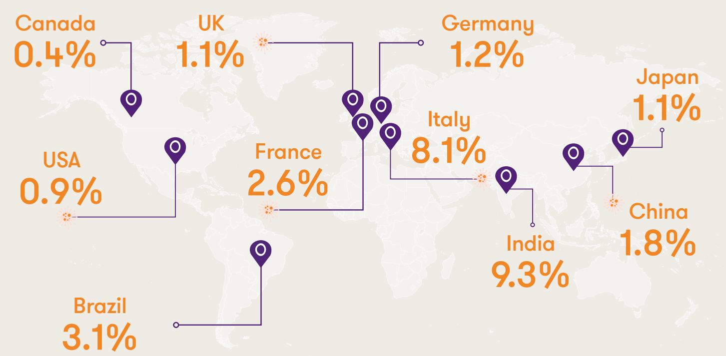
COVID-19: Impact on the Indian Shadow Banking Sector

The COVID-19 pandemic poses unprecedented challenges related to health and economic/financial stability. While the priority is to save lives, the necessary containment measures have led to dramatic decline in economic activity. As a result, in only three months, the 2020 outlook has shifted from expected growth of more than 3 percent globally to a sharp decline of 3 percent, which is much worse than the output loss seen during the 2008-09 global financial crisis. The ultimate impact on the world economy as well recovery time is highly uncertain.

In mid-February, the prices of equities fell sharply, from the previous highs that were considered to be overstretched. In credit markets, spreads skyrocketed, especially in risky segments, such as high-yield bonds, leveraged loans, and private debt, where issuance essentially came to a halt. Oil prices plummeted in the face of weakening global demand and the failure of the OPEC + countries to reach an agreement on output cuts, led to further deterioration in the risk appetite. These volatile market conditions led to a flight to quality, with yields on safe-heaven bonds declining abruptly.

Source: IMF Global Financial Stability Report (April 2020)

Percentage of non-performing loans to total gross loans: Top-10 world economies



Source: IMF Financial Soundness Indicators (April 2019)

Period of turmoil in the Indian shadow banking sector

Post the 2008-09 financial meltdown, the shadow banking sector of India had been buoyant till late 2017. However, in FY 2019, defaults by leading NBFCs shook the entire sector leading to negative sentiments in the stock market and a dearth of liquidity in the sector. All the NBFCs and HFCs shifted their focus to streamlining the existing loan book instead of accelerating the growth. The fourth quarter of FY 2020 started showing green flags as far as growth and liquidity were concerned which earlier were restricted to large NBFCs, was now visible in even the mid-sized players. However, the issues of asset quality in private NBFCs and banks, credit-related issues like the bond defaults and persistent uncertainty over the resolution of large NBFCs has led to tightening of liquidity for the sector yet again.

The COVID-19 crisis had further sparked uncertainty over growth, funding, collections, and asset quality. With the entire nation on lockdown for 40 days starting from 25 March 2019, the Indian financial sector, which has the highest percentage of bad loans amongst the top 10 world economies, came to a standstill and the action shifted to the RBI and government to provide a helping hand.

Measures by Central Bank

Since March 27, 2020 the macroeconomic and financial landscape has deteriorated, precipitously in some areas; but light still shines through bravely in some others. On April 14, the IMF released its global growth projections, revealing that in 2020, the global economy is expected to plunge into the worst recession since the Great Depression, far worse than the Global Financial Crisis. The IMF's Economic Counsellor has named it the 'Great Lockdown', estimating the cumulative loss to global GDP over 2020 and 2021 at around USD 9 trillion – greater than the economies of Japan and Germany, combined.

India is among the handful of countries that is projected to cling on tenuously to positive growth (at 1.9%). In fact, this is the highest growth rate among the G20 nations. Global financial markets remain volatile, and emerging market economies are grappling with capital outflows and volatile exchange rates. Crude oil prices remain in a state of flux, despite the agreement on production cuts by OPEC + countries. For 2021, the IMF projects sizable V-shaped recoveries: close to 9 percentage points for global GDP. India is expected to post a sharp turnaround and resume its pre-COVID pre-slowdown trajectory by growing at 7.4% in 2021-22

Following are the key steps announced by RBI on 27 March and 17 April 2020 as measures to curtail the effects of the pandemic on shadow banking sector

Moratorium on EMIs

- In respect of all term loans (including agricultural term loans, retail and crop loans) NBFCs (including housing finance companies) (lending institutions) were permitted to grant a moratorium of three months on payment of all instalments falling due between 1 March 2020 and 31 May 2020. The repayment schedule for such loans as also the residual tenor will be shifted across the board by three months after the moratorium period. Interest shall continue to accrue on the outstanding portion of the term loans during the moratorium period.
- In respect of above, no penal interest shall be charged by the lending institutions.

Refinancing facilities for AIFIs

All India financial institutions (AIFIs) such as the NABARD, SIDBI and NHB to be provided special refinance facilities for a total amount of INR 50,000 crore to enable them to meet sectoral credit needs. This will comprise INR 25,000 crore to NABARD for refinancing regional rural banks (RRBs), cooperative banks and microfinance institutions (MFIs); INR 15,000 crore to SIDBI for on-lending/refinancing; and INR 10,000 crore to NHB for supporting HFCs. Advances under this facility will be charged at the RBI's policy repo rate at the time of availing the facility.

Reduction in reverse repo rate

Owing to surplus liquidity in the banking sector due to government spending and various liquidity measures undertaken by the RBI and in order to encourage banks to deploy these surplus funds in the investment and loans in productive sectors of the economy, RBI reduced the fixed-rate reverse repo under the liquidity adjustment facility (LAF) by 25 basis points from 4.0% to 3.75% with effect from 17 April 2020. Repo rate and marginal standing facility rate remain unchanged at 4.40% and 4.65%, respectively.

TLTRO 2.0

- Long-term repo operations (LTRO) is a mechanism by which the central bank provides one year to three-year funding to banks at the prevailing repo rates and accepting government securities with matching or higher tenure as the collateral.
- The central bank announced to conduct targeted long-term repo operations (TLTRO 2.0) for an aggregate amount of INR 50,000 crore, to begin with, in tranches of appropriate sizes. The funds availed by banks under TLTRO 2.0 should be invested in investment-grade bonds, commercial paper, and non-convertible debentures of NBFCs, with at least 50 per cent of the total amount availed going to small and mid-sized NBFCs and MFIs.
- Banks will have to make such investment within 30-45 days from availing of the liquidity from RBI. The investment to be categorised by banks as Held to Maturity (HTM) even in excess of 25% of total investment permitted to be included in the HTM portfolio thereby, providing protection against mark to market losses.

Asset classification standstill

- All the accounts on which the NBFCs and HFCs will be granting the moratorium, and which were standard as on 1 March 2020, the 90 days NPA norm shall exclude the moratorium period i.e., there would be an asset classification standstill for all such accounts from 1 March 2020 to 31 May 2020.
- CICs will ensure the actions taken by the lending institutions pursuant to the above announcement would not adversely impact the credit history of the borrowers.

Exposure to Commercial Projects

The date of commencement of commercial operation (DCCO) in respect of loans given by NBFCs to commercial real estate projects delayed for reasons beyond the control of promoters can be extended by an additional one year, over and above the one-year extension permitted in normal course, without treating the same as restructuring.

Impact on NBFCs and HFCs

Business model

- COVID-19 has disrupted the business model and companies are adapting change, which would, in turn, lead to a recalibration of every model and processes in organisations.
- In the coming two to three quarters, the lending institutions would have to adopt a conservative approach in underwriting new cases for both retail and wholesale loans. The focus should be on improvement in asset quality instead of balance sheet growth in the near term.
- Companies must invest in technology-led underwriting tools, such as digital lending, video-based personal discussion, TAB-based loan application and C-KYC.

Liability

- Although measures by the RBI would help in facilitating liquidity to the sector, it may not lead to the credit flow in the economy as the lending institutions would prioritise liquidity over balance sheet growth.
- While RBI announced that funds under TLTRO 2.0 have to be deployed in investment-grade instruments only, the majority of MFIs in the small and medium-sized category do not have an investment-grade rating. This would severely impact the liquidity position in such MFIs and would lead to asset liability management (ALM) mismatch in the short term.
- Further, the lending institutions may record the interest accrued (from borrowers) as income, the corresponding cash would not flow in as a result of the moratorium leading to cash flow issues across companies. While the moratorium provides a breather on the asset side, it is the liability side that would create a bottleneck for the lending institutions. The TLTRO 2.0 announcement offers some relief, but the majority of the banks and mutual funds are reluctant to invest in the already stressed NBFCs and HFCs. Mutual funds are not investing in the money market instruments of the lending institutions in light of the recent crash in the value of liquid funds along with increased redemption pressure from the retail investor.
- Auction under the TLTRO 2.0, which was held on 23 April 2020, received bids for only half of the INR 25,000 crore offered by the RBI, indicating a sluggish sentiment to lend to NBFCs. The earlier version of LTRO, where no conditions were imposed on investment in NBFC, saw an aggressive response by banks.

Collection

- Lending institutions are likely to observe heightened delinquencies in second and third quarters (after the expiry of the moratorium) as the current halt in the business activity would severely impact cash flow of borrowers. Even salaried employees are allocating funds towards immediate family needs in anticipation of salary cuts.
- NBFCs and HFCs, which have high exposure to Tier II and Tier III segments, are likely to observe higher delinquencies compared with those who have significant exposure towards Tier I and Tier II segments.
- Collections in the project loans are expected to remain sluggish as the real estate sector is heavily impacted due to the lack of availability of labour, dearth of funds, and lack of housing demand leading to the burden of unsold inventories.
- Though the RBI has reduced repo rate by 2.1% in the last few months, the reduction in MCLR has only been 50 basis points. Banks link their lending to repo rates, whereas NBFCs ad HFCs do not. This would enable banks to transmit the lower interest rate fluidly. Hence, the lending institution would likely experience a surge in the balance transfers to banks, especially by customers with good repayment track.

Reporting

- Banks follow Indian GAAP whereas NBFCs and HFCs follow Ind-AS. The difference in quantification and reporting of ECL is likely to have a severe impact on the results of the lending institutions. The probability of default in the calculation of ECL would have to be carefully examined to capture the stress in various sectors.
- Over eight million retail borrowers of HFCs and NBFCs would be unable to take advantage of the three-month moratorium as such lending institutions have already securitised these loans. If the investor does not provide consent on the moratorium and instead choose to enforce credit enhancement, it would cause a severe dent on the liquidity profile of the seller and credit rating on the pool.

Recommendations

For regulators

Area	Recommendation
Restructuring	Permit one-time restructuring for the borrowers severely impacted by COVID-19 without reclassification of accounts as sub-standard. Restructuring could be allowed instead of moratorium extension, as moratorium tends to hamper the repayment culture of the borrowing community and is at best a temporary reprieve.
Direct liquidity infusion	RBI can exercise powers enumerated in the RBI Act, which allows direct credit to regulated entities as TLTRO 2.0. may provide funding only to prominent and top-rated NBFCs and HFCs.
Moratorium	NBFCs, and HFCs do not receive moratorium on their liabilities like customers. RBI can give at least three months deferment to the lending institutions to service their liabilities. This shall have a positive impact on these NBFCs and HFCs. The borrowers must be encouraged to pay interest component when extending the moratorium. This will help increase cash flow of the NBFCs and HFCs as well as lower the burden on the borrowers..
Asset classification	Sectors that are under severe stress because of the pandemic can be given increased regulatory support w.r.t asset classification and provisioning for an additional three to six months.
Securitisation	Benefits relating to moratorium of three month and asset classification relaxation should also be extended to the pool of securitised assets.
OTP based lending	Increase in current OTP-based E-KYC authentication limit from INR 60,000 to INR 1 lakh. This will help the lower income group (LIG) in establishing small enterprise or working capital.

For lending institutions (NBFCs and HFCs)

Area	Recommendation
Digital lending	As government insists on avoiding physical banking, the demand for digital solutions is likely to witness rapid growth. The lending institutions should reassess their business strategy and make efforts to increase the digital lending business by establishing the IT infrastructure and modifying the policies and procedures.
Cost optimisation	To weather the impact of the pandemic, the lending institutions should explore ways and means to optimise the cost. Some of the possible avenues are reducing the number of existing 'bricks and motor' model of branches to taper down the rental expenses; deferring non-essential capital expenditure; identifying 20-25% of the workforce that would operate periodically from home and increasing the use of social media to reduce traditional marketing mechanisms.
Prioritise quality over quantity	It is important for lending institutions to prioritise asset quality over growth in loan book, pause monthly target-based lending for short term and keep delinquencies to a pre-agreed and board-approved range.
Monetisation	The institutions must make balance sheet lean by reducing debt and disposing off non-core assets.
Product-wise strategy	Post lockdown, growth recovery would be divergent across business segments. For instance, certain segments would witness faster recovery like gold financing on account of increase in gold prices and agricultural vehicle financing due to better rabi crop harvestation and expectation of good monsoon.
Grievance redressal	It is estimated that approx. 60-70% of customers would opt for the moratorium imposed by the regulator. To ensure smooth functioning of operations, the lending institutions should strengthen their existing grievance redressal systems to better serve the customer demands.

Grant Thornton's Forensic team

can help you effectively brainstorm fraud risk areas across the portfolio and identify potential list of activities/priorities that might help prevent integrity breakdowns in these challenging times.

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Click here to download the recently released Grant Thornton Halt-Plan-Refresh Guide on revisiting business priorities and plans

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