

### **Business model of NBFCs being questioned as crisis intensifies**

**The problem stems from the growing reluctance of banks to lend to such firms, because the risks involved have increased**

Mumbai: As the global financial crisis intensifies, non-banking financial companies (NBFCs) are facing basic questions about the viability of their business model. Several firms are finding it difficult to operate in an environment where money is scarce, defaults are becoming common, and asset-liability mismatches have become more the norm than the exception.

At the heart of the problems being faced by NBFCs is the growing reluctance of banks to lend to such companies because the risks involved in doing so have increased since the middle of September, when investment bank **Lehman Brothers Holdings Inc.**'s bankruptcy highlighted growing credit risks in the global financial system.



**For survival: Sundaram Finance Ltd's Srinivasaraghavan says RBI has taken several steps, including cutting risk weightage and provisioning norms, for loans given to NBFCs, to help them survive the liquidity crunch.**

NBFCs also borrow money from mutual funds (MFs) and through deposits, but even that has become difficult: in the backdrop of the ongoing credit crisis, investors are turning to bank deposits and MFs are seeing investors bailing out.

“The whole business of money is about trust and credibility, and it has not been picked up by Indian regulators and political leaders,” said Dhanpal Jhaveri, executive director (finance) at **Future Capital Holdings Ltd**, the financial arm of the Future Group.

“NBFCs account for Rs4 trillion of assets in the Indian landscape and, therefore, are not an insignificant entity (in the financial system),” said Vikram Limaye, executive director at Infrastructure Development Finance Co. Ltd (IDFC). He added that the problem has more to do with the lack of credit than anything else. “...the institutionally funded models have suffered in the recent liquidity crisis. It has got to do more with the liquidity and not with solvency. There are enough assets. They are viable and making money, they are profitable entities,” he said.

According to a senior executive in the business, it also has to do with the model used by most NBFCs. The cost of capital for NBFCs is usually 2-3 percentage points higher than that for banks, but these firms can leverage up to eight times on their equity. NBFCs typically leverage five-six times, sourcing funds from banks, MFs, wholesale markets and retail deposits to generate 13-14% return on equity (RoE).

RoE for NBFCs, a measure of their profitability as compared to their equity, is a function of the number of times they can leverage. When the number of times an NBFC is leveraged falls to 4, its RoE falls to 10% or below, this executive, the head of a large Indian financial services group, added. When leveraging falls further, the business cannot sustain itself, the senior industry executive said, asking not to be named because it could lead people to conclude that his firm was in trouble.

**The Reserve Bank of India (RBI) has taken several steps, including reducing risk weightage and provisioning norms for loans given to NBFCs, to help them survive the current liquidity crisis, said T.T. Srinivasaraghavan, managing director of Sundaram Finance Ltd, a Chennai-based NBFC.**

**“No doubt the country and the NBFCs are going through a credit crisis..., (but) if we are to assume that this is the end of equity markets, mutual funds, public deposits and every other debt market, then the answer will be frightening,” said Srinivasaraghavan who is also the chairman of Finance Industry Development Council, a self-regulatory organization for the sector.**

#### **Product innovation**

Credit rating firm **Crisil Ltd**, which has been downgrading NBFCs recently, expects the business model to change over the long term.

“More than 50% of NBFCs’ borrowings have maturities of less than one year, while most of the assets have tenures of about three years,” Crisil said in a 10 November report that predicted a decline in business volumes for such firms. “Most of these NBFCs, especially asset finance companies, have significantly slowed down disbursements because of a lack of funds: the average monthly disbursements during September and October are estimated to be half of disbursements during August,” Crisil added in the report, which analysed the disbursement pattern of the 33 NBFCs it rates and that represent 30% of the sector.

“NBFCs’ share in overall retail finance space has reduced over the past few years as banks, with their superior size (and) resource diversity, have achieved dominance: banks today make more than two-thirds of retail finance disbursements, up from about 20% in 2002,” the rating agency said, adding that it does not expect this trend to reverse.

Roopa Kudva, managing director and chief executive officer of Crisil, said that despite increased defaults in NBFC portfolios, cash flows from existing assets would allow these firms to meet on time their debt obligations. “The decline in business volume will mean a further marginalization of the sector—a trend that has been accelerating over the past few years, as banks have taken over the traditional NBFC stronghold of retail lending.”

Cholamandalam DBS Finance Ltd (CDFL), a joint venture between the Chennai-based Murugappa Group and Singapore’s DBS Bank Ltd, is among the affected NBFCs. The company went through a liquidity crunch in September, but negotiated this with the help of some funding support from the promoters.

In late October, its chief executive Atul Pande resigned, the company said without specifying a reason. *The Economic Times* reported on 27 October that he was under mounting pressure from the board after the company had its first loss in 30 years. N. Srinivasan, director (finance) at Murugappa Group, said in an email reply that it would not be fair to evaluate the future scenario on the basis of the current situation, which is changing day by day.

“As long as the NBFCs are financially healthy, they can continue to co-exist as they bridge a gap that the banks could not,” Srinivasan said. “Of course, the NBFCs (and others too) will have to carefully negotiate the next 12-18 months in a planned conservative manner. Once the confidence is restored in equity markets, things should bounce back.”

Not all NBFCs have been hit. IDFC has not faced the trauma other NBFCs have faced because its business portfolio includes asset management, institutional broking and advisory services, said Limaye. But even it could face problems on the leverage front, as highlighted by the local arm of **Goldman Sachs Group Inc.** in an August report.

“The balance sheet leverage position of the company is unlikely to exceed the levels achieved in March 2008 at ~5X (five times). From our interactions with Crisil...as well as the company management, we believe IDFC would need to maintain a high capital adequacy ratio if it were to keep its current rating. We believe this may lead to reduced market expectations for earnings growth and RoE over the medium term,” Goldman Sachs analysts wrote in the report.

### **Monoline and multiline**

NBFCs monoline, which focus on one can be broadly classified into two types: core group of borrowers, and multiline, which cater to a broad variety of consumers. Monoline NBFCs such as Housing Development Finance Corp. Ltd (HDFC) face lesser risk than multiline NBFCs such as CDFL, said the chief executive of a large Indian NBFC, who asked not to be named because it may lead people to conclude that his own company is in trouble.

NBFCs focused on sectors such as housing and infrastructure—HDFC, **LIC Housing Finance Ltd**, IDFC and the Kolkata-based **Srei Infrastructure Finance Ltd**—also have greater access to cash than NBFCs in other sectors.

Besides, the lending risk associated with different segments vary widely. For instance, risks are high in the automobile finance sector, where the collateral is movable, and the consumer finance business.

Large automobile financing NBFCs in the country include CDFL, **Sundaram Finance Ltd**, **Shriram Transport Finance Co. Ltd**, **Mahindra Finance** and **Bajaj Auto Finance Ltd**.

The consumer finance or personal loans segment is crowded with players from foreign firms such as **GE Money Financial Services Ltd** and **Fullerton India Credit Co. Ltd**, as well as local companies such as Reliance Consumer Finance, a division of **Reliance Capital Ltd**.

Many of these firms will need cash infusion from promoters in the months ahead, according to analysts. RBI pushed for consolidation in the NBFC business and instituted a more stringent regulatory regime in the late 1990s, after the C.R. Capital Markets Ltd, a large NBFC, went bust. Bhansali-promoted CRB Since then, the central bank has strengthened the prudential norms such as capital adequacy ratio for these firms and also started closely monitoring them.

From 1,420 NBFCs in 1998 and 1,536 the following year, the number of deposit-taking NBFCs dropped to 371 in 2007, according to provisional data from RBI. Public deposits, too, fell sharply during this period, from Rs13,572 crore in 1998 to Rs2,075 crore in 2007.