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NBFCs offering higher FD rates than banks: Should you invest?

Don't just get swayed by high interest rates being offered by NBFCs on fixed deposits, look at the credit rating and the news flow around the company to assess how stable the company is

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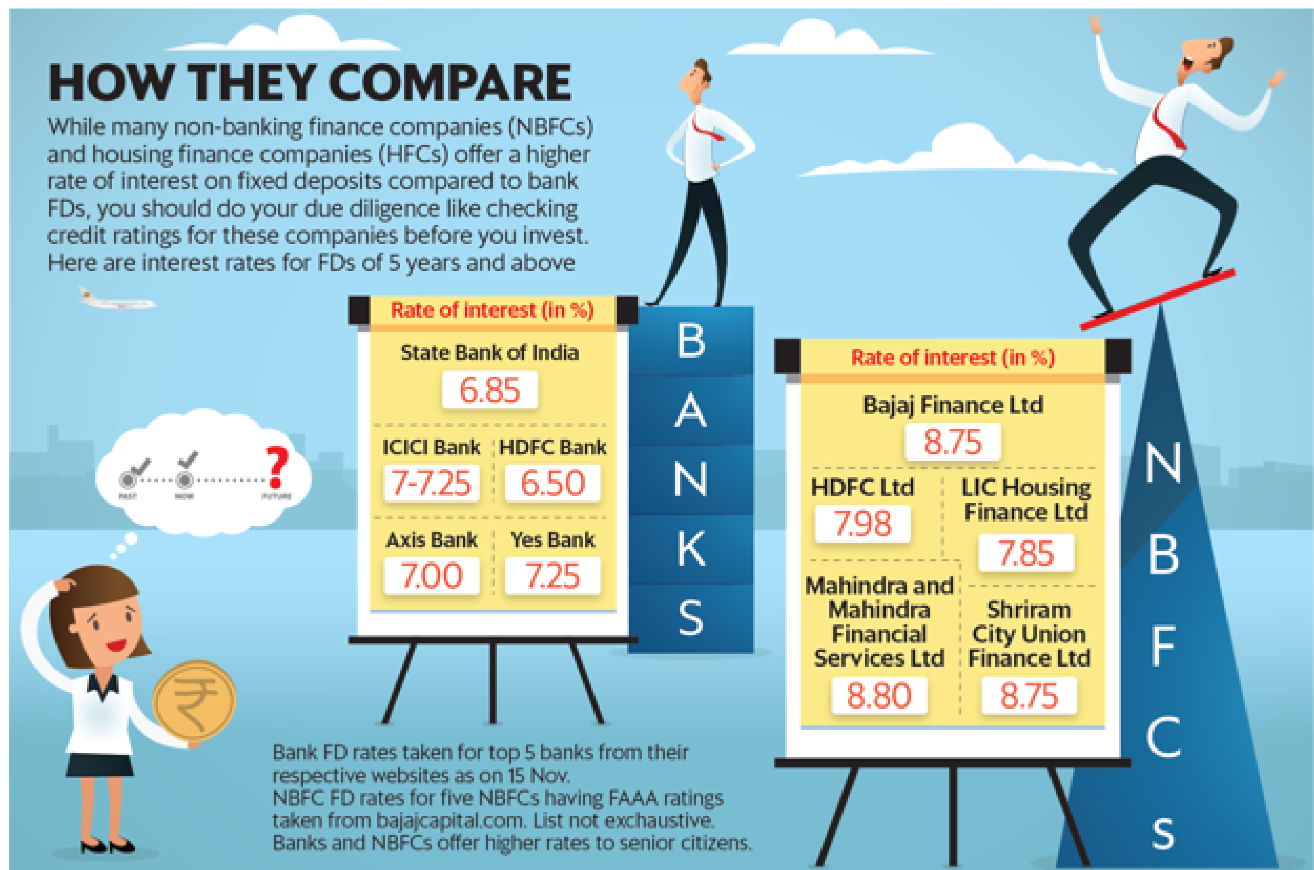

An alternative to NBFC FDs are short-term bond funds, which diversify your risk to multiple companies. Graphic: Santosh Sharma/Mint

Bajaj Finance Ltd revised its fixed deposit rates twice in October for its new FD customers, from 8.40% to 8.50% and then to 8.75%. Other non-banking finance companies (NBFCs), including PNB Housing Finance, Mahindra Finance, Shriram Transport Finance and LIC Housing Finance, also raised their FD rates in October and November. In comparison, the largest bank in the country, S**tate Bank of India, is offering an interest rate of 6.85% on its 5-year FD**.

With the Reserve Bank of India (RBI) raising the repo rate by 25 basis points (bps) each in two of its last three monetary policy reviews, the benchmark repo rate has gone up by 50 bps since the interest rate cycle turned. As a result, many banks hiked their deposit rates and NBFCs followed suit.

With higher rates, FDs from NBFCs might appear more attractive to you, but do your due diligence to ensure your deposit remains safe.

Retail deposits and NBFCs

Retail deposits only make about 10-15% of NBFCs' total funding requirement; 40-50% of the funding comes from banks, and the rest from debt capital markets. The cost of funds, or the interest paid on borrowed funds, for NBFCs is usually lower when they borrow from banks and debt capital markets compared to public deposits. "But they continue to have 10-15% of their funding from deposits to keep their customers engaged and funding diversification," said Jindal Haria, associate director (bank), India Ratings and Research Pvt. Ltd. Not all NBFCs are allowed to take deposits from retail investors.

Earlier, raising funds was a tedious process for most NBFCs and they mostly relied on bulk funding from debt markets or from banks and not on retail sources. However, the views of the managements have now changed, said Asutosh Mishra, head of research, institutional equities, Ashika Stock Broking. "Even though retail deposits would be somewhat costly, they now believe deposits are a stable source of funding," Mishra said.

While NBFCs have started viewing retail deposits as a stable source of income post-demonetisation, liquidity that helped bring down interest rates has now dried up. This has led to increased cost of borrowing from capital markets, which in some cases could be higher than the rates paid on FDs.

> **funding cost. So they are trying to diversify their funding (by extending retail deposits)**
>
> - Jindal Haria, Associate Director, India Ratings and Research Pvt. Ltd.

"Currently, the deposits are at a lower cost for NBFCs than the capital market costs for 3-5 year tenures. What NBFCs realise is that very high dependence on capital markets exposes them to a lot of volatility in terms of funding cost. So they are trying to increase diversification in their funding," Haria said.

The focus is back on public deposits because these often tend to be more sticky and are for a somewhat longer tenure. In fact, recently, larger NBFCs also launched publicity drives to attract depositors, a trend that has not been seen for a long time, he said. Institutions also highlight their credit ratings while marketing FDs.

Ratings are important

FD rates are the first thing that catches the eye of a retail investor. However, that should not be the only factor driving your decision to make an investment in an FD, particularly in a non-bank FD. This brings **credit ratings of the NBFCs** into the picture. Typically, instruments rated AAA are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry the lowest credit risk.

But there have been instances where even top-rated companies have failed on their obligations in the debt market. The most recent example being **defaults by IL&FS group of companies**, which had good ratings.

> **While there is a debate whether the rating is of any value, the fact remains that not that all AAA-rated papers default... In general, it is a fairly valuable indicator, but investors should also look at news flow around a company**
>
> - Vishal Dhawan, Founder Plan Ahead Wealth Advisors

Just like companies, NBFCs too have credit ratings from multiple rating agencies which they display prominently. Given recent example of default, should you assess an NBFC based on its ratings? Analysts believe that though even companies with good ratings could default, the overall credit rating gives you a sense of the

health of a company. “A retail investor might not have the ability to go into further details about the company. If they start getting into details, then many might not invest in these FDs,” Mishra said.

Financial planners share the view. “While there is debate whether the rating is of any value, the fact remains that not all AAA-rated papers default. Even historically, you will find some instances when there were higher quality paper defaults. But in general, it is a fairly valuable indicator for people to look at,” said Vishal Dhawan, founder, Plan Ahead Wealth Advisors.

What should you do ?

In such a scenario, you should definitely not get swayed by just the higher interest rates NBFCs are offering on fixed deposits. You need to be aware that an NBFC may be offering higher rates because it is under pressure to raise funds.

Higher credit ratings can inspire confidence but looking at that may also not be enough. “Investors need to be more careful and should take into consideration the ratings as well as news flow around the companies. It may not be easy to understand the details about the financial health of a company and it would take a lot of effort,” said Dhawan.

An alternative to NBFC FDs are **short-term bond funds**, which diversify your risk from a single company to multiple companies. “As FD rates go up, typically the yields of (short-term bond funds) mutual funds go up at the same time,” Dhawan said. That said, take professional help when investing in products that you don’t understand.

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