiscal 2022, with banks making bigger growth strides. However, NBFC growth is expected to pick up from here on, which should help sustain their ~16% AUM share.

Increase in NBFCs' AUM from just Rs 3.6 lakh crore in March 2008 to almost Rs 27 lakh crore in March 2022, and expected to increase further, indicates the importance of the sector to overall credit delivery in the economy.

Share of NBFCs in overall credit



Note: Total AUM in the financial sector; bank credit is of scheduled commercial banks and excludes exposure to financial sector. NBFCs include HFCs, but exclude government-owned NBFCs. Private banks include foreign banks and SFBs. FIs include all-India financial institutions + government-owned NBFCs
 Source: RBI, company reports, CRISIL Ratings estimates

Note: Numbers with * represent share of the segment factoring in the proposed merger of a large HFC with a private bank

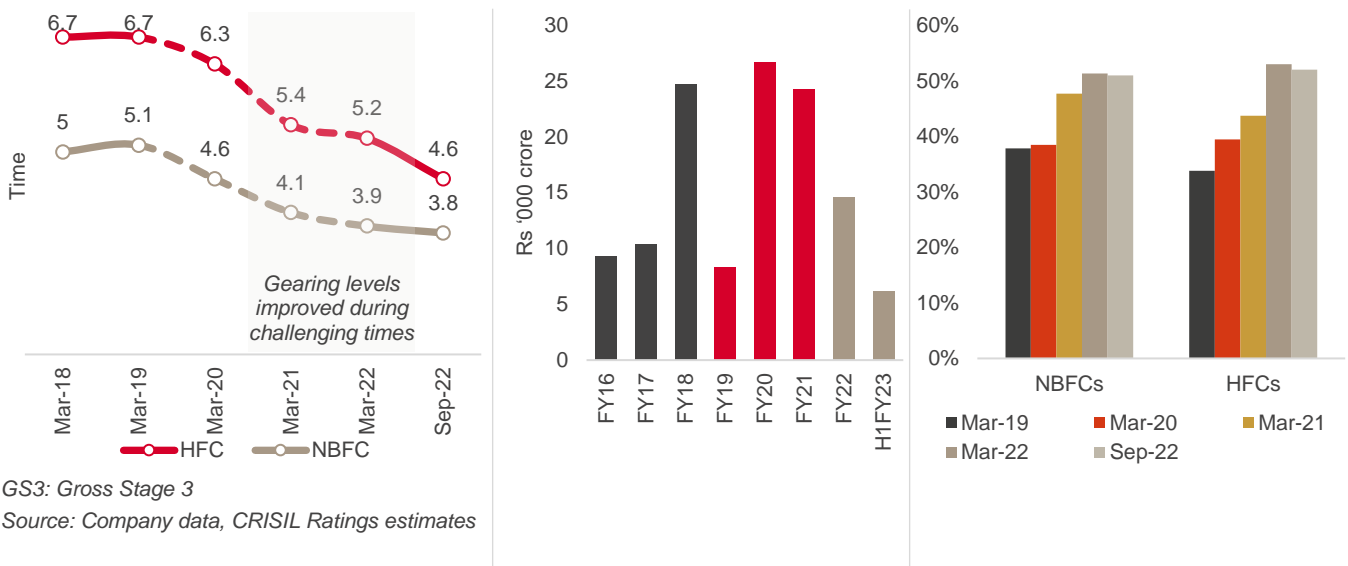
² Including HFCs, but excluding government-owned NBFCs

Stronger balance sheets, better asset quality underpin growth

NBFCs are stronger and more resilient today, and better positioned in almost all operationally critical parameters. On the capital front, NBFCs have raised almost Rs 70,000 crore of equity in the past 3.5 years, which has materially improved gearing. The subdued business landscape in the past three fiscals also contributed to the better gearing.

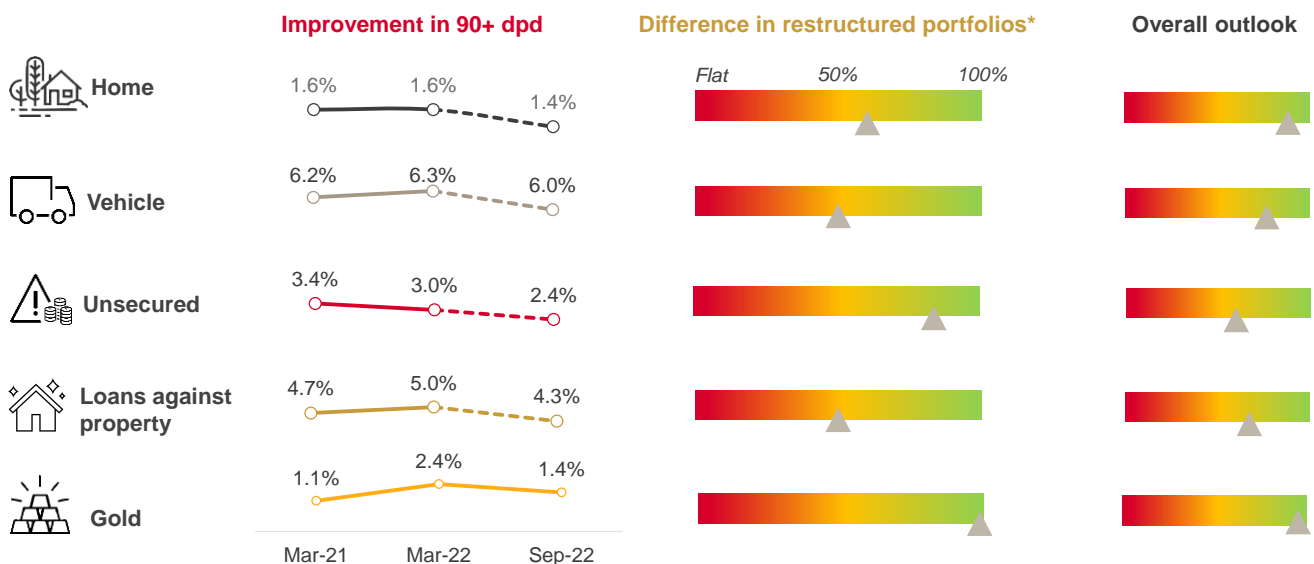
Provisioning levels also increased in the past couple of years, as NBFCs created management overlays to provide for uncertainty pertaining to the pandemic. Overall, the sector has stronger balance sheets.

Gearing, equity raising, and GS3 provisioning cover



The receding asset quality pressures are another positive. Asset quality metrics are expected to improve from here on across segments.

Asset quality expectations



Dpd: Days past due

* Difference in restructured portfolios reflects drop in the restructuring for the segment till September 2022 over September 2021

Source: Company data, CRISIL Ratings estimates

The line charts above reflect the 90+ days past due (dpd) for the asset segment, the second column reflects the change in restructured portfolios from September 2021 till September 2022, and the last column indicates the asset quality outlook for the segment. In the second and third columns, the further right the small triangle is located, the more positive is the assessment of the situation.

Between March 2021 and March 2022, there was a marginal increase in 90+ dpd for a few asset segments amid lingering concerns regarding the restructured book. Asset quality metrics have improved across segments in the first half of this fiscal based on the numbers as on September 30, 2022. The fundamentals are expected to hold with improvement in the macroenvironment. At the same time, restructured books have reduced considerably over the past year, with most segments now holding negligible outstanding restructured portfolios. It must be noted that some segments such as vehicle finance still have residual restructured book, from where there could be potential slippages. While asset quality metrics are expected to be resilient going forward, any major challenges stemming from rising inflation, interest rates and job losses remain key monitorables.

Competition from banks and rising interest rates are the key challenges

While NBFCs are relatively well placed today as compared with the past few years, competition from banks and the rising interest rate scenario pose challenges. Competition from banks has intensified, especially in the traditional segments.

The banking system has also gone through its fair share of cycles. Grappling with asset quality concerns, inadequate provisioning and weak capital buffers in 2018, the banking sector now has manageable non-performing assets (NPAs) with a healthy provision coverage ratio (PCR) and comfortable capital buffers; and is well placed to tap growth opportunities. In fact, banks have outpaced NBFCs in growth since March 2020. While the gap has narrowed this fiscal, NBFCs continue to lag.

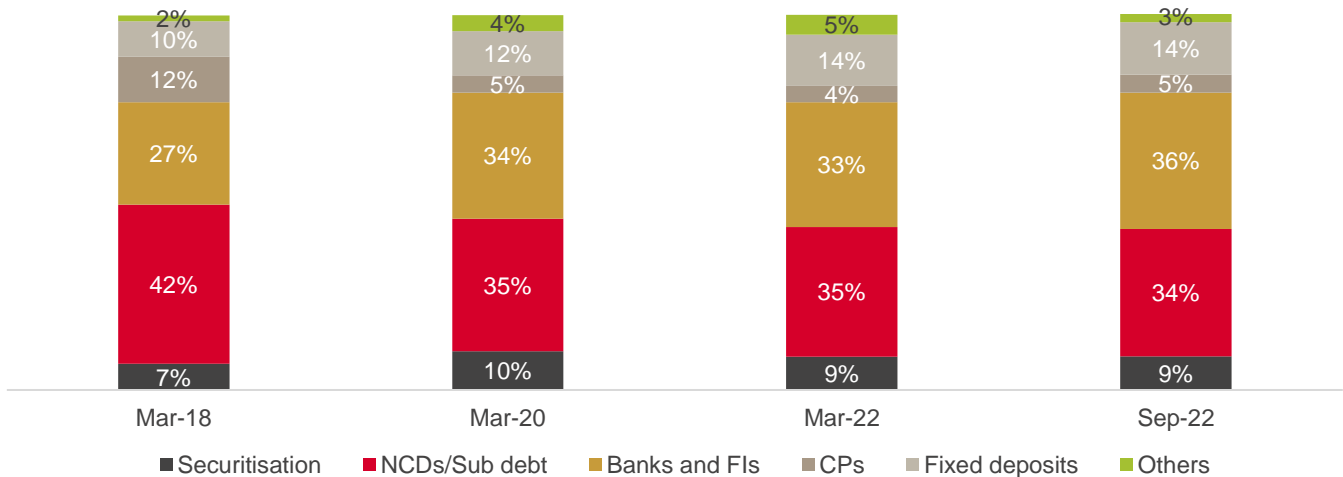
At the same time, rising interest rates will limit the competitiveness of NBFCs in some segments. The repo rate has already been increased by 225 basis points (bps) this fiscal with another ~25 bps hike anticipated, taking the total tally for the fiscal to ~250 bps. This will impact the borrowing cost for NBFCs.

NBFCs have faced funding-access challenges in the past few years, especially in debt capital markets. Banks, though, have provided significant support to them, with bank credit to NBFCs touching an all-time high of Rs 11.7 lakh crore as of September 30, 2022. Consequently, the share of bank funding in the overall resource profile of NBFCs increased to 36% in September 2022 from 27% four years ago, nearly mirroring the drop in share of non-convertible debentures (NCDs).

For deposit-taking NBFCs, fixed deposits (FDs) were a big focus area, especially as bank FD rates were low. While debt capital market issuances have been subdued over the last year or so given the rising interest rate environment, there has been some uptick in the last quarter or so.

Another funding route that has helped NBFCs is securitisation, including through direct assignment. Here, too, banks account for the bulk of pool purchases, providing indirect funding to the NBFC sector.

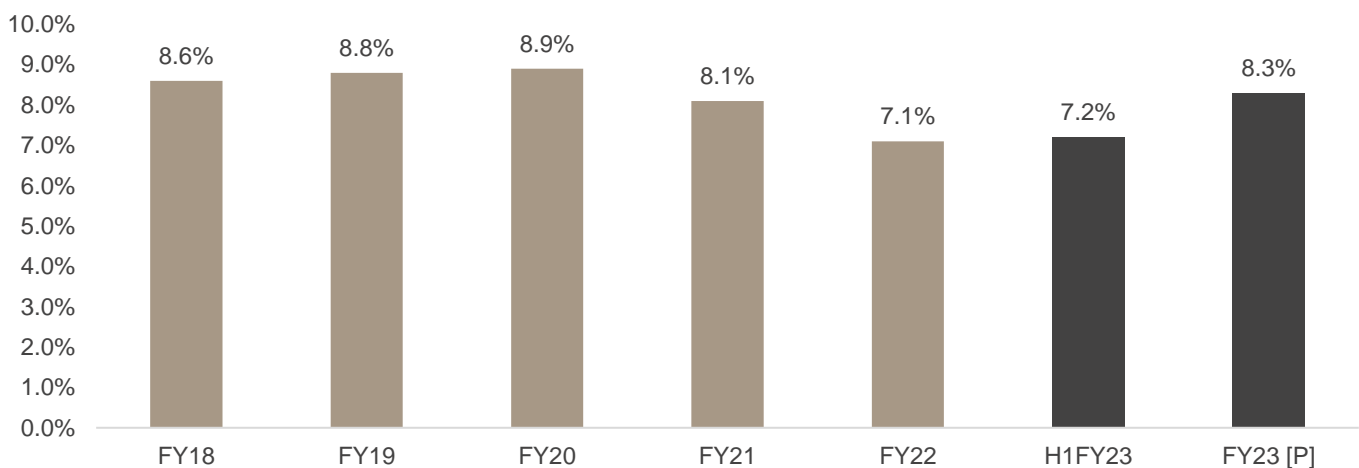
The resource profile mix for NBFCs



Source: Company data, CRISIL Ratings estimates

The rising interest rate scenario is expected to increase the cost of borrowings of NBFCs by 100-120 bps this fiscal. However, as NBFCs have the ability to pass on the higher borrowing cost for incremental disbursements in some of their asset segments, spreads are estimated to compress 40-60 bps.

Cost of borrowings to rise for NBFCs this fiscal



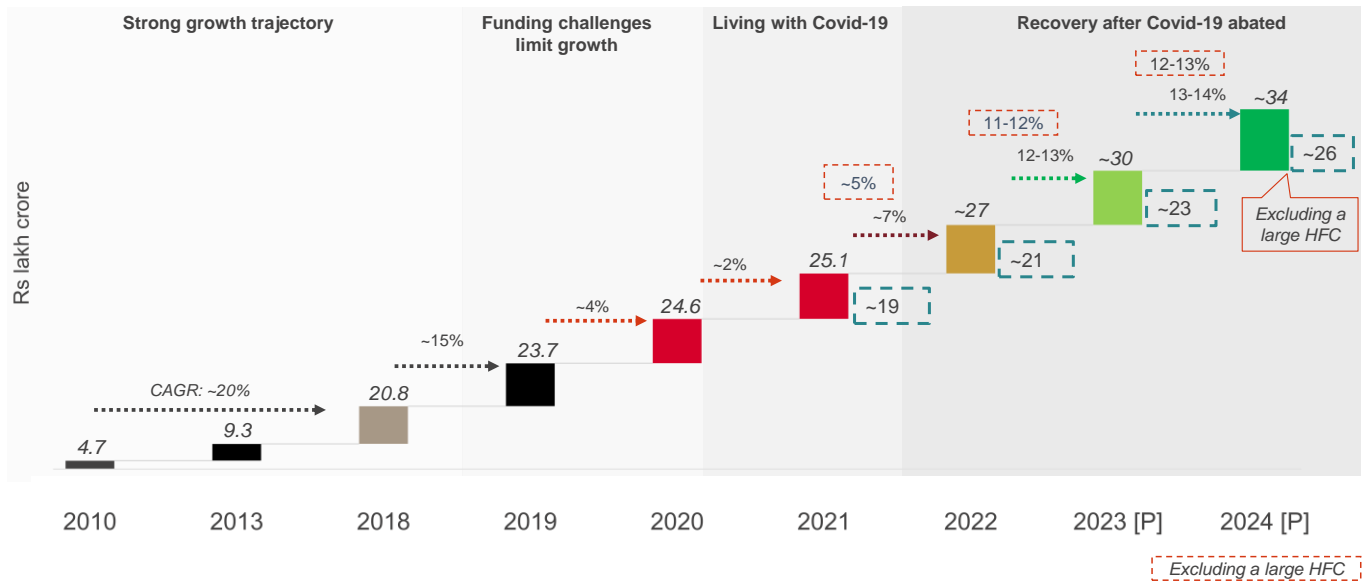
Source: Company data, CRISIL Ratings estimates

Portfolio strategy reset to drive segmental growth; AUM to rise 13-14%

Amid interest rate hikes and competition from banks, NBFCs are realigning portfolio strategies for better risk-adjusted returns. The disbursement trends reflect the changing strategies of NBFCs towards non-traditional segments. The share of disbursements in unsecured loans and MSME finance, the non-traditional segments, has increased over the past 1.5 years. In the first half of this fiscal, ~35% of incremental disbursements were for unsecured loans. MSME finance has also posted strong growth. The traditional segments, too, have seen improvement in volumes, but remain range bound compared with previous years. This will result in a change in segmental growth going forward.

Overall, NBFCs' AUM growth is expected to double to 13-14% next fiscal from ~7% last fiscal.

AUM growth to double



Source: Company data, CRISIL Ratings estimates

For home loans, the biggest segment comprising 40-45% of NBFCs' AUM, structural factors driving end-user housing demand are intact, despite the impact of rising real estate prices and interest rates. This should drive 13-15% growth in AUM next fiscal. That said, housing finance companies (HFCs) may continue to lose market share to banks amid intense competition on interest rates, especially in the urban and formal salaried segments. Rising interest will also lift the borrowing cost of NBFCs and lower their competitiveness vis-à-vis banks, which have access to lower cost funds.

Vehicle finance, the second-largest segment (20-25% of AUM), is projected to grow 13-14% next fiscal, compared with an estimated ~12% this fiscal, on the back of solid underlying asset sales. Strong pent-up demand and new launches will continue to drive car and utility vehicle sales. Economic rebound, demand for fleet replacement, and focus on last-mile connectivity will support commercial vehicle (CV) sales. In the new vehicle finance segment, especially cars, borrowers are highly sensitive to interest rates, resulting in tough competition from banks given their ability to offer finer pricing. Hence, NBFCs are likely to leverage their core strengths of last-mile connectivity, customer relationships, innovativeness, and strong understanding of micro markets to sharpen focus on used vehicle financing, which offers higher yields and better profitability from a risk-adjusted return perspective.

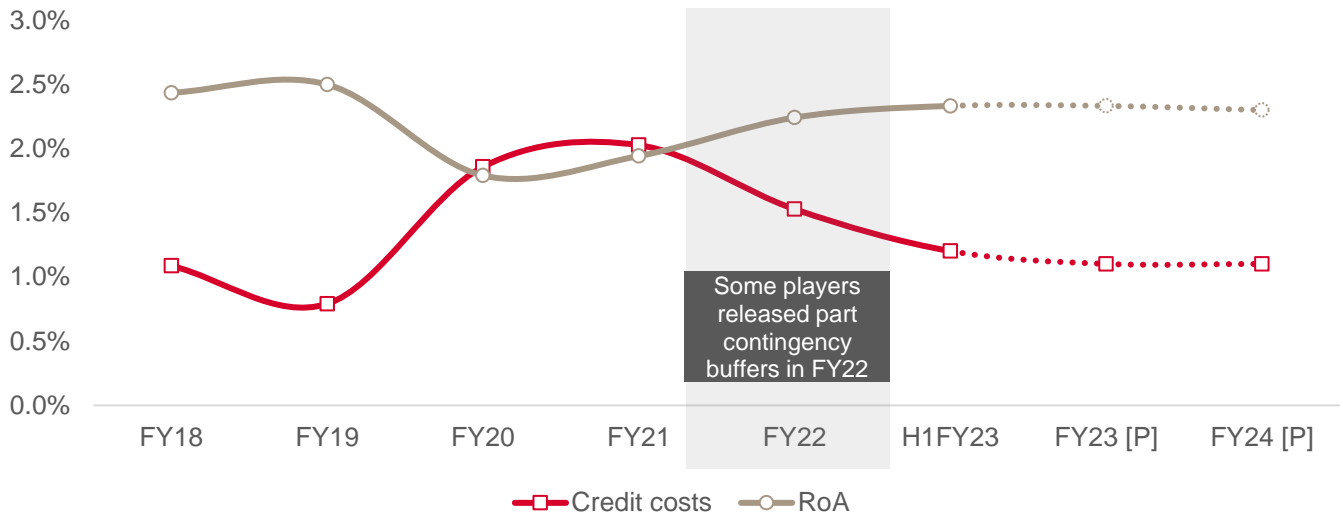
Unsecured loans (8-10% of AUM) is the cynosure for many large NBFCs. Demand for consumer loans is high across durables, travel and other personal consumption activities, while business loans have benefited from macroeconomic tailwinds. AUM in this segment is seen growing 20-22% next fiscal.

As large NBFCs turn towards non-traditional segments, symbiotic partnerships are expected to increase with segment-focused emerging NBFCs, especially in unsecured lending. This will allow large NBFCs to venture into new segments in a more cost-efficient manner, while reducing time-to-market, and support capital-efficient AUM growth for emerging NBFCs. Co-lending with banks remains another preferred route for growing AUM, especially for mid-sized and emerging NBFCs.

Rising rates to hit borrowing cost, but better credit cost to prop profitability

Though rise in borrowing cost will compress spreads, improvement in asset quality metrics should lead to better credit costs, which, in turn, should support earnings and growth prospects. Credit costs will also benefit from the substantial management overlays created by NBFCs, which will be dipped into.

Trends in RoA and credit costs



Source: Company data, CRISIL Ratings estimates

A few things bear watching though: global slowdown, inflation and the evolving regulatory framework, which could necessitate tweaks in business models, especially in new segments such as digital lending. Still, there is considerable potential for NBFCs to grow, given the scope for increase in financial inclusion and spread of formalised financial services.



HFCs: Refurbishing business models

With HFCs at an inflection point, intense competition from banks amid rising rates could have a different impact on them given sectoral nuances compared with other segments of operations for NBFCs. Hence, while structural factors driving growth are in place, higher borrowing costs due to the aforementioned factors can impact profitability.

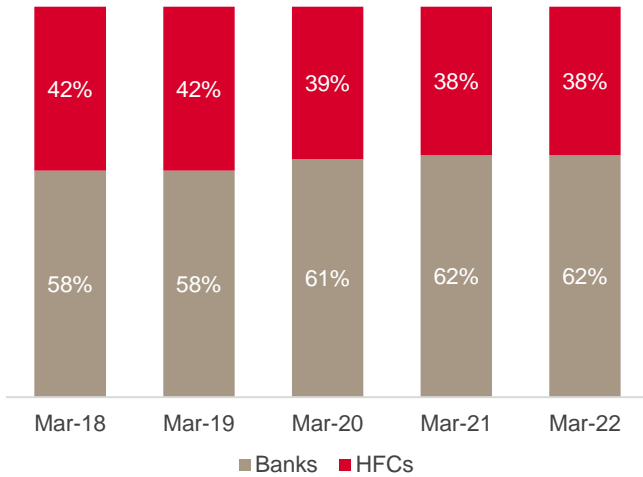
Though growth drivers intact, structural limiters to profitability persist

Similar to NBFCs, balance sheets of HFCs (account for more than half of the NBFC AUM) have also strengthened over time. Of the over Rs 70,000 crore raised by non-banks in the past 3.5 years, ~Rs 25,000 crore was raised by HFCs, significantly improving their gearing. Asset quality, especially in home loans, has proven resilient, with low restructuring levels and the Reserve Bank of India's IRACP (Income Recognition, Asset Classification and Provisioning) clarification has had a limited impact.

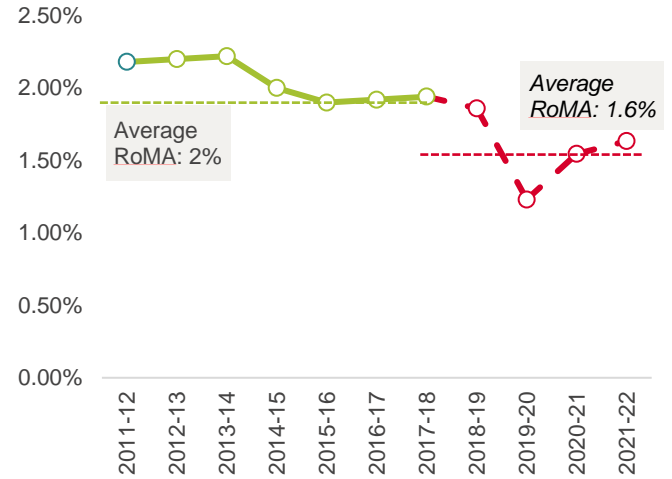
However, HFCs face structural limiters to profitability. Competition from banks has forced HFCs to concede market share in the past two fiscals (including fiscal 2023) since yield pressure continues in home loans. Therefore, thinner spreads with increasing competition may lead HFCs to realign their business models.

Interestingly though, there is a shift in the HFCs' portfolio constitution: the share of high-yielding segments such as loans against property (LAP) and construction finance, which had been on a secular downward trend given the challenges faced by the sector, are now seen rising again, albeit in a calibrated manner.

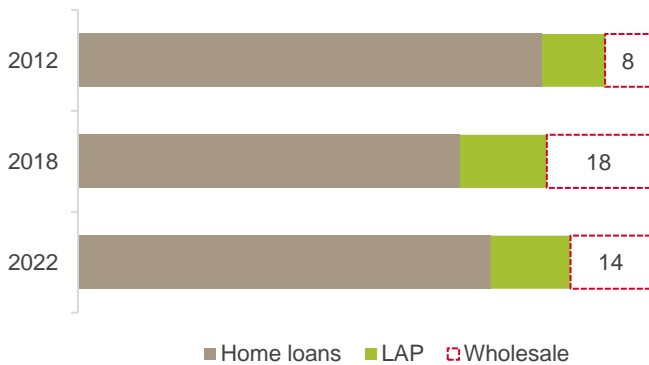
Intense competition from banks in home loans set to stay with banks' share in AUM remaining high



Trend in profitability (RoMA, %)



High-yielding segment moving to alternate platforms



Note: Numbers excluding one large HFC
Source: Company data, CRISIL Ratings estimates

Liabilities side imperatives



Key challenge is access to **competitive cost funding beyond a scale**

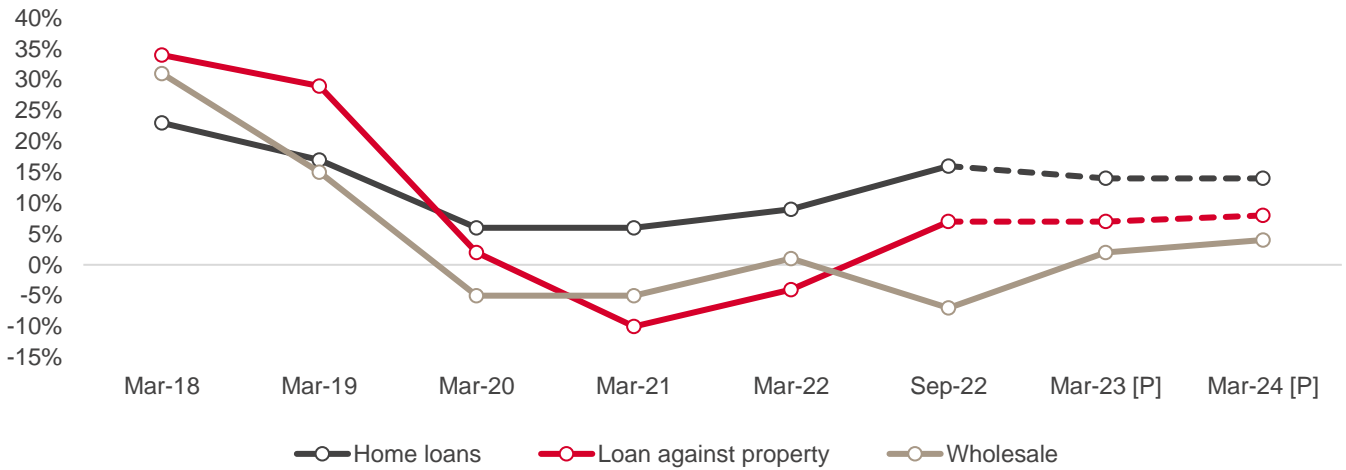


Lack of **depth in corporate bond markets**

Re-entering previously vacated space to help drive growth going forward

Similar to LAP, construction finance, which had degrown in the past couple of years, is picking up with the cautious re-entry of some HFC players. Home loan AUM should rise 13-15% this fiscal, backed by higher demand and the continued preference for home ownership. Over the medium term, growth rates in LAP are expected to be resilient even as construction finance turns green.

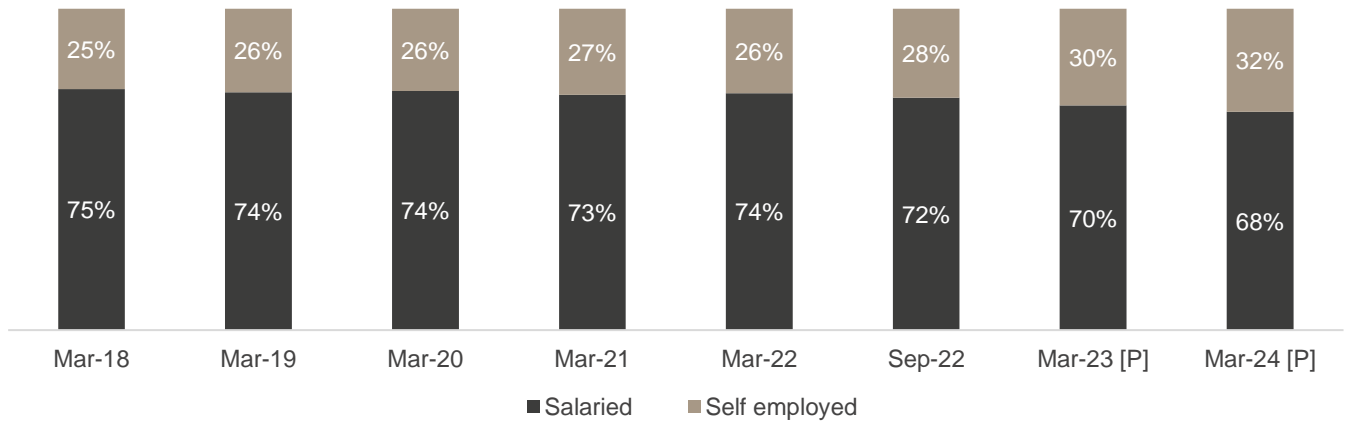
Trend in segmental growth rates for HFCs



Source: Company data, CRISIL Ratings estimates

The effect of intense competition is also visible in the rising share of self-employed customers in the portfolio, which is expected to continue increasing over the medium term as well for HFCs.

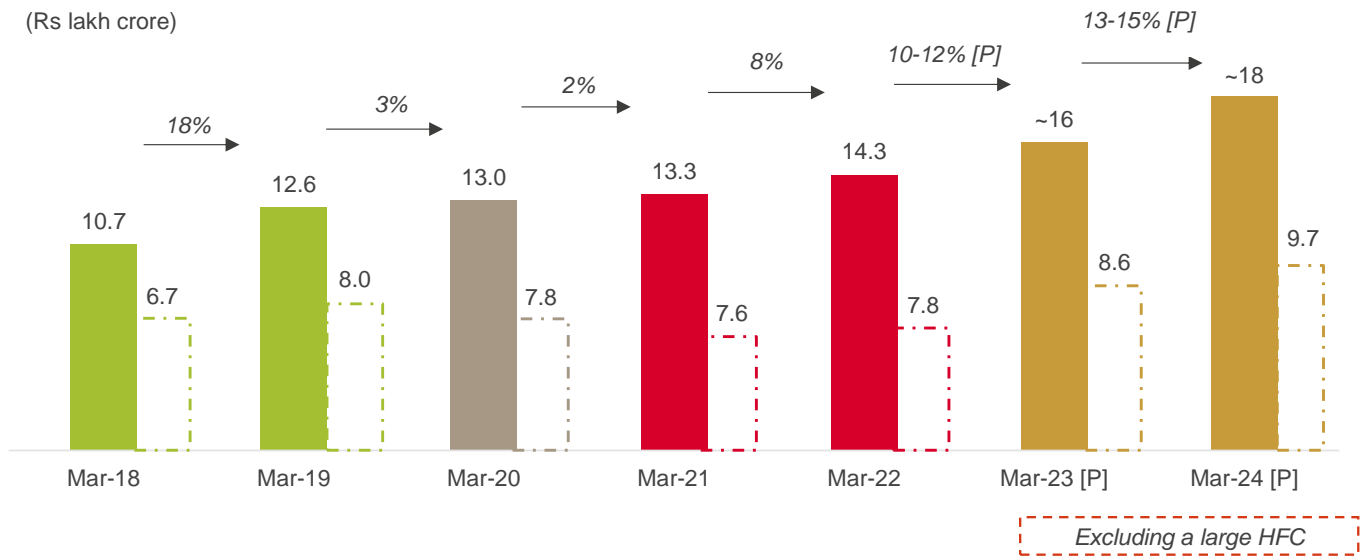
Trend in customer segment profile



Source: Company data, CRISIL Ratings estimates

Consequently, the AUM of HFCs is expected to grow 10-12% this fiscal and 13-15% in the next. However, HFCs will continue to lose share in the home loan market to banks, a trend that is unlikely to reverse in the near term.

Trend in AUM and AUM growth for HFCs

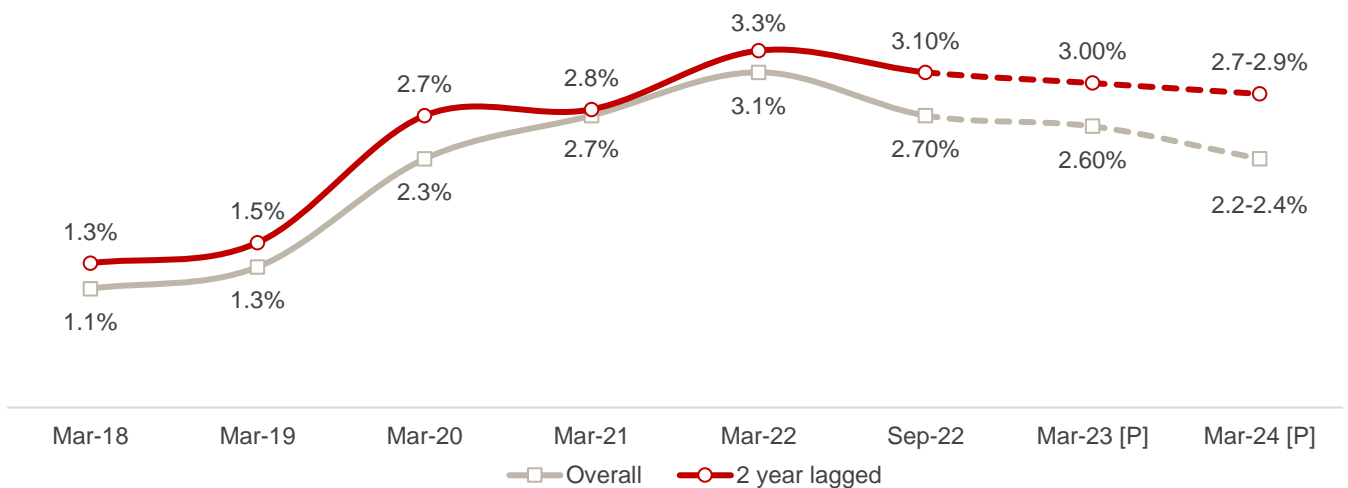


Source: Company data, CRISIL Ratings estimates

Improvement in asset quality to provide growth impetus

Even as growth will be resilient, asset quality metrics are also set to improve over the medium term. Overall delinquencies had increased in the past couple of years following deterioration in the LAP and wholesale portfolios.

Trend in 90+ dpd for HFCs



Source: Company data, CRISIL Ratings estimates

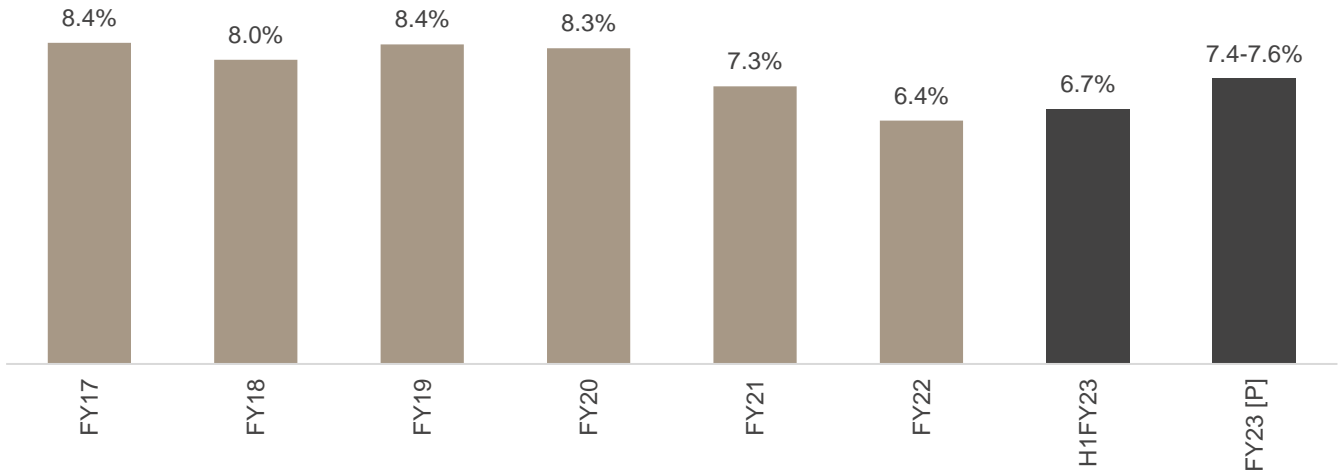
However, amid the cautious stance of players, wholesale portfolios are being cleaned up. A break-up of risk fragments based on a CRISIL Ratings assessment reflects the low-risk portfolio in the wholesale portfolio for HFCs has doubled between fiscals 2019 and 2022, which augurs well for asset quality going forward.

With players re-enter LAP and construction finance, the performance of these portfolios will remain a key monitorable.

Spread crunch inevitable, better credit costs to support earnings profile

The cost of borrowing for HFCs is set to increase in fiscal 2023. However, with the asset side for HFCs being floating, they have been able to pass on some of the rise in borrowing cost. Consequently, overall spreads are expected to compress ~25 bps.

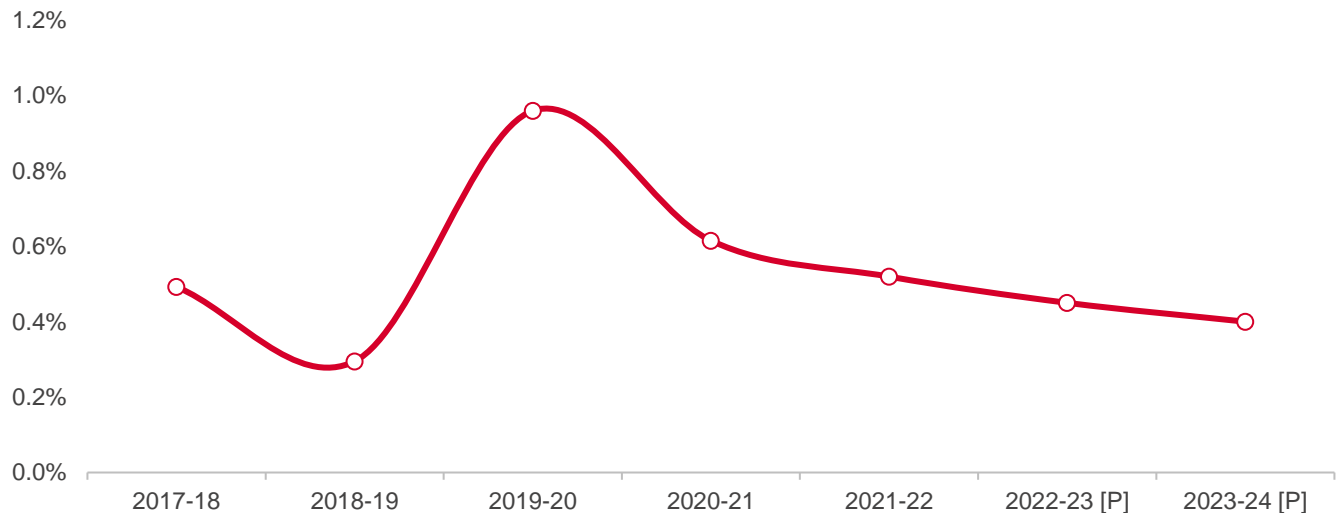
Trend in cost of borrowings for HFCs



Source: Company data, CRISIL Ratings estimates

At the same time, the expected improvement in asset quality metrics will lower credit costs.

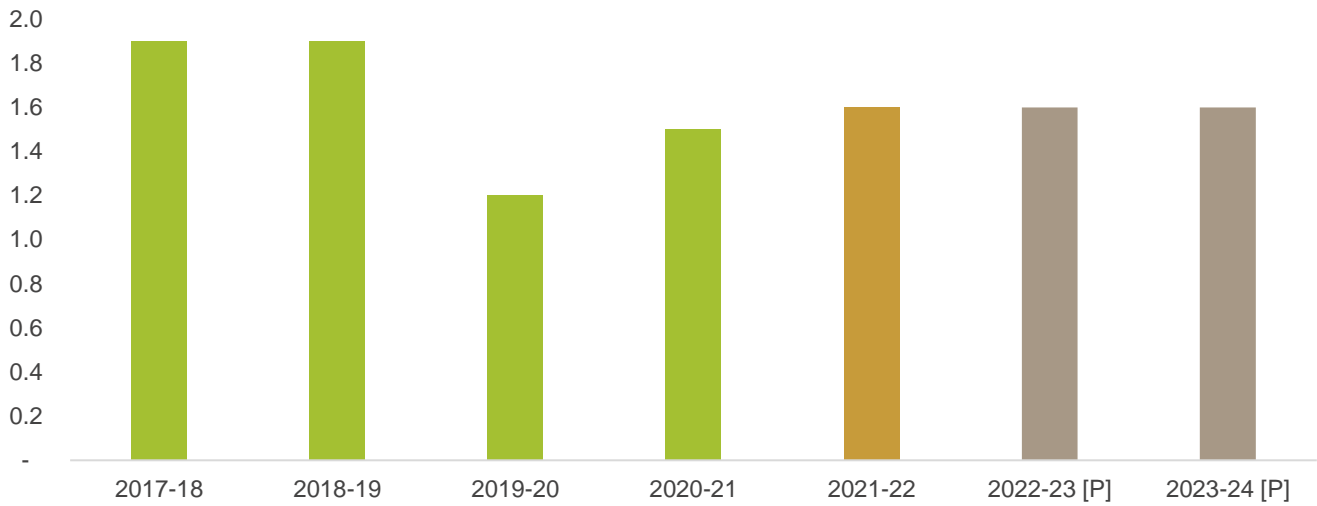
Trend in credit costs



Source: Company data, CRISIL Ratings estimates

This will, in turn, support the overall earnings profile, with return on managed assets (RoMA) expected to remain fairly stable.

Trend in RoMA



Source: Company data, CRISIL Ratings estimates

Hence, while green shoots are visible, opportunities and challenges can be different based on business models. While larger HFCs are expected to explore customer and asset diversification to boost profitability via partnerships, mid-sized HFCs will likely grow steadily given their focus on affordable housing finance. However, competition for emerging HFCs is likely to get more intense given growth ambitions of several HFCs turning their attention to the affordable housing finance segment. While the smaller players can consider partnerships, controlling credit costs will remain crucial for stable profitability.



Vehicle finance: On a fundamental drive

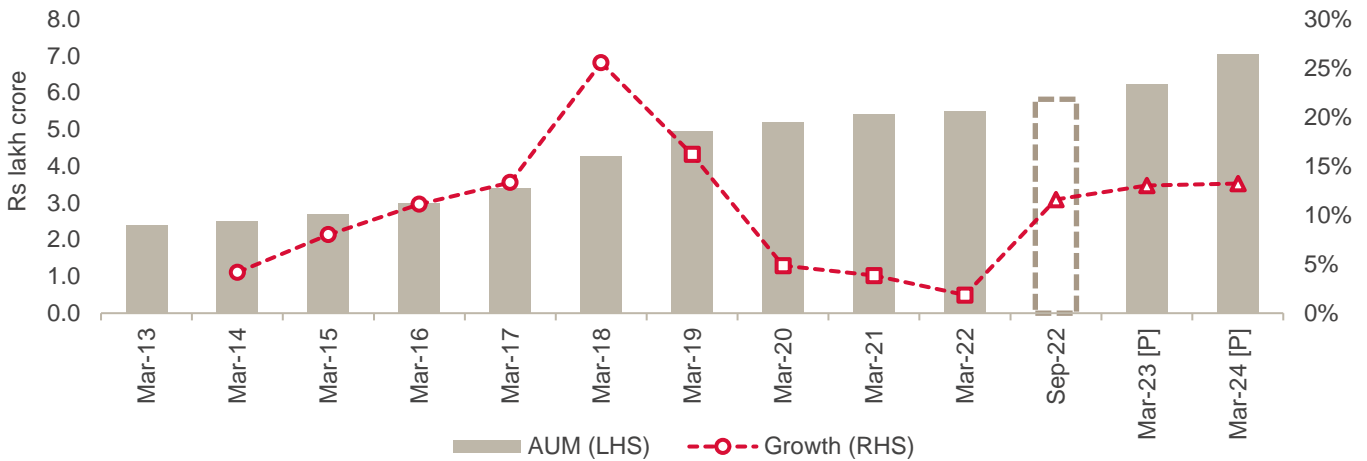
Like housing finance, vehicle finance—the second-largest segment of the NBFC AUM pie—too, faces intense competition from banks, especially in the new vehicle loan segment. However, this is a segment where NBFCs have carved a niche for themselves over the years, which should stand them in good stead.

Vehicle finance AUM to grow 12-14% over the next two fiscals

The cyclical nature of vehicle finance reflects its close linkages with the macroeconomic environment and underlying asset sales. However, after muted growth in the past three fiscals because of the Covid-19 pandemic, new asset sales across segments are expected to be buoyant this fiscal. Easing of the semiconductor shortage and pent-up demand will support uptick in car and utility vehicle (UV) volumes. Growth in CVs, the largest segment for NBFCs within vehicle finance, will be supported by improving transporter profitability and expectations of prebuying with the second phase of Bharat Stage (BS) VI kicking in. Tractor is the only segment where sales are expected to grow moderately given the high base of previous fiscals, and due to subdued farmer sentiment following an erratic monsoon and delayed kharif harvesting.

As with new vehicles, sale of used vehicles is also gathering momentum, which is expected to continue over the medium term. Entry of new players has formalised this segment, thereby supporting growth. As a result, vehicle finance AUM is expected to grow 12-14% over the next two fiscals.

Trend in vehicle finance AUM



Source: Company data, CRISIL Ratings estimates

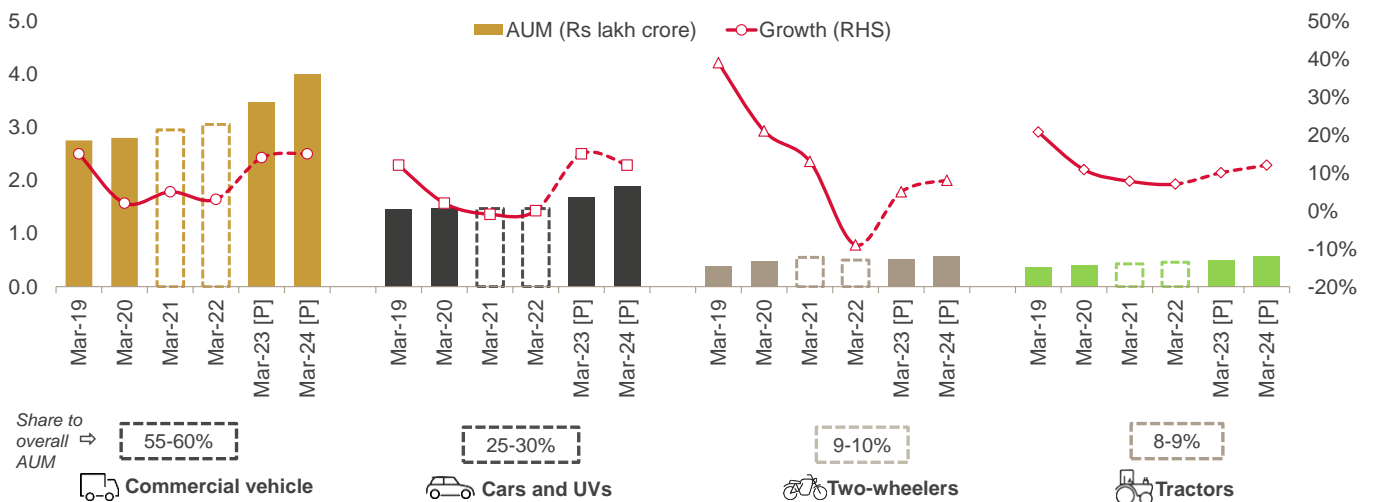
Banks to gain in new vehicle loans; used vehicles, LCVs remain NBFC forte

Driven by intense competition from banks, NBFCs are expected to cede share in the new vehicle finance segment. For instance, in the price-sensitive cars and UV space, banks have continuously gained share (~70% as of March 2022 from 67% as of March 2019) due to lower yields they offer compared with NBFCs; this trend is expected to continue. However, NBFCs are expected to maintain their leadership in CVs, specifically in the light CV (LCV) and used finance segments.

CVs to drive overall vehicle finance growth

The CV finance segment is expected to grow 14-15% in the near term. Due to the dominance of banks and revival of new car sales, growth in cars and UVs is expected to settle at ~15% (higher than the single-digit growth seen previously), though half-year growth may be higher. Growth in two-wheelers will see a robust uptick, coming off a low base. Tractor growth is expected to be relatively lower at 8-10%.

Trend in vehicle finance segmental AUM



Figures in boxes above bars show the share of the segment in overall vehicle finance assets under management

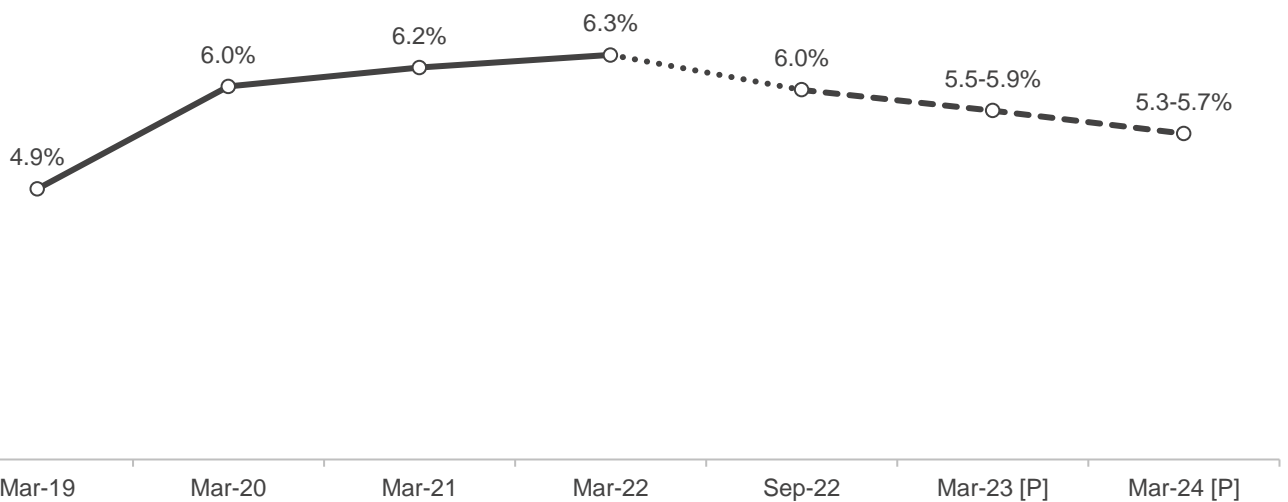
Source: Company data, CRISIL Ratings estimates

Asset quality set to improve, while growth revives

The asset quality for vehicle finance is expected to improve over the medium term on the back of structural factors. Over the past several months, freight rates have increased in tandem with rising fuel costs, which means the burden of higher fuel prices is not being borne by the transporter. This has improved transporter cash flows.

Asset quality, as measured by 90+ days past due (dpd), is likely to show improvement by the end of March 2023. Nevertheless, with the implementation of the Reserve Bank of India (RBI) circular on Income Recognition, Asset Classification and Provisioning (IRACP) norms after September 2022, reported NPAs may increase. However, the impact will vary across players, some of whom had adopted the new regime after its introduction in November 2021 and continued with it. At the same time, performance of the restructured portfolio, which has halved from the initial 1.5-2%, needs to be monitored.

Trend in 90+ dpd for vehicle finance



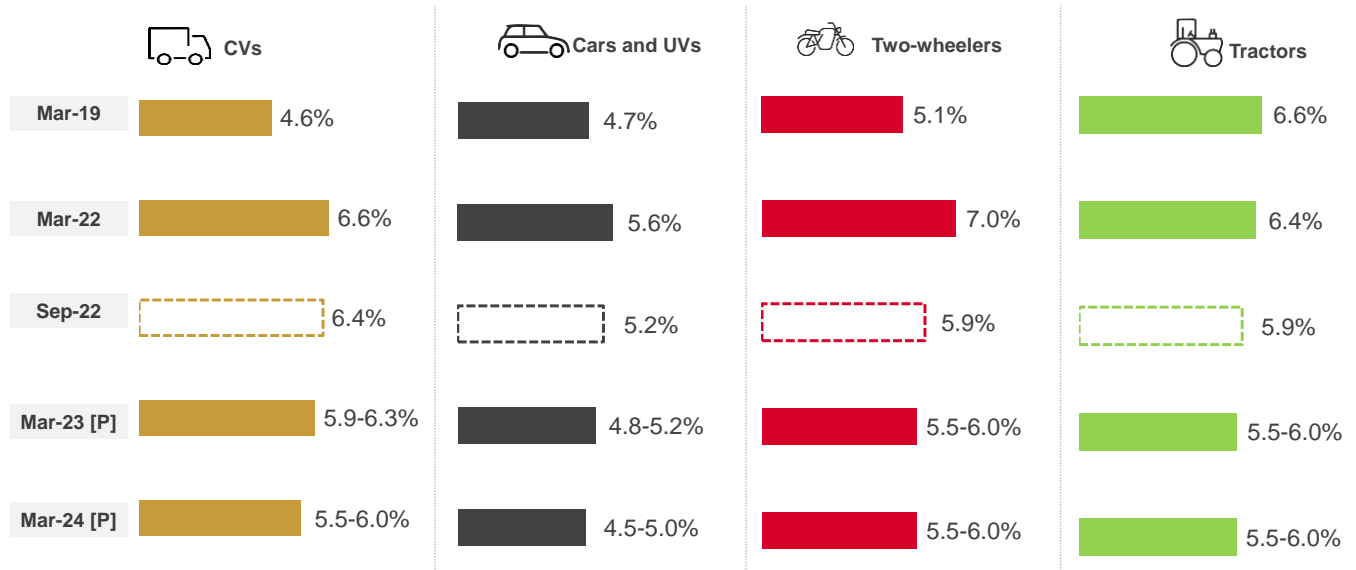
Source: Company data, CRISIL Ratings estimates

Improvement will be visible across segments

Some improvement was already visible in the asset quality of each sub-segment in vehicle finance in the first half of fiscal 2023, and this trajectory is expected to continue over the medium term. While all segments are likely to either improve or maintain steady performance, the biggest improvement is expected in the CV space, which is most closely linked to economic activity and will also ride some of the macro tailwinds.

Asset quality in the two-wheeler and tractor segments is expected to remain range bound given the characteristics of the underlying borrower segments; especially in the case of tractor, which is driven by agricultural activity and impact of the monsoons.

Trend in segmental asset quality metrics (90+dpd)



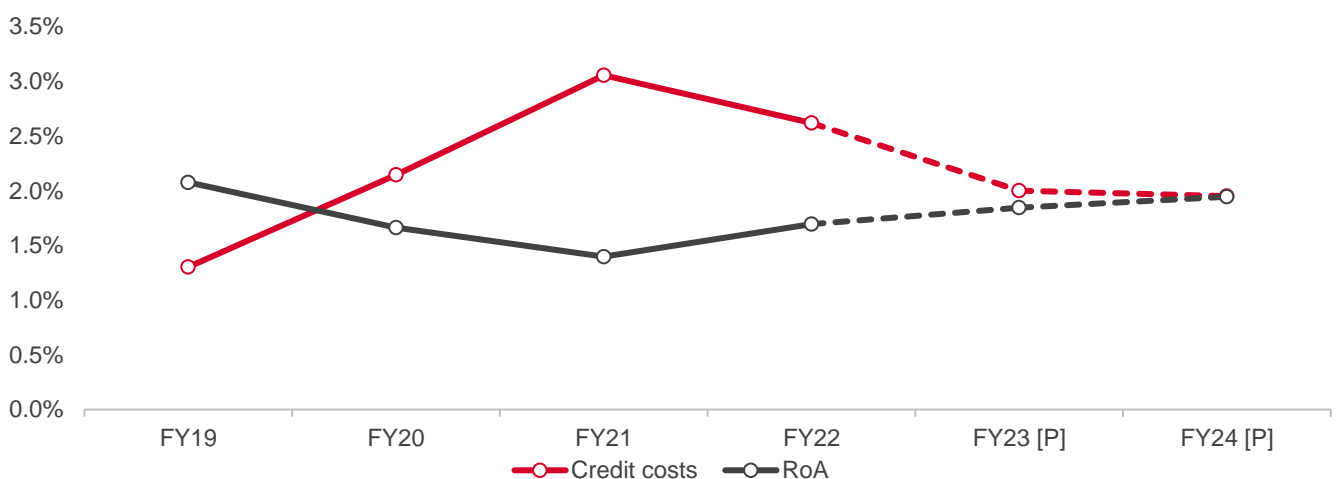
Source: Company data, CRISIL Ratings estimates

Performance of used vehicles is expected to remain reasonable, though individual players may fare differently. Interestingly, for some players delinquencies in the used vehicle space are at par or better than new vehicles, leading to increased focus on this space.

Reduction in credit costs will support profitability

While earnings are expected to remain stable overall, vehicle finance is the only segment where return on assets (RoAs) is likely to improve over the medium term. Though cost of borrowing will rise even for entities operating in vehicle finance, spread compression will be relatively lower owing to better ability to pass on the higher interest rates to new borrowers for new disbursements, especially in segments where NBFCs face limited competition. However, the biggest respite will come from improvement in credit costs: NBFCs had created sufficient management overlay buffers to counteract the pandemic’s impact in the past few fiscals. These buffers are now being dipped into, which, in tandem with improvement in asset quality, will support credit costs.

Trend in credit costs and RoA for vehicle financiers



Source: Company data, CRISIL Ratings estimates

The fundamentals are clearly in place for a revival in vehicle finance, though competition remains intense, especially in cars and UV finance. To manage this, we see an increased focus on the used vehicle segment as a risk-return strategy. While underlying asset quality or 90+ dpd will improve, reported GNPA metrics may weaken for some players because of revision in NPA recognition norms. At the same time, higher-than-expected interest rates and inflation, and their impact on borrower cash flows will be key monitorables. In the long term, niche positioning across customer/asset segments will ensure NBFCs continue to play a critical role in the vehicle financing space.



Digital lending: On the cusp of reorientation

Digital lending in India today is on the cusp of reorientation, as the segment navigates crosscurrents of increasing regulatory oversight amid continuing influx of digital lenders. Providing the much needed support to the ecosystem are enhanced mobile network coverage, rising smartphone usage, and increasing formal data availability. Indeed, the space has the potential to change the anatomy of the Indian financial ecosystem.

Drivers in place for digital lending; regulatory oversight monitorable

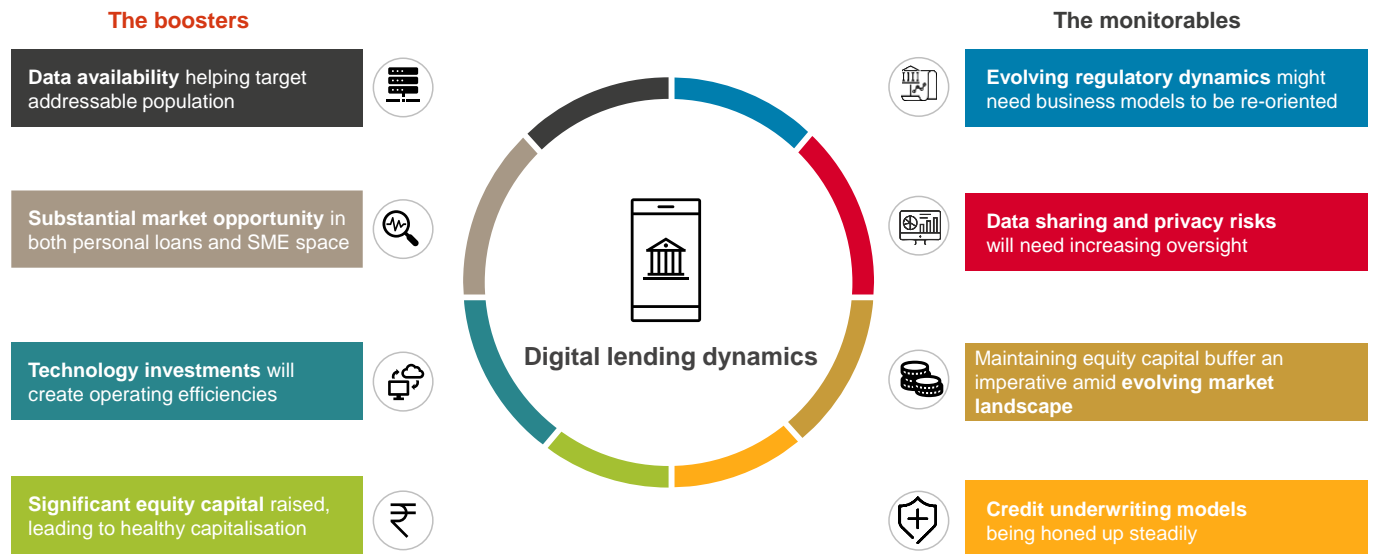
The surge in digitisation has been a journey in the making. It all started in 2010, with Aadhar authentication translating into Aadhar e-verification. The Pradhan Mantri Jan Dhan Yojana in 2014 cranked up the speed, as a number of bank accounts were opened under this scheme, bringing in formalisation of the economy. At the same time, the Rupay network was introduced. Demonetisation turned out to be the inflection point. The Covid-19 pandemic, with its own share of challenges, also provided an impetus, as digital became the way of life for a while.

Growth of digital adoption in India is reflected in the rise in the RBI digital penetration index from 100 in March 2018 to almost 350 in March 2022.

Considerable improvement in data availability over the years, enabling underwriting of some borrower segments based on alternative data sources, has been another supporting factor. In addition, there is huge market opportunity in the primary operating segments (personal and unsecured SME loans).

That said, there are some monitorables, too, in terms of data storing, sharing and privacy risks as well as evolving regulations. There is a lot of focus on data storing/sharing and usability issues across the globe. In addition, the credit underwriting models adopted by digital lenders have been constantly evolving and will need continual honing in the future as well, given the nature of the business. To top it all, the regulatory regime is still evolving.

Boosters and monitorables for digital lending ecosystem



Source: Company data, CRISIL Ratings estimates

Digital lending guidelines leading to reorientation of business models

While the regulatory regime is still evolving, the RBI has announced digital lending guidelines this fiscal, which could alter the way of doing business, increase operating expenses and change underwriting models.

The guidelines on disbursements and collections being directly between the bank account of the lender and the borrower will impact some business models. Players now have to come out with a key fact statement and disclose the annual percentage rate (APR) upfront. While charges were disclosed to borrowers earlier, too, the new guidelines could impact incremental business as borrowers will now be able to see their total annual costs and compare them with the alternatives.

The introduction of the cooling off period may affect retention of customers, which is crucial, given the short tenure of loans and the relatively high cost of acquisition. Another key guideline is on the ability to scrub phones of borrowers, which was a part of the underwriting model with a number of lenders relying on scrubbing of messages, contacts and apps to screen borrowers. This aspect will now need a rejig.

What will also be critical for the sector is the regulatory stance on first loss default guarantees (FLDGs), which is now an important component of the business model for this sector even in co-lending arrangements. Any material impact on the FLDG front could impact partnerships, thereby affecting the availability of funds, as co-lending is an asset-light business model. Nevertheless, the nimbleness of digital lenders should allow them to quickly realign models and continue their business.

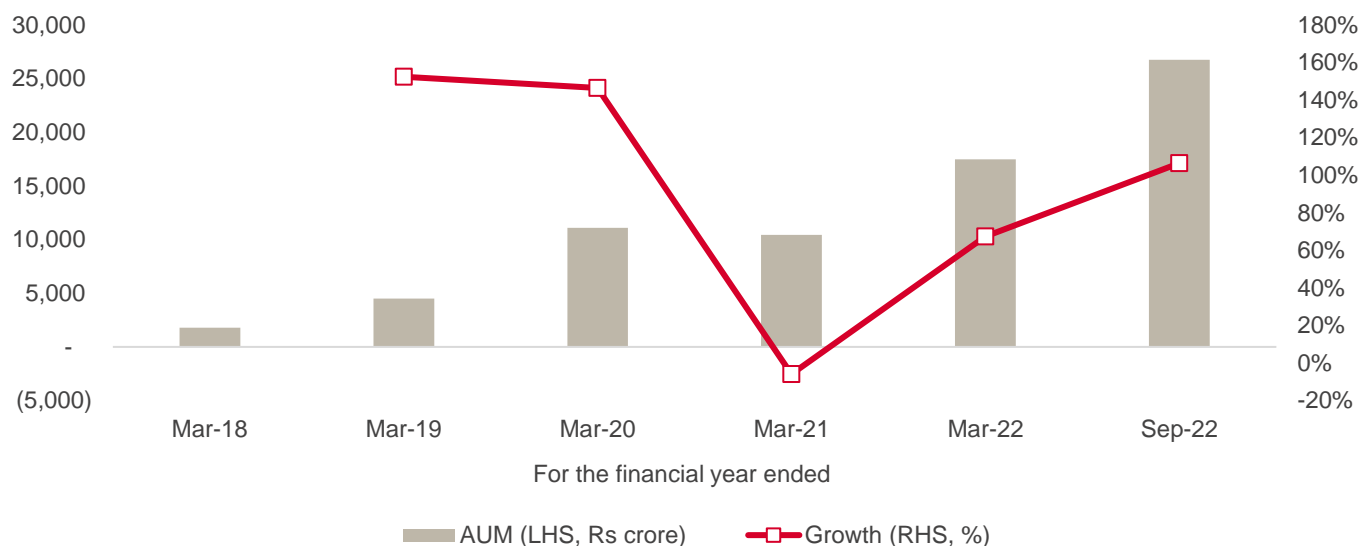
For the CRISIL Ratings set³, AUM rises sharply, asset quality resilient

For the digital lenders rated by CRISIL Ratings, AUM rose at a robust CAGR of over 75% between March 2018 and March 2022. This is despite the pandemic's impact from March 2020 till the first half of fiscal 2022. During the

³ CRISIL Ratings' study on ~15 rated digital lenders, primarily in the unsecured SME lending and personal loan segments

challenging Covid period, some players realigned their portfolio strategies towards anchor-based supply chain financing, incorporating learnings from the pandemic-led disruptions.

AUM of digital lenders rated by CRISIL Ratings



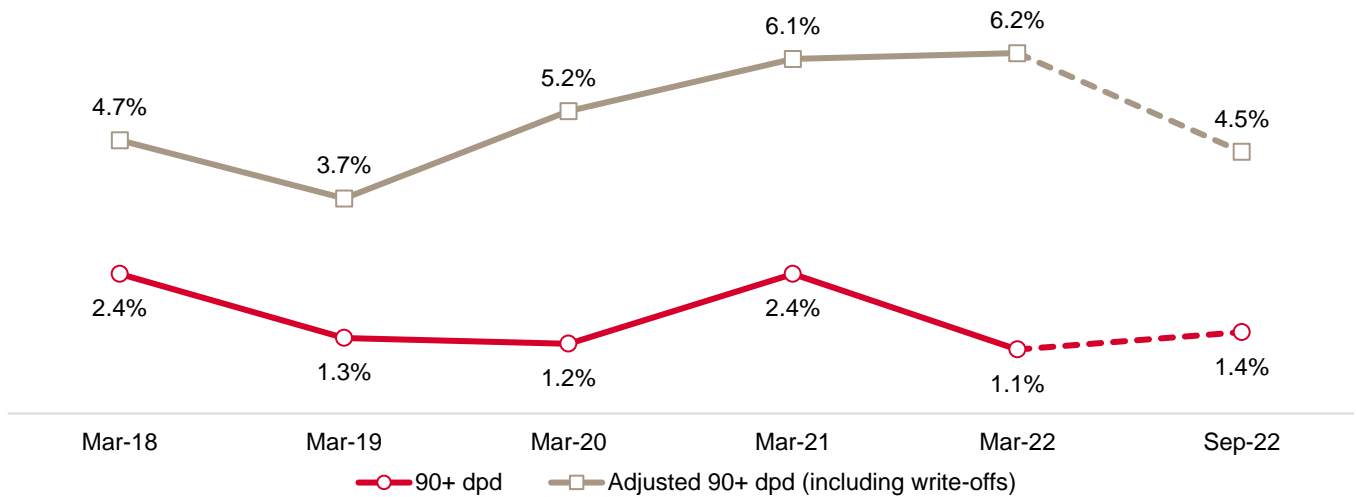
Source: Company data, CRISIL Ratings estimates

Since then, there has been a sharp rebound, with AUM almost touching Rs 30,000 crore as on September 30, 2022. Given the short tenure of digital loans, disbursements are substantially higher than what the AUM reflects. In some cases, disbursements during the year are almost 2-3 times the AUM growth for the year.

The emergence of co-lending as a theme has also supported growth of digital loans. The share of co-lending portfolio for the entities in the sample set increased to almost 37% in September 2022 from 19% pre-Covid, and the partners in most cases are banks as well as large NBFCs. Co-lending is gaining more prominence now as large NBFCs and banks are entering into partnerships in the niche segment of fintech.

While growth has been resilient, asset quality, which was impacted during the pandemic, is on the mend, and has shown an improvement in the first half of this fiscal. To be sure, some bit of improvement was due to the write-offs last fiscal. Given the business model, write-offs for digital loans are generally higher than for other segments. Consequently, the 90+ dpd adjusted for write-offs in the past 12 months increased to 6.1% on March 31, 2021 from 3.7% on March 31, 2019. If the loan book is broken up into pre-Covid and post the second wave, the book that originated post July 2021 shows resilience as the underwriting models have been tweaked to incorporate learnings from the pandemic.

Trend in 90+ dpd for digital lenders

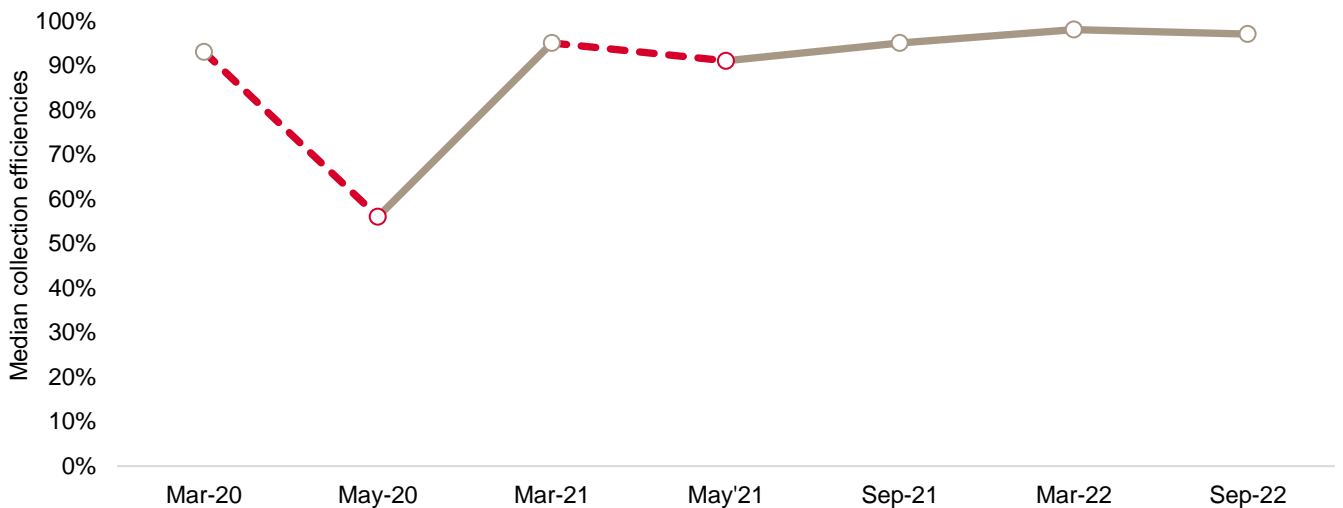


Source: Company data, CRISIL Ratings estimates

What is also interesting is that the proportion of restructured portfolios of digital lenders showed a wide range during the pandemic, from high single digits to as high as ~35%. With write-offs and recoveries, the restructured portfolios have reduced significantly to negligible levels for most players as on September 30, 2022.

Even the median monthly collection efficiency based on CRISIL Ratings' calculations has improved. Post September 2021, the collection efficiency was at the pre-pandemic level and in some instances even higher.

Collection efficiency for digital lenders



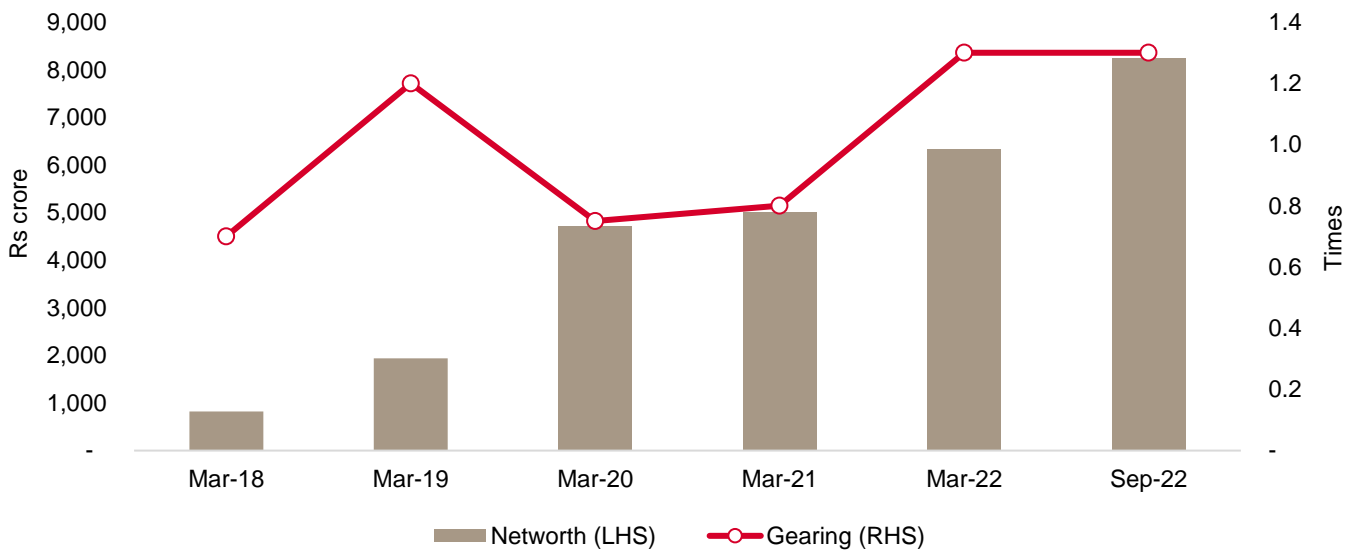
Source: Company data, CRISIL Ratings estimates

However, yields charged by digital lenders, especially for personal loans, are high, which indicates the relatively high-risk borrower segment and the inherent vulnerability of asset quality to shocks. Consequently, close monitoring of macro developments and constant refining of underwriting models will be imperative.

Capitalisation adequate, gearing comfortable; resource diversification key

Sustained strong capitalisation has supported digital lenders in the past few years. Entities in the CRISIL Ratings set raised over Rs 8,000 crore in just 3.5 fiscals, indicating both ability and consistency in raising equity. This resulted in comfortable gearing of ~1.3 times as on September 30, 2022, providing enough headroom over the medium term. That said, the ability to raise capital to support growth in the current market environment will be a monitorable.

Net worth and gearing for digital lenders rated by CRISIL Ratings



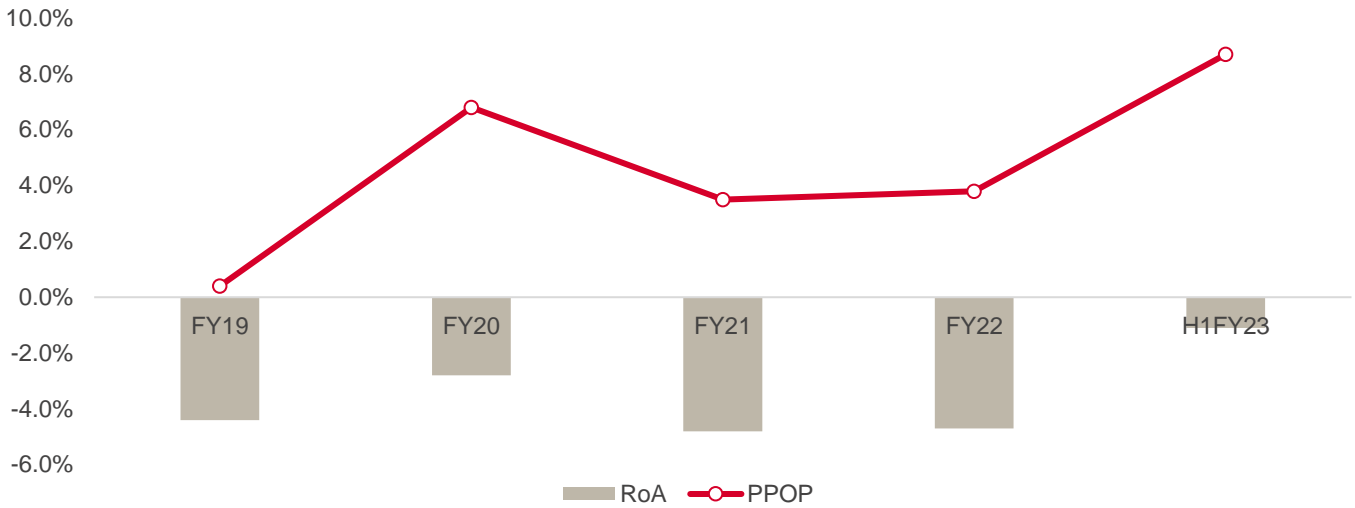
Source: Company data, CRISIL Ratings estimates

While the resource profile is diversifying with increasing share of NCDs and securitisation, the cost of funding remains high. As the entities start reporting post-tax profit level, they may see more interest from banks, which will be key to reduce the cost of funding.

Profitability now the focus area

The pandemic derailed the profitability plans of digital lenders. However, operating efficiencies are kicking in now with increasing scale, thereby positively impacting pre-provisioning operating profits. Credit costs, which had spiked to over 9% in fiscal 2022 due to write-offs, have improved to under 8% on an annualised basis as of the first half of fiscal 2023, resulting in better earnings with a number of players reporting profit, at least on a month-on-month basis. As the scale increases, earnings should remain resilient if credit cost is controlled.

RoA and pre-provisioning operating profits



Source: Company data, CRISIL Ratings estimates

The regulatory framework for digital lending is evolving and is likely to remain dynamic, and will necessitate some short-term adjustments. Partnerships will play an increasingly important role in growth. In terms of credit profile, earnings profile and asset quality are showing improvement. While steady state delinquencies may inherently be higher, given the customer segment, low leverage and track record of raising capital are positives.



Fiscal support and strengthened fundamentals augur well for infrastructure finance

Through various policy announcements, the government has reinforced the stature of the infrastructure sector as a key driver of economic growth and overall development. While the National Infrastructure Pipeline (NIP) introduced in 2019 will continue to push the infrastructure juggernaut forward, the PM Gati Shakti National Master Plan and National Logistics Policy announced in February 2022 and September 2022, respectively, will also further this cause. As per the recent Economic Survey, government capital expenditure (capex) is ~2.5% (provisional) of the GDP in fiscal 2023 and is budgeted at 3.3% for fiscal 2024.

The infrastructure sector has been a uniquely domestic story, decoupled from global headwinds such as the geopolitical challenges, global inflation, and even the pandemic to a large extent. The increasing share of central counterparties in infrastructure projects has also led to more predictable payment cycles, providing additional comfort to credit quality. Improved credit risk profile coupled with a slew of measures taken by the government to address the legacy issues of the infrastructure segment augur well for growth.

In terms of accessing credit from lenders, infrastructure continues to be one of the largest sectors. Financing infrastructure projects, however, is complex given the long gestation period and inherent mismatches in asset-liability maturity profiles since access to long-tenure borrowings is limited in India. While banks and public sector NBFCs have done much of the heavy lifting, the private sector has played a relatively subdued role given the risks entailed, which were amplified by the challenges faced by IL&FS.

Paradigm shift in infrastructure credit

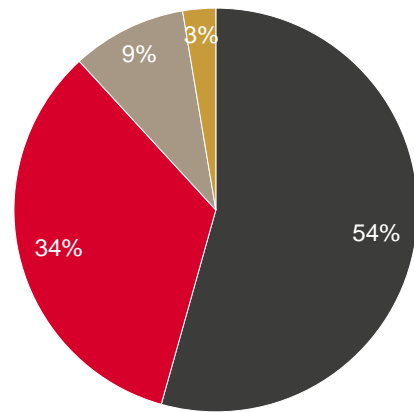
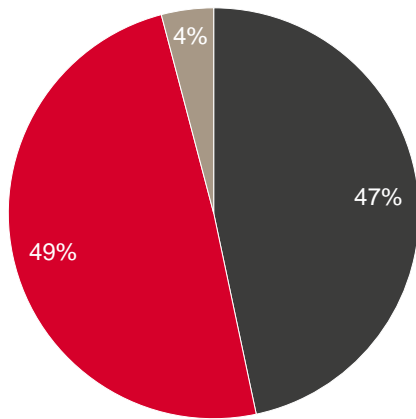
After facing challenges, the infrastructure sector clocked 11% CAGR between fiscals 2018 and 2022, and stood at ~Rs 26 lakh crore⁴ as on September 30, 2022 across NBFCs (including public sector NBFCs) and banks. This was mainly led by NBFCs, predominantly the government-owned ones. While infrastructure loans by banks (~Rs 12 lakh crore in September 2022) have grown at 7-8% CAGR, public sector-owned institutions (~Rs 13 lakh crore) have grown at 16-17% CAGR. Since private sector NBFCs have remained cautious in this segment, growth to ~Rs

⁴ All the information in this document excludes a private sector IFC that is under resolution

1 lakh crore in their AUM has been at a sluggish 4% CAGR. However, the share of NBFCs in the total infrastructure credit increased gradually to 53% as on September 30, 2022 from 46% as on March 31, 2018.

Concentration of NBFCs in the power sector will continue to be dominant in the overall portfolio mix, accounting for 54% of AUM as on September 30, 2022. However, this share is gradually declining with increasing exposure to roads and railways (34%), renewables (9%), and others (3%).

Distribution of infrastructure loans (September 2022) Sectoral mix of infra loans by NBFCs (March 2022)



■ Banks ■ Public sector NBFCs ■ Pvt sector NBFCs ■ Power ■ Roads and railways ■ Renewable energy ■ Others

Source: Company data, CRISIL Ratings estimates

The medium-term growth prospects for NBFCs remain strong on the back of resilient demand and impetus from government infrastructure spends. This pick-up will coincide with the better credit risk profiles of infrastructure projects and the strengthened balance sheets of NBFCs.

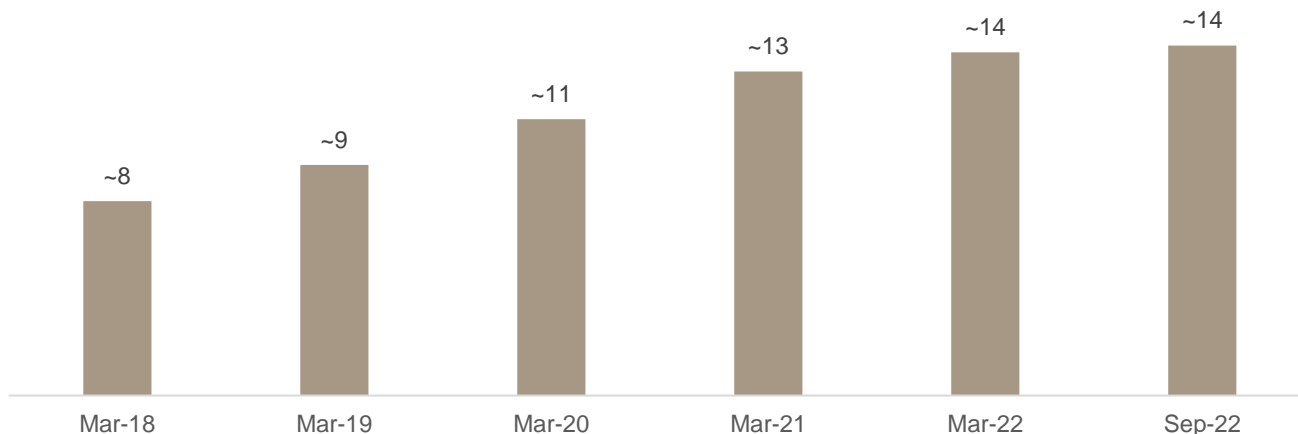
The evolving role of private sector NBFCs in infrastructure financing

Though infrastructure finance in India has been dominated by specialised financial institutions and banks, private sector NBFCs have established themselves in niche spaces. For instance, NBFC-infrastructure debt funds (NBFC-IDFs), which entered the fray in 2013, have played an increasing role in financing operational infrastructure projects even as they work within their defined categories and risk spectrum.

However, the growth of private NBFCs in this segment was impacted after September 2018, due to default by a large infrastructure financier and the consequent caution by lenders and investors towards extending credit to such NBFCs, which constrained their ability to lend. To add to this, a large infrastructure private sector financier was recently referred for resolution after it faced severe credit quality challenges.

Trend in infrastructure finance AUM of NBFCs

Rs lakh crore



Source: CRISIL Ratings

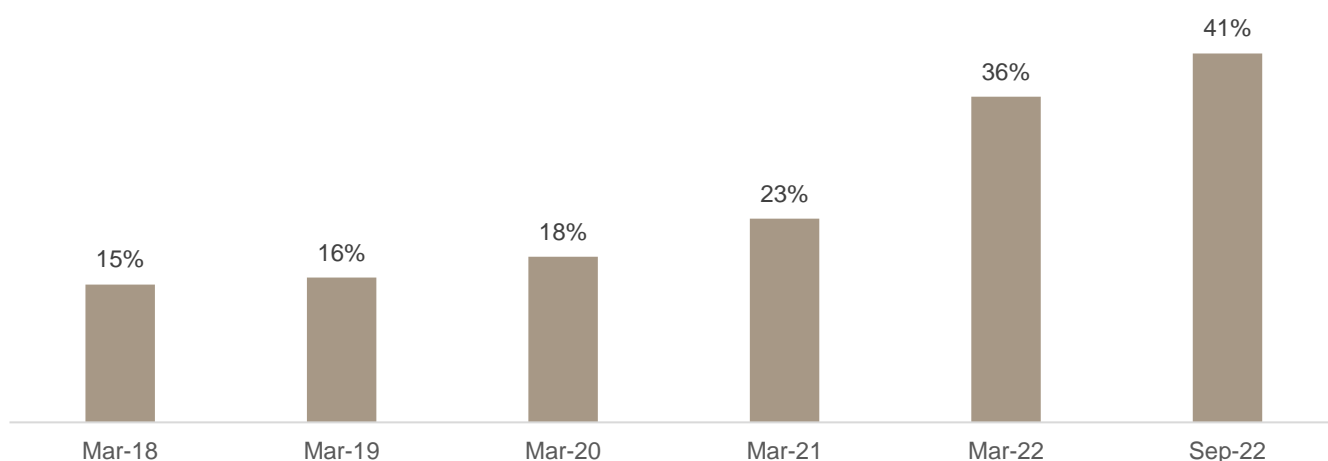
The AUM of private sector NBFCs in infrastructure financing was estimated at ~Rs 1.0 lakh crore as on September 30, 2022, which constitutes ~7% of the overall NBFC AUM pie (if government-owned NBFCs were included in the mix, the AUM would be several times that amount).

NBFC-IDFs growing at a faster clip

A key trend in the infrastructure financing space in the past decade has been the emergence of NBFC-IDFs, whose share in the overall infrastructure finance portfolio for private NBFCs increased to 41% as on September 30, 2022, from 16% as of March 2018. As a result, its AUM has more than tripled in the past four fiscals.

What separates NBFC-IDFs from other infrastructure financiers is their focus on operational infrastructure projects with a demonstrated track record and solid risk management processes. By doing so, NBFC-IDFs bypass the project risks that arise during the construction period faced by other infrastructure lenders. Hence, their asset quality has historically been strong with minimal NPAs.

Trend in share of NBFC-IDFs in the infrastructure finance AUM of private sector NBFCs



Source: Company data, CRISIL Ratings estimates

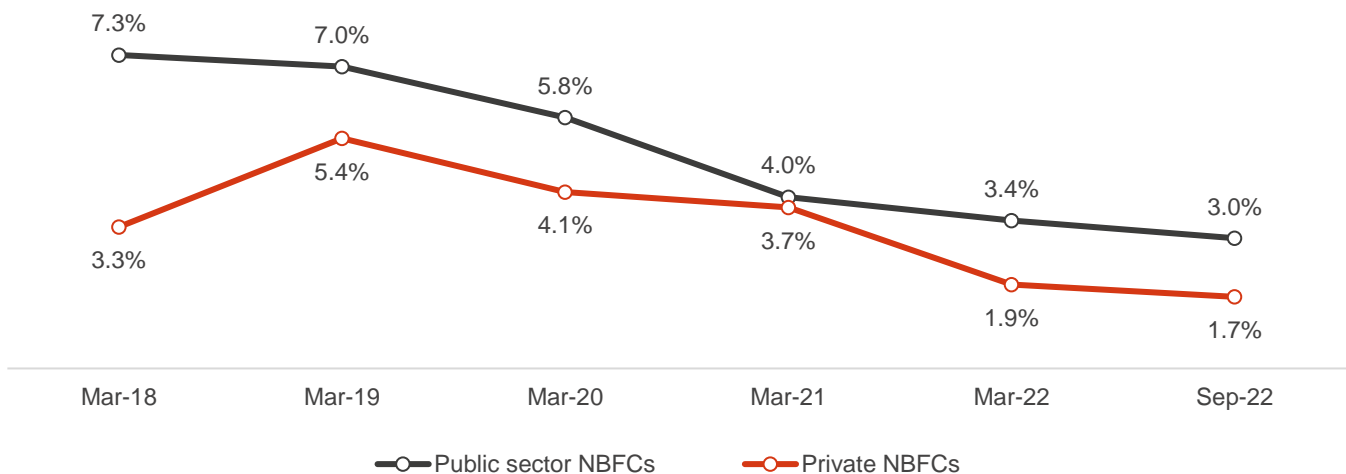
Sectoral resilience supports asset quality

Most infrastructure sub-sectors have remained resilient from a debt-servicing perspective. Government measures to address the legacy issues in the sector, equitable risk-sharing between concessioning authorities and private developers, and predictable payment cycles due to the enhanced role of central counterparties have improved the credit risk profiles of infrastructure assets. Emergence of infrastructure investment trusts aiding leverage reduction and IBC (Insolvency and Bankruptcy Code, 2016) facilitating faster resolutions of stressed assets also bode well for the sector.

As with banks, asset quality pressures for infrastructure financing NBFCs peaked in March 2018 on account of exposure to a number of projects turning delinquent due to time and cost overruns, and slippages in past restructured assets. That said, NBFCs did not see as steep a rise in NPAs as banks. Within the public sector NBFC space, two large players comprise 56% of the loans and their gross NPAs have improved significantly in the past few years, supported by write-offs: gross NPAs improved to 3.0% in September 2022 from a high of 7.3% in March 2018. The asset quality of private sector NBFCs remained under control with gross NPAs at 1.7% in September 2022.

Thus, with better asset quality and increased provision cover against non-performing advances, the aggregate solvency of NBFCs has improved considerably in the past couple of years.

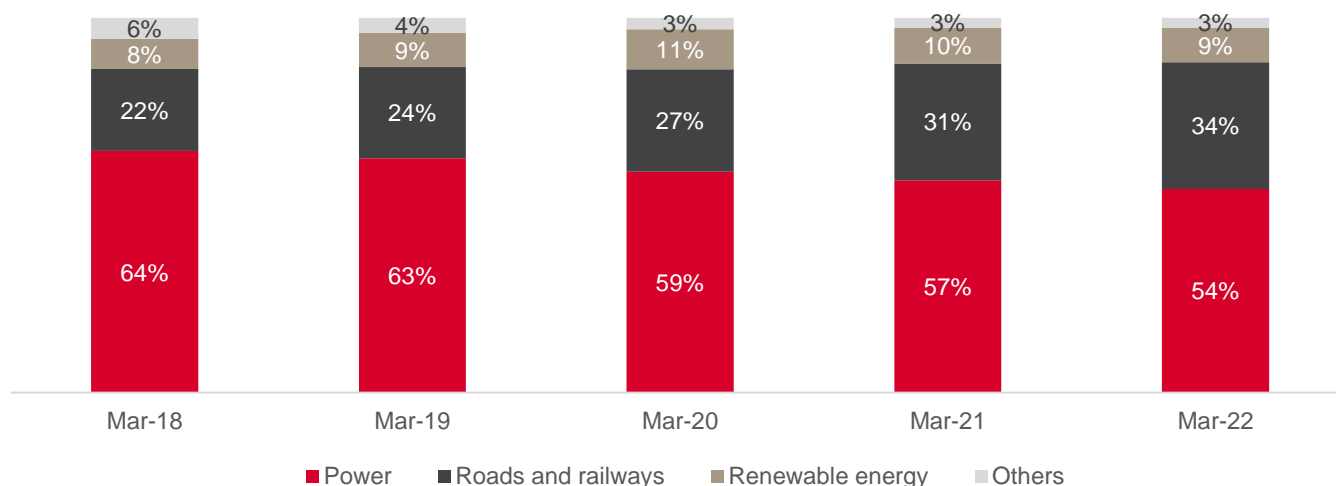
Trend in GNPA's for infrastructure finance portfolio of NBFCs



Source: Company data, CRISIL Ratings estimates

A key reason for NBFCs faring better than banks in terms of asset quality performance has been their focus on diversification. For instance, in the power sector, NBFCs have been focusing less on thermal projects that have caused considerable asset quality challenges for banks in the past. Rather, their infrastructure finance portfolios primarily comprise renewable energy and road projects, where asset quality metrics have been better so far. Hence, even if NBFCs have seen delinquencies increase due to legacy thermal power project exposure, their overall asset quality metrics have fared better than that of banks.

Trend in constituents of infrastructure portfolios at NBFCs



Source: Company data, CRISIL Ratings estimates

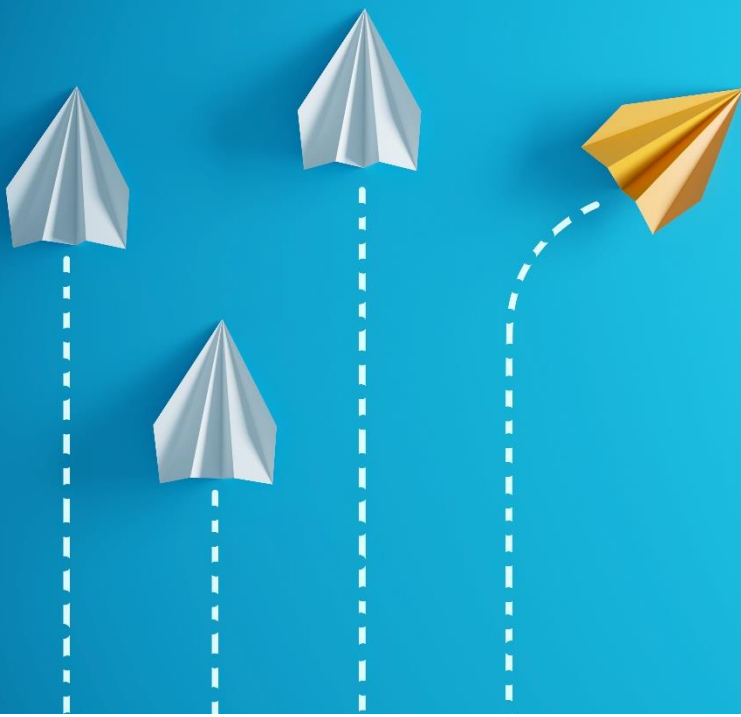
The focus of NBFC-IDFs on operational projects has kept asset quality metrics under control. Recent trends in terms of asset quality resolutions for some large assets support an improving trajectory in gross NPAs for infrastructure finance portfolios. Nevertheless, this sector has its own share of challenges, the biggest being the viability of some projects within the renewables space and the feasibility of tariffs. There are also concerns regarding the executed power purchase agreements with some state power distribution companies (discoms). Though steps are being taken to address some of these issues, control on asset quality metrics is crucial for sustainable growth in infrastructure finance, which makes it imperative to be selective about the projects being funded.

The way forward

Demand for credit from the infrastructure sector is expected to stay strong going forward, given the government's thrust on development of infrastructure projects and improvement in the macroeconomic environment. For NBFCs to be able to position themselves well in key infrastructure segments such as roads, renewables and transmission, they will need to leverage their core strengths of strong customer relationships, adaptability, local knowledge, innovation, responsiveness, and reach.

Strong risk management systems and ability to supervise credit quality will be critical for sustained growth, as will be building a healthy liability franchise with access to funding over longer time frames. Demonstrating a strong asset quality track record and a solid capital base will be important to build stakeholder confidence.

As far as asset quality concerns go, many NBFCs focused on infrastructure finance have strengthened their balance sheets with higher capitalisation, provisioning cover and liquidity. This will support their credit risk profiles in case there are large, unanticipated slippages in asset quality.



Conclusion

While NBFCs have seen decadal low growth in fiscals 2020 and 2021, they are expected to ride on the tailwinds of improved macroeconomic fundamentals and strengthened balance sheets, and expand 13-14% in fiscal 2024. Growth will likely be relatively broad-based across retail segments, although the share of non-traditional segments such as unsecured loans and MSME finance is expected to increase in incremental disbursements. Nevertheless, competition from banks in the primary segments of home loans and vehicle finance remains intense, and NBFCs could concede share to banks, especially in the salaried home loans and new vehicle finance space. Indeed, the rising rate scenario is limiting the competitiveness for NBFCs in traditional segments.

That said, given the economic rebound, growth should be broad-based for NBFCs, with larger NBFCs consolidating their positions in the overall AUM pie. Therefore, we believe for the small to mid-sized NBFCs, co-lending/partnerships will gain prominence and be critical for their growth journey over the medium term.

The improved balance sheets of NBFCs and abating of asset quality concerns will also support this growth trajectory. Asset quality metrics across segments have improved in the first half of fiscal 2023, and the fundamentals are expected to hold over the medium term with the improving macro environment. Furthermore, restructured books are negligible now. Nevertheless, inflationary pressures, interest rates and job losses remain monitorables.

Amid rising rates, borrowing costs are set to increase. But with higher provisioning buffers, credit costs are expected to be lower and support the bottom line.

The AUM of the NBFC sector has grown from less than Rs 2 lakh crore at the turn of the century to ~Rs 27 lakh crore now. From 12% in March 2008, the sector accounted for 16% of the overall financial sector credit ecosystem in March 2022. The key role that NBFCs play in furthering financial inclusion is expected to continue given the inherent strengths of last-mile funding and their ability to cater to customer segments that are difficult to address. The ability of NBFCs to adapt and innovate in this dynamic environment remains key to their long-term success.

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The Knowledge Architect of Corporate India

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 forward-looking 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 well-known 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 will help drive an inclusive and sustainable socio-economic growth for the country.

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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, and sustainability.

Shri Deepak Sood,

Secretary General

ASSOCHAM

Email: sg@assochem.co.in

The Associated Chambers of Commerce and Industry of India ASSOCHAM Corporate Office, 5, Sardar Patel Marg, Chanakyapuri, New Delhi – 110021, India

Phone: 46550555(Hunting Line)

Fax: 01123017008/9

Email: assochem@nic.in

The Associated Chambers of Commerce and Industry of India

ASSOCHAM Corporate Office, 5, Sardar Patel Marg, Chanakyapuri, New Delhi – 110021

Phone: 46550555 (Hunting Line) Fax: 01123017008/9

Website: www.assochem.org



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