Confederation of Indian Industry

NBFCs in India: Growth and stability

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Foreword

The NBFC sector in India has witnessed remarkable transformations since its emergence, with segments such as housing finance, microfinance and consumer finance contributing to its expansion. This growth is driven by various factors, such as a rising middle class, enhanced financial inclusion and positive policy interventions. Additionally, the sector has benefited from a favorable regulatory framework and a stable macroeconomic scenario. As of 2023, the NBFC sector has reached an impressive size of USD326 billion[1], underscoring its expanding influence in the financial domain. The sector has also shown resilience in terms of sound capital position, improved asset quality, adequate provisioning and higher profitability. Furthermore, the sector has leveraged digitisation to offer alternative financing options, especially to the MSMEs, which face challenges in obtaining loans from traditional banks. With the growth witnessed in the NBFC sector and India reaching an estimate of USD7 trillion GDP by 2030[1], India's financial need will rise, creating ample opportunities for NBFCs.

Digitisation has been a game-changer for the Non-Banking Financial Company (NBFC) sector, enabling faster and more efficient processes, as well as a superior customer experience. NBFCs are increasingly focusing on digitisation as a key differentiator, with a particular emphasis on the use of super apps to source and partner with customers. This trend is set to continue, as the demand for digital services continues to grow. The role of technology, data and analytics across the value chain is also set to increase, with a particular emphasis on credit and underwriting, collections, fraud management and cyber and data security/privacy. The use of scorecards powered by traditional and new age data sources is becoming increasingly popular, as NBFCs seek to improve their credit assessment capabilities. Digital collections and the role of data and analytics are also set to increase, as NBFCs seek to improve their collections efficiency.

Another area of focus for NBFCs is the lending model, with a particular emphasis on First Loss Default Guarantee (FLDG) and co-lending models. The guidelines for FLDG have been a major catalyst for growth in this segment, while co-lending requires further initiatives to scale up this model. Green and sustainable financing is also emerging as a sunrise sector, with NBFCs playing a key role in financing projects that promote environmental sustainability.

Nonetheless, the NBFC sector faces significant challenges, especially from the banking industry. Banks targeting the same customer base as NBFCs will require scale, resulting in intensified competition in the sector. NBFCs will have to explore securitisation, co-origination and co-lending to sustain their competitiveness in this scenario. M&A activity is also likely, with the capacity to alter the dynamics of the sector.

In this report, KPMG in India and Confederation of Indian Industry (CII) offer a holistic view of the NBFC landscape, highlighting the drivers of its development and expansion. It investigates the impact of technology, data and analytics throughout the value chain of NBFCs. It analyses the emergence of super apps, the potential of digital sourcing and partnerships and the application of data-driven scorecards for credit and underwriting. Moreover, it emphasises the significance of digital tools in collections, fraud management and cyber and data security. Finally, it unfolds the challenge posed by the banking industry and the strategies that NBFCs can adopt to thrive in this competitive scenario.

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1. NBFCs in India - statistics & facts, Statista, accessed on 26 January'24.

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NBFC landscape

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1.1 Economic growth and evolution of the NBFC landscape

The Indian economy was among the fastest-growing in the world before the onset of the COVID-19 pandemic. In the years leading up to the global health crisis, the country's economic indicators posted gradual improvements. The twin deficits, namely current account and fiscal deficits, narrowed, while the growth-inflation mix showed a positive and sustainable trend. Despite the geopolitical tensions worldwide, India's economy is expected to grow by 6.2[1] per cent in FY24, driven by robust domestic demand and strong growth in the manufacturing and services sectors. As the country progresses, demand for credit is likely to remain strong, especially among Micro, Small and Medium Enterprises (MSMEs) and retail, and is projected to grow by 13.5–14.0 per cent[3].

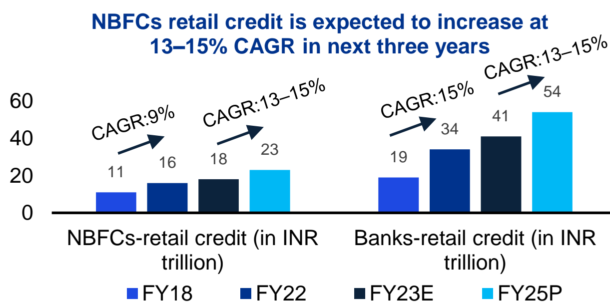
NBFCs have emerged as the crucial source of finance for a large segment of the population, including SMEs and economically unserved and underserved people. They have managed to cater to the diverse needs of the borrowers in the fastest and most efficient manner, considering their vast geographical scope, understanding of the various financial requirements of the people and extremely fast turnaround times. Non-bank money lenders have played an important role in the financial inclusion process by supporting the growth of millions of MSMEs and independently employing people.

The sector has grown significantly, with a number of players with heterogeneous business models starting operations. The last few years have seen a transformation in the Indian financial services landscape. The increasing penetration of neo-banking, digital authentication, rise of UPI and mobile phone usage as well as mobile internet has resulted in the modularisation of financial services, particularly credit.

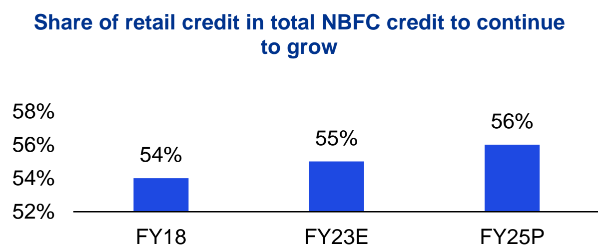
1.1.1 Key segments

In terms of asset size-wise mix, housing loans and infrastructure loans continue to account for a major chunk of the overall NBFC portfolio. Microfinance loans have increased their share from approximately 2 per cent to 3 per cent between FY19 and FY23[3]. Housing and infrastructure loans are expected to maintain their share in overall NBFC credit. In addition, auto loans, personal loans, MSME loans and microfinance loans are expected to perform better as compared to other segments in FY24.

NBFCs retail credit is expected to increase at 13–15% CAGR in next three years



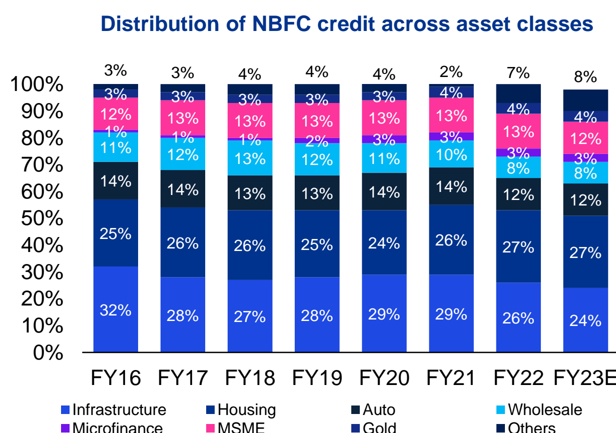
Share of retail credit in total NBFC credit to continue to grow



Note: P= Projected; Retail credit includes housing finance, auto finance, microfinance, gold loans, construction equipment finance, consumer durable finance, MSME loans and education loans

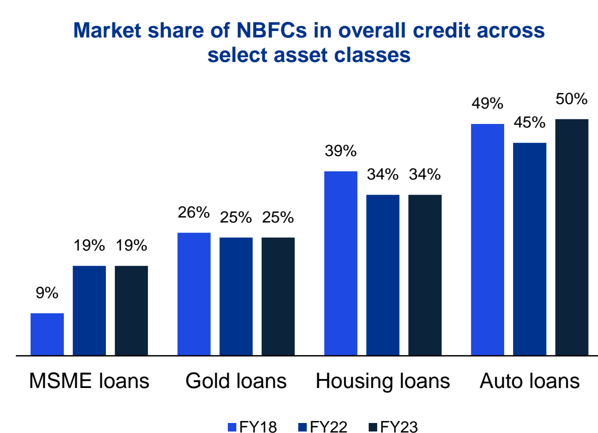
Source: Press releases, RBI, accessed on 24 January 2024

Distribution of NBFC credit across asset classes



Source: Press releases, RBI, accessed on 24 January 2024

Market share of NBFCs in overall credit across select asset classes



Source: Press releases, RBI, accessed on 24 January 2024

1. Indian economy outperforming peers, The Hindu, accessed on 24 January 2024
2. Press releases, RBI, accessed on 24 January 2024
3. Crisil MI&A, accessed on 24 January 2024
4. NBFCs, IBEF, accessed on 24 January 2024

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1.2 Evolution in NBFC categorisation

As of 30 September 2023, there were a total of 9,356[1] NBFCs registered with the Reserve Bank of India (RBI). Based on liability structure, NBFCs have been traditionally categorised into deposit-taking NBFCs (NBFCs-D), which are allowed to raise term deposits and non-deposit-taking NBFCs (NBFCs-ND). In October 2021, the RBI introduced a scale-based regulation for NBFCs to align its regulatory framework and further classify these financial institutions based on their evolving risk profile, considering the evolution of NBFCs with regard to size, complexity and interconnection within the financial sector[1]. This framework categorises:

- NBFCs in the base layer (NBFC-BL) with assets less than INR1,000 crore
- Middle layer (NBFC-ML) with assets more than INR1,000 crore
- Upper layer (NBFC-UL) and top layer (NBFC-TL) which are specifically identified by the RBI based on a set of parameters and scoring methodology

A list of 16 NBFCs-UL, identified as per the methodology specified in scale-based regulation for NBFCs, was released on 30 September 2022[2].

1.3 Key reasons for growth

Deep demographic and addressable market understanding: With their operations in the unorganised and underdeveloped segments of the economy, NBFCs have created a niche for themselves by understanding what customers want from them and guaranteeing last-mile delivery of goods and services.

Tailored product offerings: NBFCs have adapted their product offering to meet the specific characteristics of a customer group and are focused on meeting appropriate needs by carefully analysing this target segment and customising pricing models.

Wider and effective reach: NBFCs are now reaching out to Tier 2, Tier 3 and Tier 4 markets, distributing the loan across several customer touchpoints. In addition, they are building a connected channel experience that provides an omnichannel, seamless experience of sales and service 24 hours a day, seven days a week.

Technology advancements and growing fintech ecosystem for improved efficiency and enhanced experience: The use of technology is helping NBFCs customise credit assessment.

Co-lending: RBI, in November 2020, issued co-lending norms that enable banks and NBFCs to collaborate for priority sector lending (PSL).

Government and central bank Initiatives: The Government of India also unveiled several initiatives aimed at addressing some of the structural issues stressing the small business lending segment. These include granting licenses to account aggregators, initiating the Pradhan Mantri Mudra Yojana (PMMY), launching UPI platforms, unveiling platforms such as TReDS, GeM and Open Network for Digital Commerce (ONDC) and implementing GST.

After a moderation in growth post the COVID-19 pandemic, NBFCs are back on track with an expected credit growth of 13–14[3] per cent during FY24. The industry is expected to continue to witness the emergence of newer NBFCs catering to specific customer segments. The COVID-19 pandemic and consequent acceleration in both adoption of technology and change in consumer habits, as well as increasing availability of data for credit decision-making, has made it possible to build an NBFC lending business without investing large sums to have brick-and-mortar presence on the ground. Overall, between FY23 and FY25, research shows NBFC credit will increase at a CAGR of 13–15[3] per cent.

1. NBFCs, RBI, accessed on 24 January 2024
2. RBI categorises 16 large financial entities as upper-layer NBFCs, Economic Times, accessed on 24 January 2024
3. NBFCs' AUM to rise 13-15% in FY24 led by 18-20% retail loan growth, Business Line, accessed on 24 January 2024
4. KPMG in India's analysis based on reports published by RBI, IFC, World Bank

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1.4 Digitisation

NBFCs are embracing digitisation to achieve better operational efficiency, provide better customer experience, reduce costs and be complaint to the regulatory guidelines. Although the NBFCs have been facing a tough competition from the public and private sector banks and MFIs in areas such as market share, customer acquisition, asset quality and technology enhancements, they have been initiators of frugal innovation with respect to digital initiatives and innovations. NBFCs today have proved that they have both the appetite and talent to compete with larger institutions for customer attention. And the tools used to compete are cutting-edge popular technologies including cloud, low-code/no-code, data lakes and GenAI to evolve concepts such as application modernisation, super apps, data transparency and robust information security to provide seamless customer and employee experience.

01

Data democratisation — With the advent of India Stack and the account aggregator framework, the financial services sector is expected to surpass through seamless Know Your Customer (KYC) and data-driven credit decisioning processes. These government sources of data will ensure greater accessibility and reduced opacity. With the addition of more data sources, the India Stack and Account Aggregator are expected to drive the digital revolution.

02

Credit enablement frameworks — RBIs push for digital credit enablement through its frictionless platform and the advent and adoption of ONDC and Open Credit Enablement Network (OCEN) are expected to improve credit penetration, with NBFCs playing a significant role.

03

Frictionless journeys — Digitisation has led to the development of digital-first STP journeys for disbursement as well as transformed more complex journeys. The underlying systems such as loan origination system and lead management system, have transformed to enable these journeys.

04

Data-enabled underwriting and portfolio monitoring — With data democratisation, advent of credit enablement frameworks and advancement in the field of analytics, underwriting has evolved with the use of new-age lending models, which power instant credit decisioning. Portfolio monitoring is expected to evolve with access to richer and recent data sets, which will be crucial for developing robust EWS.

05

Advent of AI and large language models (LLM) — The advent of GenAI and LLMs will revolutionise NBFC operations with adoption for sourcing, servicing, collections etc.

06

Evolving regulatory landscape — The regulatory landscape is expected to evolve with the focus being on adopting digital, customer service and customer interest protection, data privacy and protection. These themes will drive regulations as financiers will need to align with consent, data storage, data privacy and other norms with the adoption of digital ways of working.

1. KPMG in India's analysis based on reports published by RBI, IFC, World Bank
2. RBI Guidelines issued on 02 September, RBI press release, accessed on 24 January 2024
3. RBI mandates for NBFC under 'Digital Lending', RBI press release, accessed on 24 January 2024

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1.5 Navigating funding challenges: Emerging sources and regulatory impact for NBFCs in India

NBFCs in India, vital contributors to the financial ecosystem, face evolving challenges in securing funds. This article examines the emerging sources of funds and delves into the impact of regulatory measures on the ease of raising capital for NBFCs.

1.5.1 Sources of borrowings of NBFCs[2] (Amount in INR crore)

Items	At the end of March 2022	At the end of March 2023	At the end of September 2023	Percentage variation	
				FY21–22	FY22–23
Debenture	10,14,611 (39.3)	11,10,234 (37.0)	11,45,536 (36.1)	3.3	9.4
Bank borrowings	9,20,555 (35.6)	11,33,221 (37.7)	11,97,626 (37.8)	18.8	23.1
Borrowing from FIs	69,078 (2.7)	89,982 (3.0)	99,844 (3.1)	21.3	30.3
Inter-corporate borrowings	89,896 (3.5)	1,05,184 (3.5)	1,04,148 (3.3)	15.5	17.0
Commercial paper	70,266 (2.7)	84,366 (2.8)	1,14,109 (3.6)	-3.2	20.1
Borrowing from government	18,562 (0.7)	18,750 (0.6)	18,758 (0.6)	-3.0	1.0
Subordinated debts	72,349 (2.8)	72,510 (2.4)	68.285 (2.2)	4.5	0.2
Other borrowings	3,29,182 (12.7)	3,87,991 (12.9)	4,21,653 (13.3)	10.6	17.9
Total borrowings	**25,84,500**	**30,02,239**	**31,69,959**	**9.9**	**16.2**

Source: Non-Banking Financial Companies Report, RBI, published on 27 December 2023

Traditional financing channels and challenges

Traditionally, NBFCs in India heavily relied on conventional financing channels such as bank borrowings and issuing debentures. However, in recent times due to multiple regulatory support and options NBFCs has explored alternative funding avenues.

1. Master Direction – NBFC Capital Adequacy Requirements, RBI, accessed on 24 January 2024
2. NBFCs: Raising Money and Risk Management, RBI, accessed on 24 January 2024
3. Private Equity Investment in India's NBFCs, McKinsey & Company, accessed on 24 January 2024
4. Basel III: Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools, RBI, accessed on 24 January 2024
5. Corporate Governance in Non-Banking Financial Companies (NBFCs), SEBI, accessed on 24 January 2024

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1.5.2 Emerging sources of funds additional to the traditional options

Private equity and venture capital:

Investments from private equity and venture capital have emerged as robust alternatives for NBFCs. This influx not only injects capital but also brings strategic guidance.

Securitisation and asset reconstruction:

NBFCs are increasingly turning to securitisation, selling loan portfolios to investors and collaborating with Asset Reconstruction Companies (ARCs) to manage risk and optimise balance sheets.

1.5.3 Impact of regulatory measures on funding requirements:

Liquidity coverage ratio (LCR)

The RBI's implementation of LCR has compelled NBFCs to maintain high-quality liquid assets. This ensures short-term liquidity resilience but demands a reassessment of liquidity management strategies.

Capital adequacy requirements

The regulatory directive will increase in risk weights for consumer lending to 125 per cent from 100 per cent. This, in turn, will impact the NBFCs with higher share of such loans in their portfolio. Capital adequacy parameter plays a significant role; hence it is very critical for NBFCs to maintain a balance of secured and unsecured mix in their portfolio.

Bank borrowing for NBFCs with higher rating

The risk weights for bank exposure to NBFCs with credit rating 'A' and above have been increased by 25 per cent. This implies that the bank will have to maintain higher capital on loans to such NBFCs, which may impact the funding profile of such NBFCs. The cost of borrowing funds from banks may also increase as the banks could increase the rate of interest to offset their higher cost of capital.

Way ahead

NBFCs in India face a challenging yet transformative landscape. By exploring alternative funding sources and aligning strategies with regulatory measures, these financial entities can secure their future growth and resilience.

1. Master Direction – NBFC Capital Adequacy Requirements, RBI, accessed on 24 January 2024
2. NBFCs: Raising Money and Risk Management, RBI, accessed on 24 January 2024
3. Private Equity Investment in India's NBFCs, McKinsey & Company, accessed on 24 January 2024
4. Basel III: Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools, RBI, accessed on 24 January 2024
5. Corporate Governance in Non-Banking Financial Companies (NBFCs), SEBI, accessed on 24 January 2024

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02

Evolving business landscape and scope of penetration

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2.1 Evolving business landscape and key growth sectors

The Indian economy continues to show robust growth, with the RBI projecting a 6.5[1] per cent GDP growth rate. This economic resilience is paving the way for significant credit growth for NBFCs. Notably, the MSME sector, along with several retail credit segments, including consumer durables, vehicle loans, microfinance and affordable housing, are leading the growth trajectory for NBFCs. The NBFC sector is expected to experience robust growth driven by high credit demand across these segments.

2.1.1 Key growth sectors in NBFC

MSME

The MSME sector is expected to play a significant role in the India growth story, with their contribution to the GDP expected to increase from ~30 per cent in FY23 to ~40 per cent in five to seven years[1]. Formal credit deployment will play a crucial role in the growth of this sector and NBFCs will be a critical contributor. The key contributors are as follows:

Trade

With the rapid growth of e-commerce as a sector, government initiatives, such as ONDC and Unified Logistics Interface Platform and demand for local products are expected to drive this sector.

Manufacturing

The government's push to increase manufacturing output, as well as focus on green energy and the electronic vehicle (EV) ecosystem, is expected to propel the MSME growth and create financing needs for capital and operational expenditure.

Services

Tourism and hospitality will be the key sectors, which will provide significant platform scope for NBFCs.

Retail credit

Sub-sectors such as consumer durables, vehicle loans, microfinance and affordable housing are witnessing a surge in demand. This growth is underpinned by strong macroeconomic factors and an increase in private consumption. NBFCs, with their agile operation models, are well-positioned to cater to this burgeoning demand.

Policy and government enablers

- The government has introduced a series of reforms and initiatives to bolster the MSME and retail credit sectors. These include the Pradhan Mantri Mudra Yojana (PMMY), Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), digitisation initiatives such as India Stack, JAM (Jan Dhan-Aadhaar-Mobile) trinity, Udyog Aadhaar for easier business registration, ONDC and the ambitious National Infrastructure Pipeline under the Gati Shakti programme.
- Additionally, the Credit Linked Capital Subsidy Scheme is aimed at facilitating technology upgradation for MSMEs.
- In the retail credit space, policies such as the PMAY are catalysing growth in the affordable housing segment. The push towards vehicle electrification and the Vehicle Scrappage Policy are driving the vehicle loan segment. Microfinance institutions are being empowered through initiatives such as PMMY and a focus on on-lending and co-lending models.

1. Crisil MI&A, RBI, and KPMG in India's analysis based on reports published by RBI, IFC, World Bank
2. RBI keeps repo rate at 6.5%, raises growth forecast, The Hindu, assessed on 24 January 2024
3. Ministry of External Affairs, indbiz.gov.in, accessed on 24 January 2024
4. NBFC article, PMO India, accessed on 24 January 2024
5. NBFC report, National Investment Promotion & Facilitation Agency, accessed on 24 January 2024

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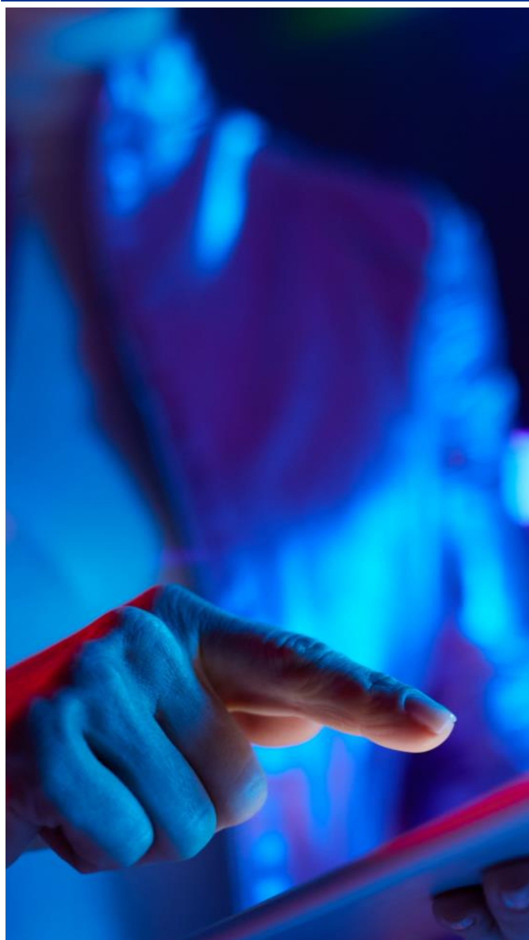
2.2 Increasing focus on digitisation by NBFCs for customer experience



The NBFC sector in India stands at a juncture of significant transformation, driven by robust economic growth, a conducive policy environment and an increasing emphasis on financial inclusion. As these financial institutions continue to diversify their portfolio and adapt to the changing market dynamics, they will be prolonged to play a crucial role.

Digital will drive the NBFC growth story, with use cases adopted across the value chain from sourcing to loan closure/cross-sell and upsell. Hyper-personalisation of services, adoption of regional languages, product innovation and partnerships will drive growth.

The evolving customer persona in terms of a mobile-first approach, rise of influencers in the digital space and demand for seamless and instant service will drive the NBFC growth story.

Partnerships and platforms will be crucial for NBFCs for sourcing and India Stack will be crucial for underwiring, KYC and portfolio monitoring. The digital age will necessitate stronger cyber and data protection practices to ensure sustainable operations.

The digital story will drive NBFCs from the perspective of experience, increased sourcing avenues, operational efficiency and risk management.

Digitisation in the front office operations

Lead generation and customer onboarding

- Most of the NBFCs have implemented multiple applications that work together to provide an integrated customer experience. These applications include customer-facing mobile apps, customer relationship management (CRM) systems for lead generation, lead management solutions, digital onboarding solutions, loan origination systems and even elements of core banking solutions to cover significant parts of the customer journey. To generate leads, NBFCs have formed partnerships with multiple sourcing platforms, allowing them to reach a larger number of potential customers. One of the leading NBFCs in the home loan segments has 93 per cent of the customers registered on mobile applications.
- For customer onboarding, NBFCs are leveraging paperless processes by utilising eKYC, C-KYC, video KYC, e-documentation, DigiLocker, account aggregators, credit bureaus and geo tagging services. For some of these services, NBFCs are riding on the wave of open banking technology by partnering with the fintechs that are operating in this space.
- NBFCs are utilising conversational AI in chatbots to address customer inquiries, offer personalised products, provide product recommendations and identify opportunities for cross-selling and up-selling. This strategic implementation enables NBFCs to enhance customer service, streamline operations by reducing the size of customer service teams and improve overall efficiency by automating routine tasks. This approach represents a true extension of omnichannel capabilities.

1. Annual Report FY23, Home First, accessed on 24 January 2024
2. Annual Report FY23, Tata Capital, accessed on 24 January 2024

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Digitisation in the middle-office operations

Credit underwriting

- To enhance credit underwriting processes, NBFCs have established partnerships with fintech companies for fraud risk management, income assessments, GST validations, MCA validations and video PD. Additionally, NBFCs have collaborated with fintech firms that provide access to alternative data, which aids in the creation of underwriting models and digital scorecards. The implementation of GenAI enables AI-driven predictive analytics for better risk assessment by analysing a broader range of data points. By adopting these approaches, NBFCs can achieve a more precise and holistic assessment of an applicant's creditworthiness, thereby mitigating the risks associated with bad loans.

Loan documentation

- NBFCs are leveraging technology to generate digital loan documents and facilitate e-Stamping and e-Signing of these documents. The e-Signing process utilises Aadhaar-linked mobile numbers, resulting in enhanced customer experience and improved operational efficiency. Notably, a prominent NBFC in the home loan segment has successfully executed 60 per cent of loan agreements through e-Stamping, with 46 per cent of agreements being digitally signed.

Loan disbursements

- NBFCs can directly disburse funds to required accounts using various digital payment methods. This enables seamless and real-time fund transfers to the intended accounts. These advancements significantly contribute to expediting the loan disbursement process and facilitating seamless customer interactions.

Digitisation in the back-office operations

Customer servicing

- The process of customer service has undergone significant changes with the introduction of WhatsApp banking and advanced chatbots. With the help of emerging technologies such as GenAI, several customer queries can be resolved by conversational bots. These chatbots offer more engaging and personalised experiences, provide round-the-clock support and reduce the workload of human customer service representatives. One of the leading NBFCs has reported that 75 per cent of its customer transactions are taking place through digital platforms. Customers now can interact through various channels, including web, mobile applications, WhatsApp, chatbots and voice bots. The NBFC has observed a significant increase in the usage of chat-based servicing, with over 800,000 interactions occurring per month on voice and chat-based platforms.

Digital collections

- NBFCs are actively investing in expanding their digital presence in the collections process, which traditionally relied heavily on physical branches and manual procedures. Nowadays, technology and process innovation allow mainstream retail customers to have the option of making EMI payments by accessing digital payment channels such as UPI, cards, net banking and e-NACH. One of the leading NBFCs has reported that more than 90 per cent of its collections are now conducted through digital channels.

1. Annual Report FY23, Home First, accessed on 24 January 2024
2. Annual Report FY23, Tata Capital, accessed on 24 January 2024

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2.3 Emerging lending models

NBFCs in India have navigated a transformative path in their lending methodologies, adapting to the ever-evolving financial landscape. Two noteworthy approaches that have garnered attention and reshaped the lending landscape are the First Loss Default Guidelines (FLDG) model and the co-lending model.

First Loss Default guidelines

The First Loss Default Guarantee (FLDG) or Default Loss Guarantee (DLG) model represents a paradigm shift in the approach of NBFCs towards collaborative lending. These guidelines, mandated by the RBI, allow NBFCs and other Lending Service Providers (LSPs) to extend credit portfolios with a guarantee against default losses. Endorsed by the RBI, this model provides a robust risk mitigation mechanism and safety net by guaranteeing coverage for the initial loss incurred in lending transactions.

01 Firstly, it enhances the risk appetite of NBFCs and banks by instilling confidence in banks and other regulated entities to collaborate with NBFCs and LSPs.

02 Furthermore, the NBFCs benefit from these arrangements by transferring/sharing the risks and heavy cost of funds associated with loan portfolios. This encourages banking sector to invest in lending to diverse segments of the economy through NBFCs.

03 The RBI's guidelines play a pivotal role in ensuring the model's effectiveness, aligning it with regulatory standards and supervisory measures.

- By mandating adherence to stringent criteria on DLG providers and LSPs (eligibility criteria for DLGs and cap on default loss guarantee up to 5 per cent and tenor), the central bank promotes financial stability and consumer protection. As the guidelines only apply to digital lending arrangements, REs and NBFCs are encouraged to introduce technology-enabled lending products, thereby contributing to enhanced credit penetration and lower operational costs.
- NBFCs can leverage this opportunity to build partnerships with banks to build and scale up loan portfolios in underserved segments while incurring lower cost of funds and obtaining increased liquidity.

Co-lending models

Complementing the FLDG model, which promotes collaboration among NBFCs and banks, the co-lending model further inculcates confidence in collaborative partnerships. In this model, NBFCs join forces with traditional banks to co-finance loans, leveraging the strengths of both entities. The collaborative nature of co-lending enables NBFCs to tap into the extensive reach and resources of banks while banks benefit from the agility and specialised knowledge of NBFCs in catering to specific market segments. Alternative funding opportunities like the ones mentioned are great opportunities for small fintechs, NBFCs and can also be extended to unrated NBFCs or funded by organised lenders. These collaborative models will boost the digital lending space and provide safeguards towards regulatory capital and maintaining quality growth in portfolio.

Blueprint to scale up co-lending model

To successfully scale up co-lending initiatives, NBFCs need to meet certain requisites. Some of them are as follows:

Robust risk management framework — Efficient credit assessment tools and risk mitigation strategies must be in place to navigate the complexities of collaborative lending. Clear risk-sharing agreements between the NBFC and the partner bank are crucial to ensure a fair distribution of responsibilities and liabilities.

Technological infrastructure — NBFCs need to invest in scalable and agile technology that facilitates seamless integration with partner banks. This not only streamlines the loan origination and approval processes but also enables quick decision-making, a critical factor in the competitive lending landscape.

Alignment of target segments and policy norms with the bank — Negotiate at a win-win arrangement, process optimisation with maximised automation and seamless integrations with low-code solutions.

Extensive strategic planning — Transformation in organisational structure, synchronising operational processes and matching the policy and technological compatibility. A well-defined operational framework that outlines the roles, responsibilities and contributions of each party is essential.

Regular monitoring and evaluation mechanisms — Assess the performance of the co-lending arrangement and make necessary adjustments.

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2.4 The rise of green and sustainable finance — NBFCs are leading the change

NBFCs, a beacon of resilience in financial infrastructure

The Indian financial sector has successfully weathered numerous challenges, demonstrating remarkable resilience in the face of disruptions. It has successfully navigated through uncertain economic climates marked by high inflation and constrained consumption, managed large-scale financial defaults or mitigated the unexpected breakdowns in financial intermediation caused by the COVID-19 pandemic.

With India's GDP steadily approaching a 7 per cent[1] annual growth rate, inflation being subdued and credit offtake growth reaching double digits, it sets the right pitch for NBFCs to embark towards the next wave of strong growth.

India needs ~USD200 billion annually to meet the net-zero target and about ~USD2.5 trillion for its 2030 Nationally Determined Contribution (NDC) commitments. Despite this scale of the ask, the annual flows towards climate finance annually have fallen below USD50 billion, with a concentration on clean energy and energy efficiency[2].

Green and sustainable finance avenues for NBFCs

- With regards to compliance, risk management, customer acquisition or product development, the new paradigm would require NBFCs to scale on the sustainability agenda and embrace much-needed means of integrating environmental, social and governance (ESG) aspects in the way they run their business.
- This not only holds the key towards unlocking newer and cost-effective sources of raising capital through means such as green bonds and sustainability-linked loans or equip themselves to assess emerging climate and social threats in taking new exposures but also, for that matter, growing the product suite towards catering to climate and transition requirements.
- Given the width and depth of the NBFC network across India, this will lead to the next level across avenues such as efficient MSMEs, affordable housing, energy transition, improved EV adoption, sustainable agriculture, sustainable tourism and financial inclusion.

The road ahead for non-banks to take lead on sustainability

NBFCs are uniquely placed in the Indian financing setup unlike the banks which focus on funding large-scale infrastructure projects. Given this flexibility on the ticket size as well as risk profiles, there is no shortage of avenues. For instance, financing climate and transition funding across MSMEs and startups, or segments such as EVs or niche products for clean tech equipment manufacturing.

This offers NBFCs a compelling advantage to invest in green product development to cater to nuanced loan structures and financing for the sustainable shift. For instance, a sustainability-linked loan (SLL) with an interest rate linked to performance indicators such as a reduction in emissions and an increase in direct employment. Similarly, a moderately and competitively priced loan for greater offtake in mass-consuming segments such as EVs.

Opportunities and levers for business growth for NBFCs

NBFCs have various ways to grow their business, including obtaining affordable loans from multilateral development banks and using blended finance instruments to access concessional capital. Additionally, NBFCs can transform their operations by utilising digital tools and resources, which not only reduces their environmental impact but also improves governance and resource management. Overall, opportunities and sustainability are important drivers for growth in the NBFC sector and being innovative and ahead of the curve will lead to success in the market.

Sustainable finance — Opportunities for NBFCs

Asset side
Electric vehicles, sustainable agriculture, solar rooftops, MSMEs, financial inclusion

Liability side
Sustainability-linked loans, green bonds, multilateral financing, blended finance structures

Business outcomes
Diversification of loan book, addressing E&S risks In portfolio, lowering cost of capital, net-zero trajectory

1. Union Budget presented by GOI
2. Landscape of Green Finance in India report, Climate Policy Initiative
3. KPMG in India's analysis based on reports published by RBI, IFC, World Bank

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03

Role of technology, data and analytics across the value chain

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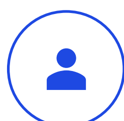
3.1 Role of technology in the NBFC sector

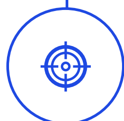
Technology is increasingly playing a pivotal role in every aspect of NBFC operations. It has become a key enabler for providing superior customer service, effective credit decisioning and disbursement, portfolio monitoring and collections as well as for other mid- and back-office functions.

3.2 Five key themes which are driving technology in the NBFC sector



Emergence of super apps and partnerships: Super apps are increasingly becoming one-stop shops to address customer needs from an end-to-end perspective. While super apps are prevalent in the banking industry or e-commerce perspective, NBFCs will have a crucial role in terms of embedding their products and servicing customers through app-enabled journeys. The key to success lies in delivering seamless experiences, instant decision-making and superior customer satisfaction.

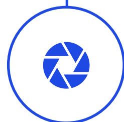
Emergence of frictionless enabling platforms/protocols: RBI's frictionless platform for credit enablement and OCEN are game changers in the financial services industry. These platforms will ease integration efforts and provide rich data sources that can be leveraged across the loan lifecycle.



Adoption of digital-first and paperless journeys: NBFCs are pivoting to digital-first and mobile-first journeys to ensure operational ease, better controls and superior customer experience.

Increased adoption of analytics: Analytics has become crucial in the current business context with multiple use cases across the following:

- **Sourcing** — Pre-approved databases to ensure faster sanctions and attractive offers for customers
- **Customer lifetime value** — Analytics to maximise customer lifetime value and ensure product suite penetration is optimised as well as partnerships are created to provide comprehensive offerings to customers as well as enable cross-/up-sell with a greater degree of success
- **Credit decisioning** — Credit decisioning has been revolutionised with financial and nonfinancial data sources, which has increased the accuracy of scorecards
- **Portfolio monitoring** — Accurate portfolio monitoring and evolved EWS leading to better collections



Emergence of GenAI and LLM: GenAI and LLM will be critical for scaling while ensuring a hyper-personalised experience is provided in a cost-effective manner. Emergence of capabilities to interact with customers at a dialect and sub-dialect level is critical for raising awareness as well as for sourcing, servicing and collections.

1. KPMG in India's analysis based on reports published by RBI, IFC, World Bank

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The themes will define the way technology is adopted and the following aspects will drive technology:

Flexibility in terms of integrations and adapting to business needs	Faster time to market for development and updates	Scalability in a cost-effective manner	Responsiveness and uptime to ensure seamless experience	Security to ensure adequate controls are in place from data perspective

With increased technology adoption, risk management and controls become extremely important. Aspects such as access control, cloud/data centre security, integrations management and validations become crucial and features to be careful about from a future context.

3.3 Cyber security and privacy

The rapid adoption of automation, digital mechanisms, outsourcing vendors and emerging technologies such as AI/ML has raised concerns about operational resilience, cyber security and privacy. NBFCs need to create robust mechanisms to address these concerns.

Cyber security

Cyber security is one of the significant threats firms are currently facing and it consistently ranks among the top risks globally. Cyberattacks can take various forms and shapes and derail the financial stability of a country. According to some estimates, the Indian financial services sector witnessed approximately 1.3 million[1] cyberattacks last year, which proves that cyber threats outpace technology advancements. While the regulator has established comprehensive regulations, the onus is on regulated entities for robust adoption.

Operational resilience

Recently, some regulated entities have been in the news because of the non-availability of critical applications, resulting in inconvenience to customers. It is imperative for NBFCs to design and implement robust BCP and DR plans to minimise business and operational disruptions. It requires the creation and deployment of a well-defined BCP, optimal investments in technology and oversight from the Board and relevant IT/IS committees.

Data privacy

The generation, collection, processing and storage of vast amounts of data raises several concerns on the privacy front. Accordingly, regulators globally have recognised the need to maintain accountability when collecting and processing personal data of customers. This will require NBFCs to build controls around personal data processing activities to avoid penalties and disruptions. It is imperative to integrate privacy-preserving controls/practices in the operating strategy for NBFCs.

1. Decoding the 2023 Cybersecurity Landscape in BFSI, The Banking and Finance Post, assessed on 24 January 2024
2. KPMG in India's analysis based on reports published by RBI, IFC, World Bank

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04

Liquidity and fund management

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4.1 Traditional funding avenues for NBFCs

NBFCs in India actively seek diverse funding avenues to meet their multifaceted financial needs. Their need for funding arises from their role in providing credit to sectors underserved by traditional banking. Traditional sources including bank borrowings, debentures and commercial papers, play a crucial role in fulfilling these funding requirements. This funding sustains their operations, facilitates liquidity and supports the crucial function of fostering financial inclusion by reaching segments that may be overlooked by traditional banking institutions. The ongoing exploration of funding avenues underscores the dynamic nature of NBFCs in navigating the evolving financial landscape to efficiently cater to the diverse needs of the Indian economy.

4.a Different sources of funds for NBFCs

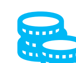
Item description	March 2021	March 2022	March 2023	September 2023
1. Share Capital, Reserves and Surplus	26.7	29.4	29.1	27.9
2. Total Borrowings	63.0	60.6	61.5	62.1
of which:	19.8	20.6	21.9	22.2
2.1 Borrowings from banks	0.4	0.4	0.3	0.4
2.2 CPs subscribed by banks	3.0	2.9	2.7	2.4
2.3 Debentures subscribed by banks	3.0	2.9	2.7	2.4
Total from banks (2.1+2.2+2.3)	**23.2**	**23.8**	**25.0**	**25.0**
2.4 CPs excluding 2.2	1.6	1.4	1.5	1.9
2.5 Debentures excluding 2.3	22.8	20.4	19.5	19.6
3. Others	10.2	10.0	9.5	10.0
Total	**100.0**	**100.0**	**100.0**	**100.0**

Source: RBI Stability Report 2023

Equity

- Equity is the most flexible form of capital available for NBFCs. Considering the onset of Internal Capital Adequacy Assessment Process (ICAAP) norms, it has become imperative for NBFCs to hold additional free equity. Equity capital (including reserves and surplus) accounted for approximately 26–29 per cent (*refer to the table above*) of the total funding available to NBFCs between March 2021 and September 2023.

Deposits



- Irrespective of whether an NBFC is authorized to accept deposits from the public or not, they are allowed to accept Inter Corporate Deposits (ICDs). In the case of deposit-taking NBFCs, retail deposits have traditionally played a significant role in meeting their stable long-term funding needs, provided there is enough volume of such deposits.

1. KPMG in India's analysis based on reports published by RBI, IFC, World Bank

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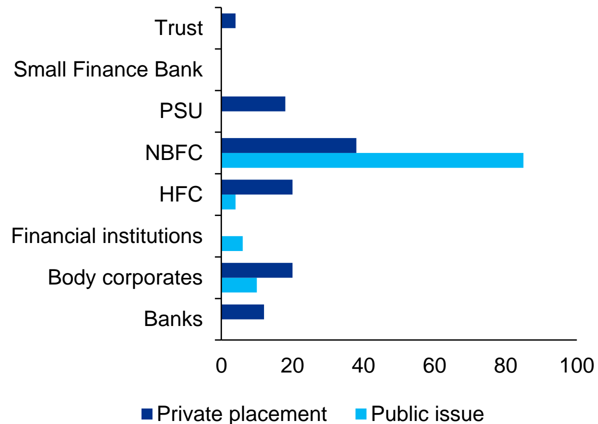
Debentures and commercial papers

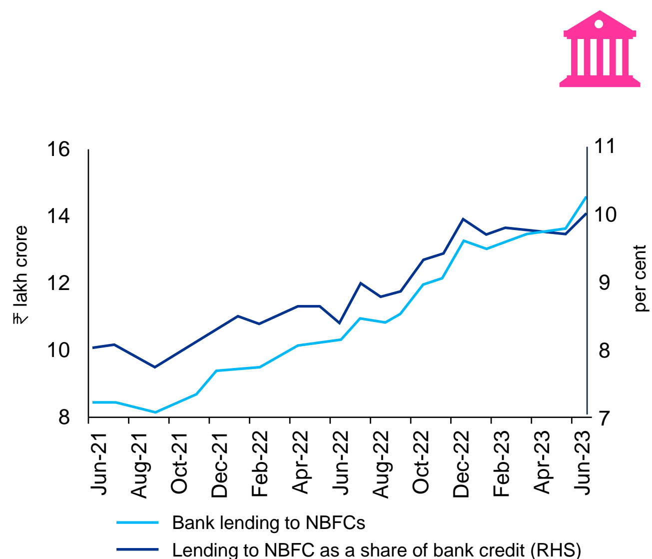
- Debentures (long-term debt instruments) and commercial papers (short-term debt instruments) serve as additional sources of stable funding for NBFCs. These debt instruments contribute to ~25 per cent (*refer to the chart on the right side)* of their funding.
- According to the RBI financial stability report of December 2023, NBFCs constitute a significant portion of the corporate bond issuers. NBFCs that are issuing debt instruments are largely funding it through a public issue. (*refer to the chart on the right side)*



Source: RBI Stability Report 2023

Funding from banks

- NBFCs traditionally receive a majority of their funding from banks as debt. This provides NBFCs stable funding which has increased over time, as has the share of Bank credit to NBFCs. (*refer to the chart on the right side*)
- This funding can be in terms of direct borrowings from banks or can be through commercial papers or corporate bonds purchased by banks.



Source: RBI Stability Report 2023

1. KPMG in India's analysis based on NBFC report published by RBI

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4.2 Emerging funding avenues for NBFCs

In response to dynamic market demands, NBFCs in India are proactively embracing diverse funding channels. For enriching the NBFCs' landscape, foreign direct investment serves as a gateway for international capital. Additionally, securitisation strategies are being employed to convert loans into tradeable securities, thereby improving the company's liquidity. Collaborative co-lending models, often forged with fintech partners, present innovative financing solutions. Simultaneously, venture capital injections offer crucial equity support, fostering NBFC expansion and innovation. These emerging funding avenues underscore the sector's adaptability, leveraging global investments, financial markets and strategic collaborations to ensure sustained financial robustness in an ever-evolving landscape.

Foreign Direct Investment (FDI)

FDI is a crucial funding stream for NBFCs, providing access to cheaper foreign credit as well as strategic partnerships. FDI injects equity that strengthens the financial stability of NBFCs and supports their growth and expansion. In addition to capital, foreign investors bring valuable expertise in risk management, technology and regulatory compliance, which enhances the operational frameworks of NBFCs and improves their competitive position in the financial market. However, FDI in NBFCs is subject to regulatory guidelines from the RBI to ensure the stability of the Indian financial system.

Fintech partnerships

In addition to being a funding avenue for NBFCs, fintech partnerships offer technological advancements, data analytics capabilities and enhanced customer reach. This enhances the overall efficiency of the NBFC and its ability to compete in the rapidly changing financial market of India, giving the company an edge over other peers.

Co-lending

Co-lending, also known as co-origination, is a collaborative lending model where two or more financial entities come together to jointly extend a loan to a borrower. These entities then share the risks and rewards based on pre-agreed terms. This is typically an arrangement between a bank and an NBFC. If used accurately, NBFCs can rely on this for increased liquidity and profitability.

Public deposits (PD)

It is a critical source of funding that turned around and increased during FY22–23. PD is mainly beneficial as they are comparably lower on costs, longer maturity, helps in diversification by reducing dependencies on specific lenders or capital markets and helps in brand imaging. With the recent addition of upper layer NBFCs, this acts as an extremely critical opportunity for NBFCs with good liquidity.

Securitisation of assets

Securitisation is a vital funding avenue for NBFCs. This process involves converting illiquid loan portfolios into tradable securities through special purpose vehicles (SPVs), hence unlocking additional liquidity. By issuing these securities, NBFCs obtain upfront capital, hence are able to facilitate lending activities. Securitisation offers additional financial flexibility to NBFCs and more diverse products for investment in the financial market.

Green bonds and sustainable funding

Green bonds are one of the leading avenues for climate-friendly sustainable funding. If an NBFC is taking a step towards being more environmentally friendly, they can issue green bonds which provide an easy connection for the investors to make positive social and environmental impacts. This makes green bonds very attractive for investors, more so for institutional investors such as banks.

Venture capital and private equity

Venture capital and private equity are extremely desirable emerging avenues off funding for NBFCs. This mode of funding offers significant operational flexibility to NBFCs compared to other avenues since there is no obligation to pay dividend immediately.

In the current market where, rapid changes are taking place in the regulatory landscape for NBFCs, NBFCs should err on the side of caution and keep additional free capital. It is important for the management of NBFCs to identify the various sources of funding accessible to them as well as identify the advantages and disadvantages of each funding avenue. This will prove imperative for ensuring flexibility of operations at the same time balancing the cost of capital.

1. KPMG in India's analysis based on reports published by RBI, IFC, World Bank
2. RBI Stability Report 2023, RBI, accessed on 24 January 2024
3. RBI NBFC Report September 2023

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4.3 Liquidity management in NBFCs

Liquidity management is imperative for any financial institution to ensure financial stability and meet short-term obligations. NBFCs in India employ various practices to maintain optimal levels of liquid assets, often balancing the need for profitability and risk mitigation. NBFCs are focused on diversifying funding sources considering most NBFCs cannot depend on the large-scale diversification offered by retail deposits.

Liquidity stress testing, robust cashflow projections and monitoring of maturity profiles are integral to liquidity management in NBFCs. Guidelines enforced by RBI have been important cornerstones in shaping effective and sound liquidity management strategies that safeguard NBFCs against market fluctuations

4.3.1 Liquidity risks in NBFC

Cumulative mismatch as a percentage of outflows over next year	No. of NBFCs having liquidity mismatch		
	Baseline	Medium	High
Over 50 per cent	1 (0.1)	2 (0.3)	3 (0.8)
Between 20 and 50 per cent	3 (0.8)	3 (1.3)	3 (1.2)
20 per cent and below	2 (0.4)	12 (8.8)	28 (13.0)
Note: Figures in parenthesis represent percentage share in asset size of the sample.			

Source: RBI Stability Report 2023

4.3.2 Measures taken by NBFCs for liquidity management

Regulatory requirements

NBFCs are required by the RBI to report their liquidity position via the Structural Liquidity (SLS) and the Short-Term Dynamic Liquidity (STDL) Statements. These involve maturity bucket analysis and gap and mismatch analysis. In addition to the above, NBFCs are also required to assess their Liquidity Coverage Ratio (LCR) on a daily basis, which is a stressed measure of short-term liquidity. Currently, systematically important NBFCs are required to maintain a minimum of 85 per cent LCR.

Source: RBI Stability Report 2023

1. KPMG in India's analysis based on reports published by RBI, IFC, World Bank

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Behavioural analysis

For loans and advances which allow for behavioural options, such as prepayment, behavioural analysis must be conducted to incorporate the impact of behavioural tendencies into the projected cashflows for efficient tracking of the liquidity position. Similarly on the liability side for deposit-taking NBFCs, early-withdrawal rate analysis and non-maturity deposit analysis should be conducted.

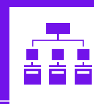
What-if scenario analysis

The company must conduct scenario analysis to consider scenarios in which it may face a liquidity crunch and proactively have a liquidity contingency plan in place in case the scenario arises.

Other quantitative measures

NBFCs may adopt the "Stock" approach for liquidity management, which provides a snapshot of the current liquidity position. It is complemented by the "Flow" approach which forecasts future cashflows and assesses the sustainability of liquidity over time. NBFCs should also consider stress testing for liquidity.

Involvement of senior management



Senior management of the company should be informed about the company's liquidity position. This can be done through various methods, one of which is through setting risk tolerance limits beyond which the senior management and subsequently the board should be informed. These tolerance limits should ideally be based on quantitative measures being tracked regularly.

The senior management should guide the setting up of the initial liquidity management framework of the company and thereafter approve any changes in this.

4.4 Interest rate risk management in NBFCs

Interest rate risk management practices in NBFCs aim to mitigate potential adverse impacts on earnings and capital caused by fluctuations in interest rates. NBFCs employ strategies, such as interest rate derivatives and matching between rate sensitive assets and liabilities, to hedge against interest rate volatility. Robust risk measurement models assess the impact of rate changes and help with prudent decision making. Effective interest rate risk management enhances financial resilience and ensures that NBFCs can adapt to interest rate movements while sustaining profitability and safeguarding against potential risks.

Reporting requirements

NBFCs are required by the RBI to report their interest rate sensitivity position via the Interest Rate Sensitivity (IRS) statement. This involves maturity bucket analysis and gap and mismatch analysis.

Other quantitative measures

Other approaches that can be adopted to track their interest rate risk position are traditional gap analysis, duration gap analysis and the market value of equity approach.

Interest Rate Risk in the Banking Book (IRRBB)

RBI has released the final guidelines for IRRBB in February 2023, for banks. This implies that RBI is strengthening its regulatory framework for interest rate risk management. This would have implications for NBFCs wherein they may also be required to adopt the more advanced and robust framework based on BCBS-issued guidelines on IRRBB in the near future. This framework includes behavioural analysis, automatic interest rate options and both economic value of equity and net interest income analysis under 6 different shocks.

1. KPMG in India's analysis based on reports published by RBI, IFC, World Bank
2. RBI Stability Report 2023, RBI, accessed on 24 January 2024

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05

Competition faced from the banking industry

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5.1 Traditional roles in credit delivery

NBFC over the last two decades has evolved into mature lending enterprises contributing meaningfully to India's credit aspirations. The RBI, as the regulator, envisioned a regulated environment that strikes a balance between supervision and freedom for NBFCs to focus on credit growth and inclusion. This environment fostered NBFC's into being agile and dynamic enterprises by nature.

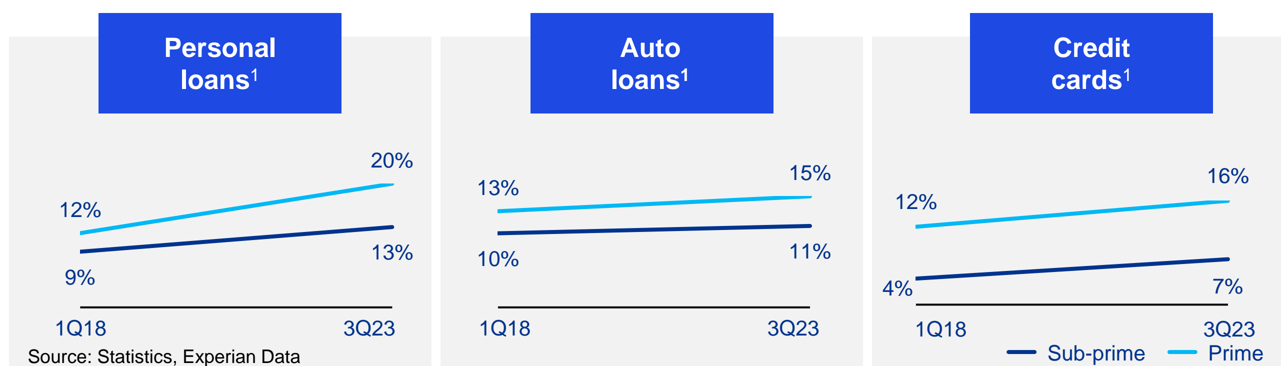
NBFCs offer two distinct advantages compared to their larger counterparts, the banks. Firstly, their field-heavy operating model which allowed them to underwrite customers with non-traditional income sources and their geographically dispersed reach across the hinterlands of India, which allowed them access to credit underpenetrated regions untouched by banks.

For NBFCs, the lack of deposit acceptance capabilities meant banks had a cost of fund advantage and would thus out-bid NBFCs when it came to acquiring highly rated, high-income and easily accessible retail and wholesale customers. This resulted in NBFCs inherently catering to the residual credit demand of the country. Despite this, NBFCs today have established meaningful share across products and continue to penetrate deeper in the landscape.

NBFCs core strategic advantage comes from their years of building know-how of borrower industries and behaviour, gathering regional insights and developing well-oiled distribution mechanisms iteratively over decades. Leveraging their agility, NBFCs also moved fast to adopt alternate data to better understand their customers and develop efficiencies in underwriting which has further enabled growth.

Banks exploring previously uncharted territory

As traditional customer pools start to dry up, both public and private banks are expanding their nets to capture previously overlooked customer cohorts. Evidence of this can be seen in the sourcing distribution of banks across select retail products. The share of prime, below prime customers in sourcing shows an upward trend over a five-year period[1].



Source: Statistics, Experian Data

Another indicator of the shift in focus is the rising bank credit flow to previously underserved sectors such as MSME and microfinance and the growth in Tier 2 and beyond regions, both of which have been NBFC's home ground. This signifies increased competition by banks with their non-bank counterparts.

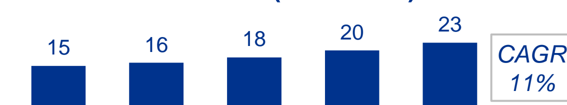
Another growing phenomenon among banks is acquiring NBFC customers who have built their credit profiles over a period, by offering competitive pricing. Thus, customer retention is a vital area of competition.

Scheduled commercial banks growing faster in rural and semi-urban regions[2]

CAGR % (FY18–23)	Rural	Semi urban	Urban
# of accounts	9.5 %	9.6%	8.7%
Credit limits sanctioned	9.7%	9.8%	9.4%

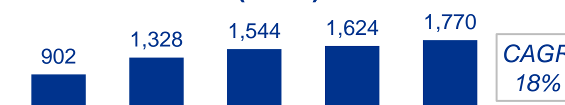
Source: RBI Database on Indian Economy

Bank credit to MSME[3] (lakh crore)



Source: Report on Trend and Progress of Banking in India 2022-2023, RBI

Bank credit to MFI^[4] (crore)



Source: NBFC, MFIN website

1. Statistics NBFC, Experian Data, accessed on 24 January 2024
2. RBI Database on Indian Economy, accessed on 24 January 2024
3. Report on Trend and Progress of Banking in India 2022-2023, RBI, accessed on 24 January 2024
4. NBFC, MFIN website, accessed on 24 January 2024

^ excluding SHG

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5.2 Market share fluctuations indicate competitive intensity across certain products and ticket size segments

Although NBFCs share of India's aggregate credit portfolio has grown from 17 per cent in FY19 to 21 per cent in FY23[1], a detailed analysis of market share fluctuations across product segments and tickets size buckets indicates intensified competition for NBFCs in segments such as housing finance, LAP, consumer durables, auto loans and gold loans. However, there seems to be limited threat in segments such as two-wheeler loans, unsecured business loans, microfinance, commercial vehicles and personal loans.

A. Housing finance

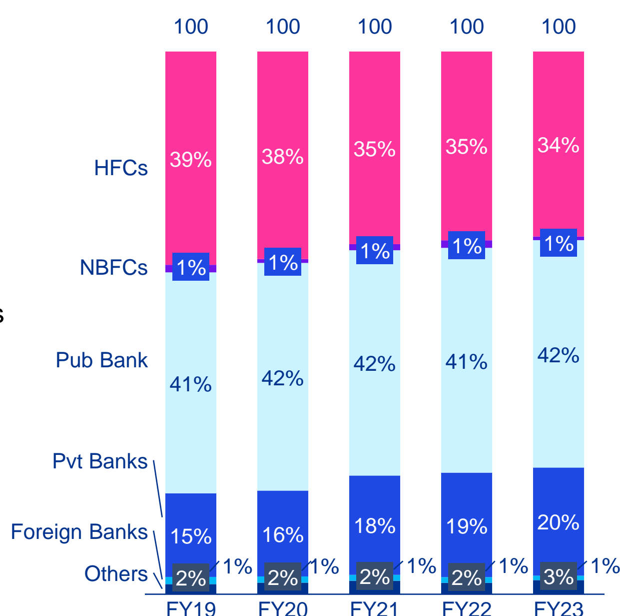
Despite the recent growth of NBFC-HFCs, especially in the affordable segment, at an overall housing finance level HFCs and NBFCs have lost an aggregate 6 per cent market share between FY19 and FY23[2]. The major beneficiaries of this loss have been private banks.

HFCs have lost market share across all ticket size buckets, while NBFCs have made inroads in the 5–20 lakh segment, doubling their market share from 0.7 per cent to 1.4[2] per cent. The IIFL and DHFL liquidity shocks are potential grounds for the subdued performance of HFCs since FY19.

HFCs have been worst hit in Tier 1–3 regions, losing >4 per cent market share[2], performing relatively better in Tier 4+ towns, where the loss was limited to ~2 per cent.

The <75 lakh ticket size segment is preferred by both public banks and HFC, indicated by portfolio concentrations of >80 per cent[2]. This indicates direct competition from public banks in the medium-term.

Housing finance portfolio market share[2]



Source: Statistics, Experian Data

B. Auto loans

In FY19 NBFCs, public and private banks participated almost equally in the total auto loans portfolio with 34 per cent, 30 per cent and 33 per cent market share, respectively[2]. As of FY23 however, NBFCs have lost more than 10 per cent market share[2], equally to both public and private banks.

Significantly curtailed sourcing in FY20 and FY21, specifically in the 5-10 lakh and >10 lakh ticket size buckets caused this negative market share trend.

Considering regional perspectives, NBFCs struggled across all city tiers, with private banks claiming majority of the wins in Tier 1 and 2 and public banks in Tier 3 and 4[2].

Auto loan disbursement growth[2]

> 5 lakh	FY20	FY21	FY22	FY23	4Y CAGR %
NBFCs	-13%	-39%	36%	79%	7%
Pub banks	0%	18%	34%	55%	25%
Pvt banks	-1%	0%	35%	35%	16%
Total	**-4%**	**-7%**	**35%**	**52%**	**16%**

< 5 lakh	FY20	FY21	FY22	FY23	4Y CAGR %
NBF	-1%	-50%	21%	14%	-9%
PUB	-10%	4%	-24%	2%	-8%
PVT	-17%	-7%	-16%	-23%	-16%
Total	**-7%**	**-29%**	**-4%**	**3%**	**-10%**

Source: Statistics, Experian Data

C. Consumer durables

Digital commerce has driven the growth of consumer durable loans, attracting young borrowers through buy now pay later models. NBFCs have gained a 25 per cent market share in CD loans, but private banks have experienced rapid growth in loans under 1 lakh, resulting in a small reduction in NBFCs' market share[2].

D. Gold loans

A recent regulatory edge for banks permitting a 90 per cent LTV compared to 75 per cent for NBFCs has revived the interest of banks, specifically public banks in gold loans. Although market shares have not yet changed materially, banks registered 20 per cent y-o-y growth in FY23, signaling potential threat in the near term[3].

1. RBI Database on Indian Economy, accessed on 24 January 2024
2. Statistics, Experian Data, accessed on 24 January 2024
3. Report on Trend and Progress of Banking in India 2022-2023, RBI, accessed on 24 January 2024

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E. Loan against property

Recently there has been significant interest from all stakeholders including regulators, industry participants, banks, NBFCs and fintechs in the loan against property product. The government's focus on upliftment of the MSME sector is clear, with a host of recent initiatives to boost this section of the industry.

Although NBFCs have fared well to forego only 3 per cent market share on an overall LAP product level between FY19 and FY23[1], the evaluation of competitive intensity for NBFCs reveals contrasting results when divided between low-ticket size and high-ticket size lending segments.

While NBFCs have protected their position in the smaller ticket segment, private banks are aggressively expanding across all other ticket sizes posing significant threats to both NBFCs as well as public banks.

Whereas HFCs disbursement growth has been negative in the INR 1–5 crore bucket, registering an average 17 per cent CAGR (FY19–23) in the <50 lakh bucket[1], private banks are aggressively growing disbursements by almost 20-25 per cent (FY19–23) across all ticket size buckets[1].

Market shares changes in LAP portfolio[1]

Ticket segment		HFC + NBFC	Pub Bank	Pvt Bank
<50L	FY19	49%	21%	24%
	FY23	55%	16%	23%
		6%	-4%	-1%
0.5-2 Cr	FY19	41%	10%	40%
	FY23	39%	9%	46%
		-3%	-1%	6%
2-5 Cr	FY19	43%	7%	38%
	FY23	34%	6%	49%
		-9%	-1%	11%
>5 Cr	FY19	60%	6%	24%
	FY23	39%	4%	43%
		-21%	-2%	18%

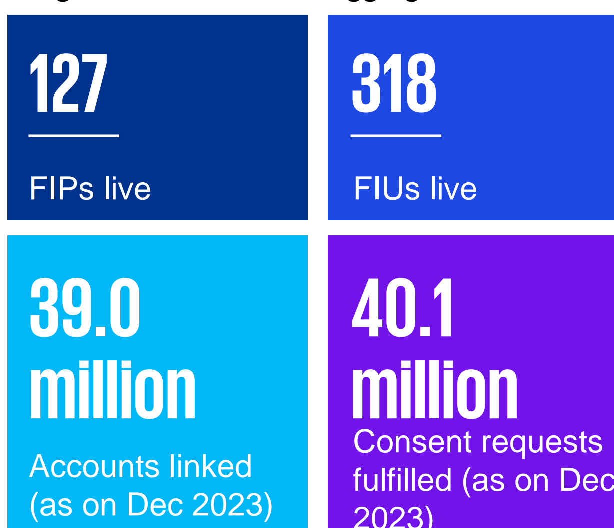
Source: Statistics, Experian Data

5.3 Technology bridging the information divide

The Account Aggregator (AA) framework and OCEN standards are revolutionary initiatives by the Indian Government towards an open architecture financial ecosystem. Standardized and consent-based data sharing has the potential to significantly transform the way underwriting is done and level the playing field between various lending enterprises by bringing in information symmetry. It is expected that retail borrowers, specially MSMEs will be the primary beneficiaries of the AA and OCEN initiatives and in-turn LAP and Business loans are poised to benefit greatly.

This poses a threat to NBFCs who have relied on years of internally generated knowledge base of the on-ground situation of to have an edge in underwriting them vis-à-vis banks.

Progress of the Account Aggregator framework[2]



Source: Sahamati.org

Banks prioritising digital channels

New private banks such as IndusInd, RBL, IDFC First have been front-runners in building fintech collaborations and digital capabilities. Moreover, even public sector banks, such as Bank of Baroda which has formed a multitude of fintech partnerships and SBI which has launched the YONO app, are showing intent and openness towards digital channels for sourcing. NBFCs have largest wallet share in fintech lending, but this may change with greater technology adoption by banks.

1. Statistics, Experian Data, accessed on 24 January 2024
2. Sahamati.org, accessed on 24 January 2024
3. KPMG in India's analysis based on reports published by RBI, IFC, World Bank

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5.4 Emerging themes and the way forward

The M&A activity over the last 10 years has predominantly revolved around the five key themes

Growth in exposure to microfinance to meet priority sector targets

- AU SFB's acquisition of Fincare SFB[1] was primarily driven by the objective to build a microfinance portfolio and access Southern India through Fincare's presence.
- Kotak acquired Sonata Finance[1] (a microfinance enterprise) in FY23 to complement its rural and semi-urban PSL exposures in North India.
- IndusInd Bank acquired Bharat Financial Inclusion Limited[1] to grow its microfinance portfolio and meet PSL targets.
- Kotak acquired BSS Microfinance[1] primarily to acquire its business correspondents to supplement Kotak's existing field network.

Consolidation of public banks

Over the past decade, state-directed acquisitions of public banks have occurred, including Indian Bank's takeover of Allahabad Bank and Punjab National Bank's acquisition of Oriental Bank of Commerce[1]. Further consolidation is anticipated, resulting in larger entities with specialised capabilities with the potential to disrupt the credit markets.

Expansion through M&A

- Kotak acquired ING Vysya[1] to establish its reach in southern India and gain access to the MSME customer franchise.
- Svatantra's acquisition of Chaitanya, CreditAccess' acquisition of Madura Microfin, Centrums Acquisition of Altura represent growing consolidation in the NBFC for scale and size[1].

Privately held NBFCs continue to prefer capital market exit opportunities

NBFC have experienced IPO success across product categories such as wholesale lending, housing finance and microfinance. Public markets have shown higher appetite for the value that NBFCs bring by offering better price discovery (i.e., high valuation multiples). Going forward, more MSME/LAP and vehicle finance NBFCs may seek listing.

Fintechs inorganic route to banking through stressed assets

Slice and BharatPe's partnerships with North-Eastern Small Finance Bank and PMC Bank[1] show that the RBI is open to fintech companies becoming involved in banking through these collaborations.

Fundamental changes in the operating environment over the past 10 years present partnerships a viable alternative to M&A:

- **Technology:** API for data interchange has revolutionised the way lending businesses operate and has paved the way for real-time information exchange between core systems.
- **Intermediation:** Led by technology there has been a host of intermediaries for fraud verification, KYC, reconciliation, underwriting, etc.
- **Alternate data:** Borrowers now possess a significantly larger digital presence than ever before, and this trend is continuously expanding.
- **Credit bureaus:** Popularisation and understanding of CICs amongst borrowers and accurate reporting of data by lenders has improved significantly.
- **Regulation:** There have been proactive regulatory changes in areas such as KYC (Aadhaar, Video, etc.), outsourcing, digital lending, co-lending, etc.
- **Governance:** Governance standards of NBFCs have improved significantly.
- **Limited arbitrage:** Scale-based regulations have bridged the NBFC-bank regulatory arbitrage to a large extent.
- **Operational harmonisation:** Banks have harmonised activities such as risk-based pricing, collection practices and Non-Performing Assets (NPA) recognition.
- **Overlapping market:** Enhanced information transparency has resulted in the convergence of target customer groups between Banks and NBFCs.

Partnerships will become important alternatives due to significant changes, as M&A in stress assets and public bank consolidation continues. Additionally, high valuation multiples make strategic acquisitions expensive and unrealistic.

1. NBFC report, VCC Edge.com, accessed on 24 January 2024

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06

Evolving regulatory landscape

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6.1 Scaled based regulation

NBFCs significantly contribute to India's economic growth, particularly in under-banked areas. Over the past decade, NBFCs have grown significantly in number, size, complexity and interconnectedness within the financial sector. Many entities have grown and become systemically significant, which fueled by a lighter regulatory framework may pose potential systemic risks.

To align the regulatory framework for NBFCs keeping in view their changing risk profile, the RBI issued the 'Scale Based Regulation — A revised regulatory framework for NBFCs' (the Framework') which has been effective from 01 October 2022.

With the increase in net owned funds from INR2 crore to INR10 crore[1], the Framework has categorised NBFCs into four buckets based on the asset size, business activity and perceived risk.

The lowest layer exhibiting the least risk i.e. based on an asset size of less than INR1,000 crore, shall be termed as 'NBFC-Base Layer' followed by the 'NBFC-Middle Layer' with an asset size of more than INR1,000 crore.

'NBFC-Upper Layer' i.e. the third bucket which poses a sizeable amount of systemic risk shall comprise of NBFCs that are specifically identified by the RBI as warranting enhanced regulatory requirement based on a set of parameters and scoring methodology prescribed in the Framework. The top bucket i.e. 'NBFC-Top Layer' is ideally expected to be empty and shall be populated only if RBI is of the opinion that there is a requirement to move an NBFC from upper layer to top layer keeping in mind the potential systemic risk arising from the specific NBFC.

Based on categorisation, the regulatory framework shall differ with NBFC-Base Layer being least regulated and NBFC-Upper Layer attracting bank-like regulations. The Framework for NBFCs is expected to structurally benefit the sector from the risk management and stakeholders' perspective. However, in the short-term, there could be some effects on business due to rising capital requirements, the introduction of Common Equity Tier-1 requirement of 9 per cent for NBFC-UL and the introduction of the Internal Capital Adequacy Assessment Process.

Along with changes in the categorisation of NBFCs from a regulatory perspective, corresponding changes are also brought into the provisions of Income-tax Act, 1961 (the Act) to provide necessary reliefs.

6.2 Digital lending guidelines

The expansion of digital lending has led to various concerns in the digital ecosystem, primarily relating to the unbridled engagement of LSP with banks and NBFCs. On 02 September 2022, the RBI released the 'Guidelines on Digital Lending' to address the importance of fostering innovation and inclusivity in the lending sector while ensuring customer protection.

The digital lending guidelines cover regulations for customer protection, grievance redressal and fee methods, emphasizing transparency in loan terms, LSP involvement and customer data usage.

Default Loss Guarantee (DLG), commonly known as FLDG, has been a popular model under digital lending. On 08 June 2023, RBI issued guidelines on Default Loss Guarantee in Digital Lending (DLG guidelines). The said DLG guideline provides for a cap on DLG of 5 per cent of the amount of the loan portfolio. The DLG guidelines also outline the procedures for recognizing NPAs, the format in which disclosure of loan loss provisions should be provided, the treatment of DLG for regulatory capital purposes and the disclosure requirements related to DLG.

The said DLG guidelines encapsulate RBI's support and recognition of the role of fintech lending and innovation in expanding formal credit to unserved and underserved segments. Laying down a uniform policy has increased certainty and clarity for banks/NBFCs and provided an impetus to digital lending.

As a result, there's been a reevaluation of existing NBFCs/LSP agreements, LSP/DLA consolidations and reassessment of some fintechs' going concern due to insufficient capital support.

1. Press Release, Reserve Bank of India, accessed on 24 January 2024

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6.3 Technology risk and cyber security regulations

The Indian Financial Services industry has been subject to a raft of regulations in the domains of cyber and information security over the past few years. This has significantly increased the compliance burden on regulated entities. Some of the key regulations that NBFCs have to comply with are the Master Directions on (i)Technology Risk, Governance, Controls and Assurance practices (ii) Outsourcing of IT services (iii) Implementation of 'Core Financial Services Solution' by NBFCs (iv) Guidelines on Digital Lending. Banks will also need to critically evaluate the provisions of the recently issued Digital Personal Data Protection Act (DPDPA), 2024.

01

Master Directions on Technology Risk, Governance, Controls and Assurance practices

These Master Directions will come into effect from 01 April 2023 and focus on the themes of (i) IT Governance (ii) IT Infrastructure and Services Management (iii) IT information security and risk management (iv) Business Continuity and Disaster Recovery Management and (v) Information Systems Audit. NBFCs would need to review their preparedness and plan for compliance especially in the areas of cyber crisis and BCP DR plans, constitution of relevant IT and IS committees, enhancing the CISO/CIO function, performing periodic risk assessments, building an enterprise data dictionary and implementing audit and system logging capabilities.

02

Master Directions on Outsourcing of IT services

These Master Directions came into effect from 01 October 2023 and focus on measures that entities would need to take to manage the outsourcing risks specifically on third-party providers of Information Technology (IT) and IT enabled Services (ITeS). NBFCs would be required to maintain an inventory of third-party services and service providers, identify material services and perform due diligence and periodic assessments of third parties across the entire outsourcing lifecycle. The requirements for policies, procedures and the roles and responsibilities of the Board, senior management and IT function are also explicitly defined.

03

Implementation of 'Core Financial Services Solution' by (NBFCs)

This regulation mandates that NBFCs-Middle Layer and NBFCs-Upper Layer with 10 and more 'Fixed point service delivery units shall be mandatorily required to implement 'Core Financial Services Solution (CFSS)', akin to the Core Banking Solution (CBS) adopted by banks. The CFSS shall provide for seamless customer interface in digital offerings and transactions relating to products and services with anywhere/anytime facility, enable integration of NBFCs' functions, provide centralised database and accounting records and be able to generate suitable MIS, both for internal purposes and regulatory reporting. Banks would need to do a gap assessment of their existing technology infrastructure to assess compliance with the above requirements.

04

Digital Lending Guidelines

The Digital Lending Guidelines issued in September 2022 regulate the data processing practices of digital lending agents including NBFCs. Some key requirements include obtaining explicit consent of the customers before collecting, processing and sharing their data, providing them with a detailed notice containing information on data retention period, purpose for collection of consent, list of third parties with whom data will be shared etc.

05

Digital Personal Data Protection Act 2023

Digital Personal Data Protection Act 2023, which received presidential assent in August 2023 is a comprehensive, sector-agnostic legislation that governs personal data processing by corporates. It will require NBFCs to obtain explicit consent from individuals before or at the time of processing as well as bestow specific rights on them to exercise greater control over their personal data including the right to access, erasure, correct and designate a nominee for their personal data. It requires corporates to provide a detailed privacy notice in English or any of the constitutionally recognised languages on request. In addition, organisations will need to recognise, document and mitigate privacy risks as part of overall risk management systems.

Forthcoming supervisory outlook

The regulator is continuing its efforts to reduce the differences between banks and NBFCs. More policy reforms are expected to improve governance, risk management, liquidity management and asset quality for both types of institutions. For NBFCs to grow steadily, they must also adopt higher technology and digital practices, improve supervision and reporting and implement customer protection measures. NBFCS need to stay updated on industry trends and strive to upgrade their practices, particularly in risk management and digital lending. This section explains some recent regulatory interventions.

1. Press Release, Reserve Bank of India, accessed on 24 January 2024
2. Digital Personal Data Protection Act, Ministry of Electronics and Information Technology, Government of India, accessed on 24 January 2024

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07

Conclusion

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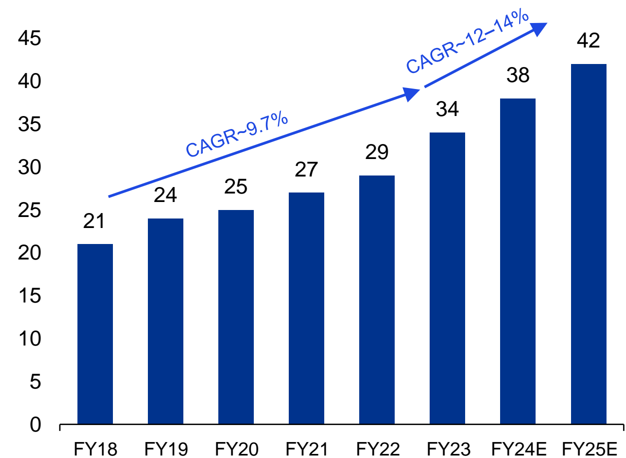
There are five key aspects that will be considered to measure the success of this sector in a holistic manner. Key considerations will include the sourcing and nature of business, the operating performance, credit performance, funds management and capital management. Key aspects are outlined below:

7.1 Ticket size and asset under management

With the extensive adoption of technology and integration with the fintech ecosystem, disbursements across products have been very strong for NBFCs which is likely to continue in the coming years. Unsecured business loans with ticket size <5 lakh and secured MSME LAP with ticket size between 20–25 lakh will drive growth in the MSME credit space[1]. Vehicle finance is expected to register strong growth along with affordable housing where the average ticket size is between 9 lakh to 12 lakh for NBFCs[1]. Gold loans with average ticket size up to 1.25 lakh have emerged as a popular and alternative route for financing and has seen participation from various fintechs due to the secured nature of the product and same day disbursals. As a result, the AUM for NBFCs is projected to grow by 12–14 per cent until FY25, reaching INR42 trillion.

NBFC credit to grow at CAGR 12–14% between FY23 and FY25 (in INR trillion)

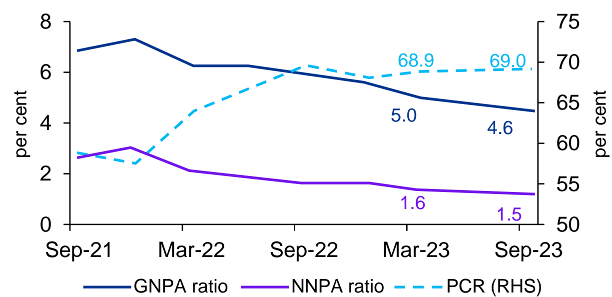


Source: IPO Note, HDFC Securities

7.2 NPAs and provision coverage ratio (PCR)

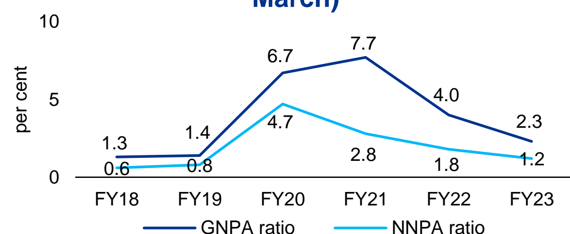
The RBI allowed NBFCs time till 30 September 2022 to follow NPA upgradation norms, which clarified that loan accounts classified as NPAs may be upgraded as standard assets only if entire arrears of interest and principal are paid by the borrower. During FY22–23, the asset quality of NBFCs improved, with lower slippages leading to a decrease in the GNPA ratio to its lowest level in five years. PCR increased from 51.5 per cent at the end of March 2020 to 68.9 per cent at the end of March 2023 for NBFCs *(please refer to the attached chart).* As at the end of September 2023, the asset quality of the sector showed further improvement as the GNPA and NNPA ratios fell to 4.6 per cent and 1.5 per cent, respectively. This trend is expected to sustain only if the delinquencies and asset quality are maintained within acceptable limits, composition of unsecured loans in NBFC portfolio is in check and collections are optimised with use of technology and analytics.

Asset quality of NBFCs — NPA and PCR



Sources: RBI supervisory returns and staff calculations.

HFC's GNPA and NNPA ratios (at end-March)



Note: Data are provisional
Source: National Housing Bank (NHB)

1. Crisil and KPMG in India's analysis based on reports published by RBI, IFC, World Bank
2. Financial Stability Report 2023, RBI, accessed on 24 January 2024
3. Report on trend and progress of banking in India 2022-23, RBI, accessed on 24 January 2024

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7.3 Cost of funds

NBFCs need to keep a vigilant eye on the cost of raising funds for their operational expenses and lending. During the pandemic period, NBFCs became cautious in lending to preserve the asset quality, which restricted AUM growth. The restricted demand drove AUM growth, especially across higher-yielding segments, which impacted profitability positively. The low-interest environment translated into lower cost of funds, resulting in higher spreads, which further impacted profitability positively. The microfinance segment also witnessed equity infusion from private equity and Alternative Investment Funds (AIFs). This in turn has helped the NBFCs to increase their spreads and decrease their debt levels in FY23 which is expected to remain consistent for the next ~2 years with a marginal increase in the cost of funds only due to the rate hikes.

7.4 Liquidity and Asset Liability Management (ALM)

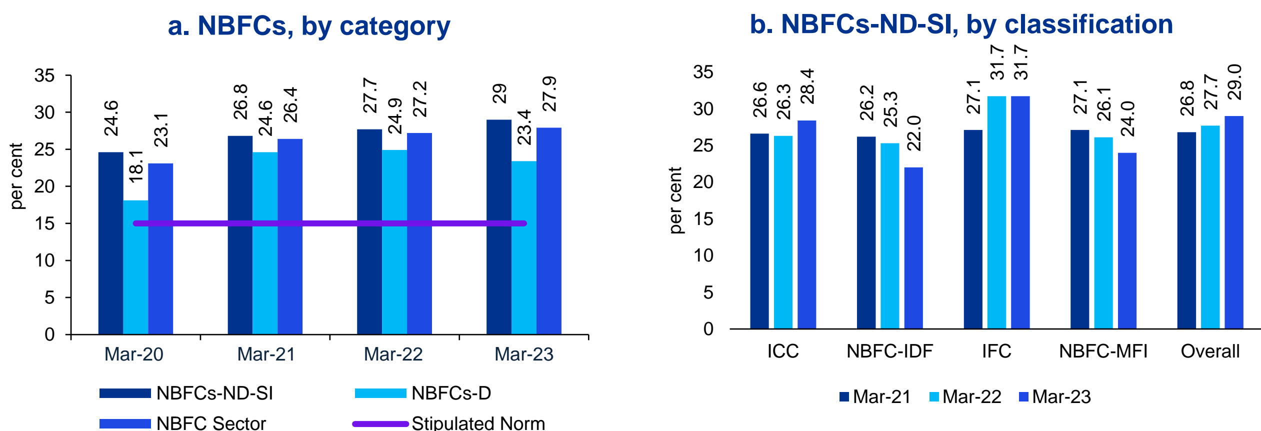
NBFCs must ensure the resilience of their operations by monitoring several liquidity indicators. These include the liquidity coverage ratio, net stable funds ratio, high-quality liquid assets (HQLA) and expected cash inflows and outflows for the next 30 days. In addition to this, it is crucial to prepare profile and monitor the liquidity at a granular maturity level. This has to be complemented with robust MIS capabilities. The guidelines by RBI on ALM mandates that NBFCs segregate the 1-to-30-day time bucket into granular buckets of 1–7 days, 8–14 days and 15–30 days of cash inflows and outflows. These buckets should be used to estimate their short-term liquidity requirements based on their business projections and other commitments for planning purposes as well as monitor their short-term liquidity risk on a dynamic basis over the next one day to six months. The guidelines suggest keeping the negative mismatches in these buckets to a maximum of 10 per cent, 10 per cent and 20 per cent, respectively.

7.5 Capital adequacy ratio

NBFCs have consisted reported to be adequately capitalized till FY23, with capital to risk weighted assets ratios (CRARs) well above the regulatory requirement (not less than 15 per cent of aggregate risk-weighted assets, including both on and off-balance sheet items).

RBI kept on releasing further guidelines on capital requirement post circulation of SBR mandate. This initiative translated into improvement in the CRAR of NBFCs-NDSI, barring NBFC-IDF, during FY22–23 on the back of higher Tier 1 capital than a year ago. Overall, CRAR of the sector continued to be at 27.6 per cent comfortably so far and is expected to improve further as the operational and risk profile of the NBFCs optimises further. The regulatory support in exploring funding alternatives and advancement in digital lending may also impact capital adequacy of NBFCs positively in coming years. However, it can only be sustained if NBFCs proactive strive to advance their operation and upgrade to sophisticated practices for risk management before scaling up.

CRAR of NBFCs



Note: Data are provisional.
Source: RBI supervisory returns.

1. Financial Stability Report 2023, RBI, accessed on 24 January 2024
2. Report on trend and progress of banking in India 2022-23, RBI, accessed on 24 January 2024

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The International Finance Corporation (2018) report on MSMEs in India estimated that there is a credit gap of INR2.6 lakh crore in the MSME sector. It is expected that this large gap between the demand and supply in the MSME lending market will be addressed by FY36 with the help of fintech. With proper governance and linking the lending to consumption linked opportunities along with good quality asset growth will result in better margins and ROA for the NBFC sector.

Key indicators and their benchmarks

To scale up and build a healthy sustainable loan book, the NBFCs need to keep a close eye on the following performance indicators — growth rate of credit, CRAR, cost of funds, cost to income ratio, GNPA, ROA along with liquidity indicators. The industry trends indicate the following benchmarks to ensure a sustained growth.

Growth indicators

- Credit growth: > 20%
- NIM: > 5%
- ROA: > 2.5%

Cost indicators

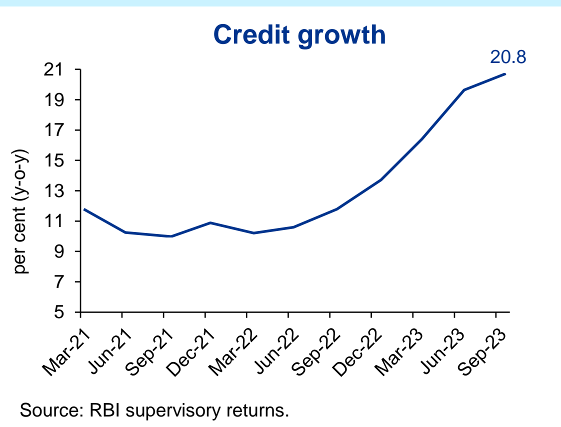
- Cost of funds: 8%(borrowings) - 13% (debentures)
- Cost to Income ratio: > 43%

Asset quality

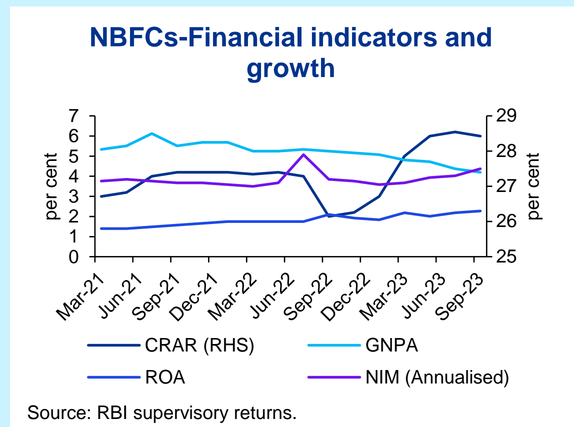
- GNPA: < 4.5%
- NNPA: <1.5%
- PCR: > 70%

Capital adequacy

- CRAR: >=15% (ind avg = 25.2%)
- Liquidity: LCR >= 85% (100% by Dec'24) -ve mismatches across 1-7d <= 10%; 8-14d <=10%; 15-30d <= 20%



Source: RBI supervisory returns.



Source: RBI supervisory returns.

Conclusion

NBFCs are expected to play a crucial role in the India growth story fuelling formalised credit penetration among the underserved. Policy push, regulatory oversight and digital across the value chain are expected to define the growth of this sector.

1. Statista report, accessed on 24 January 2024
2. Financial Stability Report 2023, RBI, accessed on 24 January 2024
3. NBFC report, CAFRAL, accessed on 24 January 2024
4. Master direction on Scale Based Regulation 2022, RBI, accessed on 24 January 2024
5. NBFCs gearing up for growth 2022, CRISIL, accessed on 24 January 2024
6. NITI Aayog report 2036, Government of India, accessed on 24 January 2024

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