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NBFC and HFC Update

Reported NPAs to spike in the near term in view of the RBI's revised NPA recognition and upgradation norms

NOVEMBER 2021

Highlights

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NPAs of NBFCs (including HFCs) are expected to spike in the near term

Impact on earnings performance would be visible over the next few quarters if the forward flows into the NPA category are not contained

Augmentation of internal controls and MIS would be crucial as NBFCs have sizeable branch-based collections, which are typically in cash

- The Reserve Bank of India (RBI), via its notification of November 12, 2021, provided clarification on the income recognition, asset classification and provisioning (IRAC) norms for banks, non-banking financial companies (NBFCs) and All India Financial Institutions (AIFIs). The key points include the classification of special mention accounts (SMA) and non-performing accounts (NPAs) on a day-end position basis, upgrade from an NPA to standard category only after the clearance of all outstanding overdues and harmonisation of the 'out of order' status of cash credit (CC)/overdraft (OD) accounts and the treatment of delays in interest payments on a 90-day overdue basis.
- NBFCs {including housing finance companies (HFCs)} are expected to be impacted by the daily SMA/NPA recognition and the stricter NPA upgradation requirement. This could push up the NBFC and HFC NPAs as of March 2022 by about 160-180 bps and 60-80 bps, respectively, over the March 2021 levels.
- The restructured books of NBFCs and HFCs are estimated to have increased to 4.1-4.4% and 1.8-2.2%, respectively, as of September 2021 vis-à-vis 2.2% and 1.0%, respectively, in March 2021. Slippage from the restructured book is expected to be higher for NBFCs at about 20-25% vis-à-vis 3-5% for HFCs.
- Entities would have to tighten their internal controls and augment their management information systems (MIS) for the timely recognition and updating of cash collection and the time taken for reconciliation .
- Increased focus on collections could have a bearing on the near-term NBFC growth, till the entities are able to control forward flows into the NPA category. As borrowers who slip into NPA are likely remain in the category for a longer period vis a vis the past, their credit profile and ability to secure incremental credit could also be affected.
- Provisions carried by entities by way of the expected credit loss (ECL) basis and management overlays remain higher than the pre-Covid levels; this is expected to support near-term earnings. However, it would be critical to contain the flow into the NPA category.

Key takeaways from RBI notification - I

Heading	Details	Impact
Upgradation of NPAs	NPA accounts to be upgraded to the standard category only after the entire arrears are cleared To be complied with immediately	▪ Banks have largely been following this norm for upgrading their NPAs. NBFCs, however, have been upgrading an NPA account to the standard category, even with partial payments of the outstanding overdues, as long as the total overdues on the reporting date were for less than 90 days. ▪ Going forward, movement to the standard category for NBFC NPAs would be impacted as their target borrowers generally have limited ability to clear all dues.
Classification of SMA/NPA	SMA/NPA classification of an account, on any specific date, is to be done on a day-end position basis SMA classification to be made applicable for all loans, including retail loans To be complied with immediately	▪ Limitations in upgrading and a tighter NPA recognition norm would result in a spike in the NPAs in the near term and higher stickiness of the NPAs going forward for NBFCs. ▪ Gross Stage 3 (GS3) reporting vis-à-vis NPA reporting to the RBI could see increased divergence. Provisions under IndAS are generally higher than the IRAC norms; provisions were further augmented because of the Covid-19 pandemic. Thus, no significant incremental impact is envisaged on the near-term profitability. However, pressure would be felt over the medium term if the forward flow from the stage 2/SMA category is not contained. ▪ Entities would have to tighten their internal processes to capture their collections in a timely manner, especially cash collections by branches, agents, etc. We estimate that close to 40-45% of the NBFC and about 5-10% of the HFC are cash collections ▪ Tight NPA recognition and upgradation criteria could also affect the borrowers' credit profile, which could impact their ability to secure incremental credit. ▪ Increased focus on collections could have a bearing on the near-term growth till the entities are able to control forward flows into the NPA category.

Key takeaways from RBI notification - II

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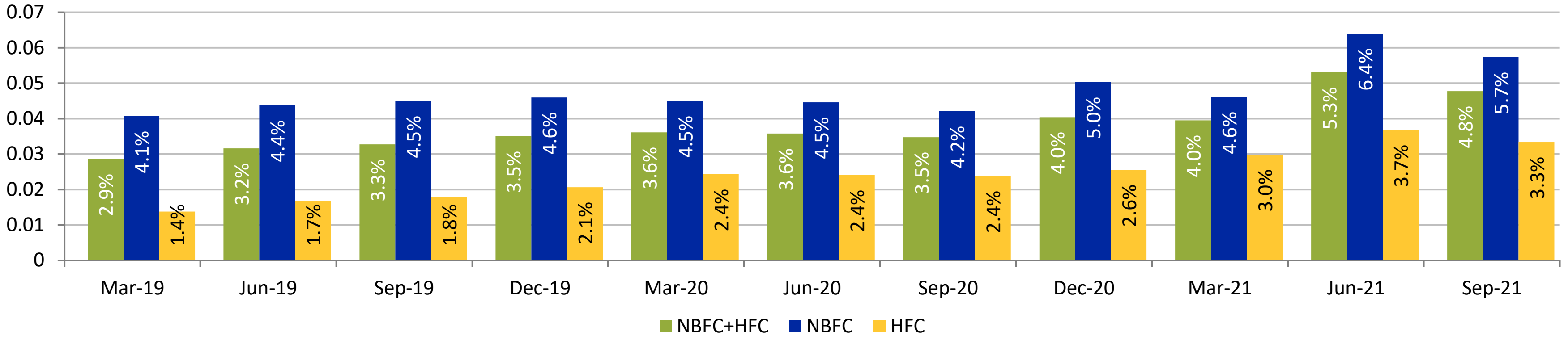
Heading	Details	Impact
Specification of due/repayment dates in loan document	Exact dates of repayment along with a break-up between principal and interest to be provided for all fresh loans and loan renewals To be complied with before December 31, 2021	▪ Most entities provide a detailed repayment schedule to their borrowers at present; so, no significant impact is envisaged
Clarification of out of order CC/OD accounts	CC/OD is to be treated as out of order if the account remains overdrawn for more than 90 days, or If the CC/OD account is not fully utilised and the credits are less than the interest debited during the previous 90 days To be complied with immediately	▪ More a clarificatory guideline; no significant impact envisaged
NPA classification in case of interest payments	In case of term loans, an account would be classified as NPA if the interest applied remains overdue for more than 90 days To be effective from March 31, 2022	▪ This is to largely streamline the NPA recognition of such loans with the more than 90 days overdue norm
Customer education	Improve awareness about SMA/NPA classification and upgradation process among the branch staff and borrowers To be complied with before March 31, 2022	

Overdues moderate from peak levels of June 2021

Exhibit 1: Asset quality trends – GNPA/Gross Stage 3



Source: ICRA Research, data of 22 NBFCs and 11 HFCs (excluding PSUs); Note: NBFC+HFC data is computed based on the NBFC (excluding PSU) and HFC share in the overall sectoral AUM
Sep 21 is estimated

- The asset quality improved in Q2 FY2022 as lockdowns and travel restrictions were significantly relaxed, which bolstered the business cash flow of the borrowers and consequently the loan collections by lenders. Loan collections, which had declined in May 2021 and June 2021, revived steadily over the next few months and were close to the Q4 FY2021 levels in September 2021.

- The implementation of Restructuring 2.0 for borrowers impacted by the second wave of the pandemic also arrested forward flows. Relatively relaxed criteria, which allowed the restructuring of accounts that slipped into harder overdue buckets but were 'standard' as of March 2021, also contributed favourably.

Increase in restructured book in H1 FY2022

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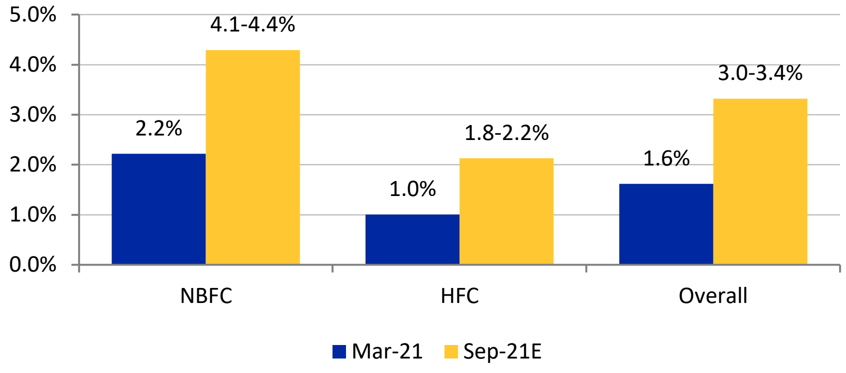
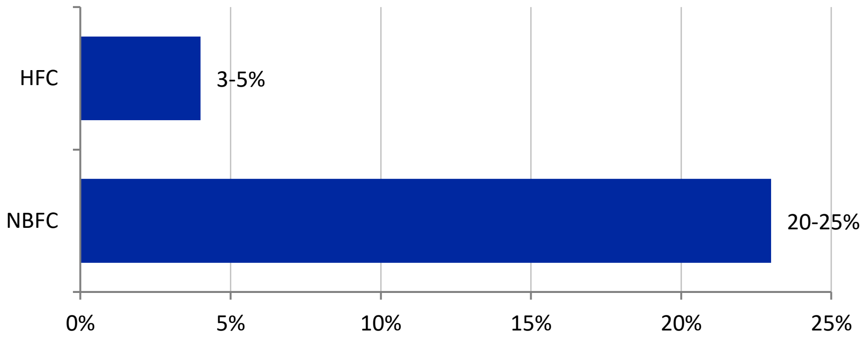
Exhibit 2: Restructured book trend



Source: ICRA Research, ICRA sample of large entities; E – Estimates

Exhibit 3: Estimated slippages from restructured book

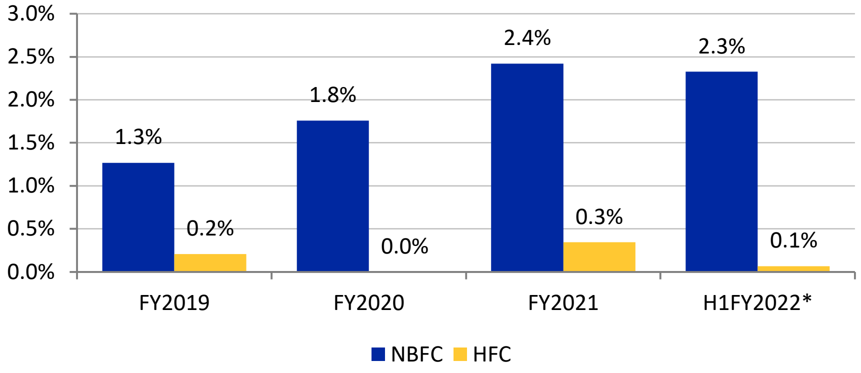


Source: ICRA Research

- The increase in the restructured book has been on expected lines. The restructured book of NBFCs and HFCs doubled over March 2021 levels.
- Slippage from the NBFC restructured book is estimated to be higher at 20-25% vis-à-vis 3-5% for HFCs, considering the prolonged stress witnessed in some of the key NBFC target segments, namely vehicle, business loans, etc.

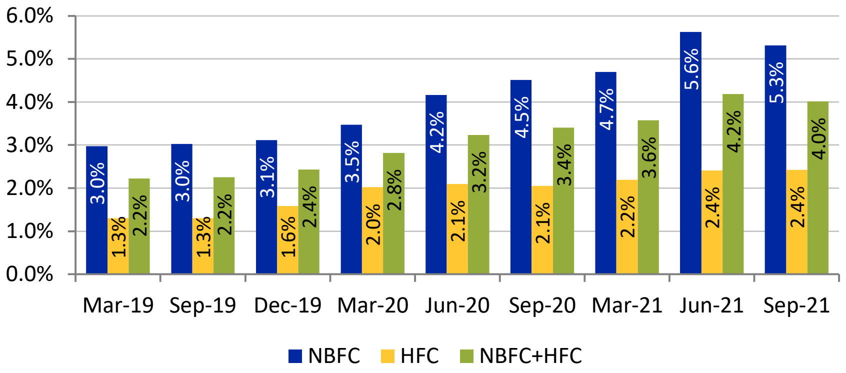
Provisions remain high, providing some buffer

Exhibit 4: Write-offs remain high (% of AUM) for NBFCs



*Source: ICRA Research, data of 22 NBFCs and 11 HFCs, excluding PSUs ; * H1 FY2022 is estimated and annualised*

Exhibit 5: Overall provisions have moderated from Jun-21 levels but remain above Mar-21 levels



Source: ICRA Research, data of 22 NBFCs and 11 HFCs, excluding PSUs ; Sep 21 is estimated

- NBFC write-offs remained high in H1 FY2022, but lower than the levels witnessed in Q3 and Q4 FY2021. Entities used a part of their provisions to set off against these write-offs in Q2 FY2022. Notwithstanding the improving collection efficiency in Q2 FY2022, asset quality pressures remained, especially for the borrowers and segments that were more impacted by the disruptions in the last and current fiscal. We expect write-offs to remain high in FY2022 and similar to the last fiscal in the base case.
- The overall provisions are currently 1.6x the pre-Covid levels (December 2019), i.e. NBFCs – ~1.7x and HFCs – ~1.5x. Entities, under IndAS, are carrying higher overall provisions compared to the regulatory levels under IRAC norms. So, an increase in the NPAs and a corresponding increase in the provisions as per IRAC on account of the new RBI guidelines, are not expected to significantly impact earnings in the near term. However, it would be critical to contain the flow into the NPA category over the medium term.

Reported NPAs to spike again in H2 FY2022 after the moderation witnessed in Q2 FY2022

Currently, the difference between NPAs and GS3 is not very significant. It would, however, increase going forward; NBFC and HFC NPAs could be higher by 160-180 bps and 60-80 bps, respectively, over the March 2021 levels.

Exhibit 6: NBFC GNPA trends and expectation

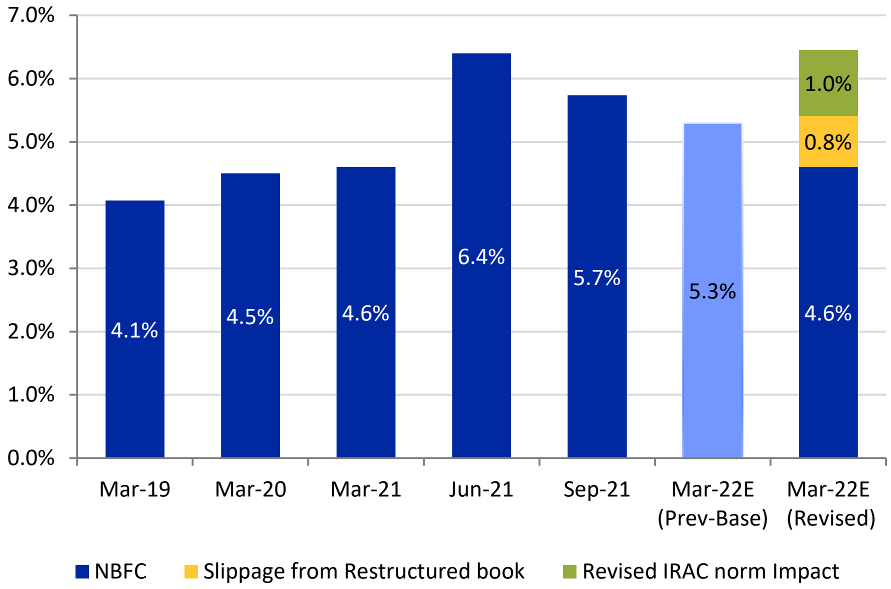
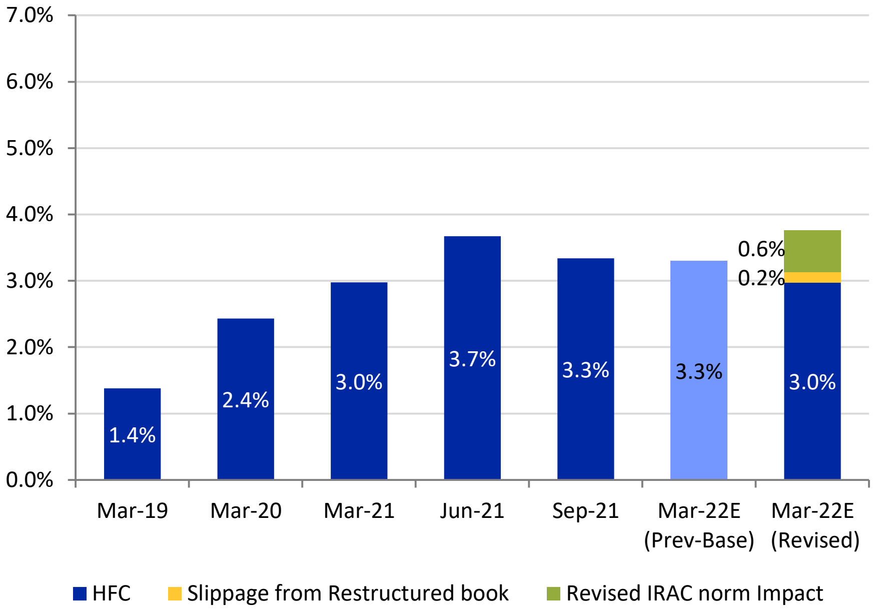


Exhibit 7: HFC GNPA trends and expectation



Source: ICRA Research; Data of 22 NBFCs and 11 HFCs (excluding PSUs); Note: NBFC+HFC data is computed based on the NBFC (excluding PSU) and HFC share in the overall sectoral AUM Sep 21 is estimated;
Note: Impact of the Revised IRAC norm is assumed to be on a incremental basis. The write-off assumption is maintained at the same levels as the past estimates.

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Thank You!