CHAPTER 2
THE OPERATING ENVIRONMENT

INTRODUCTION

This chapter looks at the external and internal environment of NBFCs with particular reference to finance companies. The chapter is laid out as follows: The first part dwells on the business and funding profiles of finance companies. The second part deals with the salient aspects of the regulatory framework applicable to finance companies; and examines the impact of the regulatory aspects on the financial policies of these companies. The third part uses the Porter's Model for analysing the competitive forces present in the operating environment of finance companies; and dwells on the emerging trends in the operating environment.

BUSINESS AND FUNDING PROFILES

The “typical” product mix of finance companies consists of lease, hire purchase and bill discounting. These are referred to as fund based financial services. Table 2.1, which presents the income mix of finance companies reveals that fund based incomes account for a major part of the total income (66% of total income during 1994-95; and 77% of total income during 1996-97).

Table 2.1
Income Mix for finance companies
(in percentage terms)

<table>
<thead>
<tr>
<th>Source of Income</th>
<th>1994-95</th>
<th>1996-97</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease &amp; Hire Purchase</td>
<td>47</td>
<td>58</td>
</tr>
<tr>
<td>Bill Discounting</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Investment Income</td>
<td>11</td>
<td>5</td>
</tr>
<tr>
<td>Others</td>
<td>22</td>
<td>17</td>
</tr>
</tbody>
</table>

Note: Other incomes include interest income on other forms of lending such as short term loans and inter corporate deposits.

Source: Association of Leasing and Financial Services Companies (ALFS).

Most lease plans offered by finance companies fall under the category of finance lease. The assets offered under the lease plans include plant & machinery furniture & fixtures, data processing equipments, commercial vehicles and passenger cars. The leases are written for lease terms (non-cancellable period of the lease) varying between 3 to 8 years. The typical lease rates
quoted during 1996-97 for equipments, which qualify for a tax relevant depreciation rate of 25%, have been in the following range:

Table - 2.2
Sample Lease Rates

Basic Data
- Cost of Asset is assumed to be Rs.1000
- Lease rentals are payable monthly in advance
- Tax Relevant rate of depreciation is taken as 25%
- A lease management fee of 1% of asset cost is payable upfront.

Rental Range:

<table>
<thead>
<tr>
<th>Rental (ptpm)</th>
<th>Lease Term</th>
<th>Implied Rate of Interest (Range)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rs.35.5-Rs.37.0</td>
<td>3 years</td>
<td>20% - 24% per annum</td>
</tr>
<tr>
<td>Rs.25-Rs.26.5</td>
<td>5 years</td>
<td></td>
</tr>
<tr>
<td>Rs.19.5-Rs.21.0</td>
<td>8 years</td>
<td></td>
</tr>
</tbody>
</table>

Note: ptpm denotes per thousand per month.

The hire purchase plans offered by finance companies are for terms, which vary between one to three years. The assets offered under the hire purchase plans are the same as those offered under the lease plans. Whether a transaction will be structured as a hire purchase or lease transaction will, interalia, depend upon whether the hirer (lessee) wants to avail of the depreciation tax shields (capital allowances); or wants to transfer these tax shelters to the lessor. During 1996-97 the gross yields (pre-tax yields) on hire purchase transactions were in the range of 24% - 28% per annum.

In the bill-discounting segment, most finance companies discount both clean bills and L/C backed bills – the discount rate for the former being higher than the latter. During 1996-97 the yields on such short-term lendings were in the range of 24%-30% per annum.

There are also other forms of fund based financing which aren’t common to the product portfolios of all finance companies. For example large finance companies are involved in dealer financing which entails extending loans to select dealers of, say, commercial vehicles manufactured by reputed manufacturers. The finance company lends to the dealers on the recommendation of the manufacturer(s). The dealers use the funds for onward lending to individual borrowers. The dealers are committed to repay the loans as per a predetermined repayment schedule regardless of their recovery experience with the ultimate borrowers. The
finance company takes the credit risk on the dealers; and there is no recourse to the manufacturer in the event of the dealer defaulting on repayments.

**Financing Mix:**

Table 2.3 presents the trends in the debt mix of finance companies between 1994-95 and 1996-97.

<table>
<thead>
<tr>
<th>Source of Debt</th>
<th>Year</th>
<th>1994-95 (%)</th>
<th>1996-97 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debentures</td>
<td></td>
<td>4</td>
<td>9</td>
</tr>
<tr>
<td>Bank Borrowings</td>
<td></td>
<td>22</td>
<td>4</td>
</tr>
<tr>
<td>Term Loans</td>
<td></td>
<td>30</td>
<td>10</td>
</tr>
<tr>
<td>Fixed (Public) Deposits</td>
<td></td>
<td>23</td>
<td>71</td>
</tr>
<tr>
<td>Others</td>
<td></td>
<td>21</td>
<td>6</td>
</tr>
</tbody>
</table>

Source: Association of Leasing and Financial Services Companies (ALFS)

From Table 2.3, we find that the principal sources of debt funding for finance companies during 1996-97 have been

- Fixed Deposits (also referred to as public deposits)
- Term Loans
- Debentures
- Bank Borrowings
- Others which will include sources such as intercorporate deposits and current liabilities.

A separate survey conducted by the Reserve Bank of India among 129 finance companies reveals the following trends in the capital structure of these companies:
Table 2.4
Capital Structure of Selected Finance Companies 1995-96 and 1996-97

<table>
<thead>
<tr>
<th>Source of Finance</th>
<th>Year</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1994-95 (%)</td>
<td>1996-97 (%)</td>
<td></td>
</tr>
<tr>
<td>Share Capital</td>
<td>6.4</td>
<td>6.2</td>
<td></td>
</tr>
<tr>
<td>Reserves &amp; Surplus</td>
<td>13.3</td>
<td>9.8</td>
<td></td>
</tr>
<tr>
<td>Borrowings-of which public deposits</td>
<td>58.8</td>
<td>61.2</td>
<td></td>
</tr>
<tr>
<td>Trade dues &amp; other Current Liabilities</td>
<td>31.4</td>
<td>34.4</td>
<td></td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>1.2</td>
<td>19.6</td>
<td></td>
</tr>
</tbody>
</table>

Source: Reserve Bank of India Bulletin, July 1999

The analysis of the assets structure of these (129) finance companies reveals the following position during 1995-96 and 1996-97

Table 2.5
Asset Structure of Selected Finance Companies 1995-96 and 1996-97

<table>
<thead>
<tr>
<th>Assets</th>
<th>Year</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1994-95 (%)</td>
<td>1996-97 (%)</td>
<td></td>
</tr>
<tr>
<td>Cash &amp; Bank Balances</td>
<td>30</td>
<td>26</td>
<td></td>
</tr>
<tr>
<td>Investments</td>
<td>87</td>
<td>8.7</td>
<td></td>
</tr>
<tr>
<td>Receivables (primarily in the form of stock on hire)</td>
<td>61.3</td>
<td>62.1</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>1.6</td>
<td>1.5</td>
<td></td>
</tr>
<tr>
<td>Net fixed assets</td>
<td>24.0</td>
<td>23.9</td>
<td></td>
</tr>
<tr>
<td>- of which leased assets</td>
<td>21.4</td>
<td>21.2</td>
<td></td>
</tr>
<tr>
<td>Other Assets</td>
<td>1.4</td>
<td>1.2</td>
<td></td>
</tr>
</tbody>
</table>

Source: Reserve Bank of India Bulletin, July 1999

From Table 2.4 we find that public deposits account for a fairly sizeable proportion of the capital structure of finance companies. Empirical evidence on the maturity structure of the public deposit portfolios of finance companies reveal that, on average, one year deposits account for about 70% of a "typical" public deposit portfolio. This implies that one-year
public deposits plus current liabilities account for about 40%-45% of the capital structure of finance companies (These calculations are based on Table 2.4).

From table 2.5 we find that the stock on hire and assets on lease account for about 75%-85% of the total assets of finance companies. Put differently, assets structure of finance companies has a pronounced tilt towards assets with maturity period exceeding one year. Taken together, tables 2.4 and 2.5 reveal that for finance companies repriceing dates and maturity dates are often longer on the asset side than on the liability side. This aspect is explored in greater detail in Chapter 4.

**Implications for Financial Policies**

The preceding discussion on the product mix and the financing mix of finance companies highlight the following considerations which need to be taken into account while framing financial policies:

- The product mix of finance companies is heavily tilted in favour of finance leases and HP. These asset-based financing plans are designed to recover the cost of the asset plus an acceptable rate of return from the lessee (hirer) over the lease term (hire period). Hence a major source of risk for the asset portfolio of a “typical” finance company is “credit risk”.

  Therefore framing appropriate credit policy in terms of credit appraisal, monitoring and recovery assumes considerable importance in the financial management of finance companies. The residual value risk (product risk) is not very significant except in the case of vehicles where the finance company is willing to take a higher exposure to residual value. Of course residual value risk will be a major source of risk for operating leases; but the exposure to such leases is marginal for most finance companies.

- The balance sheet of a finance company consists of both interest rate sensitive assets (e.g. lease & HP) and interest rate sensitive liabilities (e.g. bank borrowings, public deposits). Hence a finance company is exposed to interest rate risk. This risk is usually addressed through an interest sensitivity clause built into the lease/HP agreement. This clause provides the right to the lessor to change the lease rates in response to changes in interest rates. Typically the clause links the changes in lease rates to changes in the prime lending rate of banks. However the interest sensitivity clause doesn’t completely eliminate exposure to interest rate changes because the duration (or average term to maturity) of the asset portfolio is usually longer than the duration of the liability portfolio. As a result the changes in the values of the assets and liabilities (in response to a change in the market rate of interest) do
not offset one another. Therefore it is important to assess the interest rate risk exposure; and frame appropriate interest rate risk management policies. [See Chapter 4].

Given a mismatch between the cash flow patterns associated with assets and liabilities, finance companies are exposed to liquidity risk – the risk of liability outgo exceeding the asset inflows during any given period. It is therefore important for these companies to insulate their balance sheets from liquidity risk by efficiently managing their liquid asset positions; and/or their liability structures. These issues are addressed through the liquidity policy.

From table 2.5 we find that the exposure of finance companies to financial investments is not very significant. Hence market risk i.e., the risk associated with the volatility in market prices of the financial assets – doesn’t have a significant bearing on the financial performance of most finance companies. Nevertheless, such finance companies, which have significant exposures to group companies (companies within the promoter’s group), need to be concerned about the liquidity and marketability of such investments. Also, the level of public deposits held by a finance company has a bearing on its investment policy through the statutory liquidity ratio requirement. So, it is important to understand the key drivers of the investment policy and formulate an appropriate (financial) investment strategy.

REGULATORY FRAMEWORK

The Reserve Bank of India (RBI), as the apex body, is responsible for administering the regulatory framework circumscribing the Non-Banking Financial Sector. The regulatory framework applicable to this sector has evolved over time, which is briefly reviewed in the following section.

Development of Regulatory Framework

Although NBFCs (Non-Banking Financial Companies) have been operating for quite a long time, an attempt to regulate them started only in the sixties. Regulation of these intermediaries was found to be necessary for the following three reasons:

♦ Ensuring efficacy of credit and monetary policy
♦ Safeguarding depositors’ interest
♦ Promoting healthy growth of NBFCs.

Thus, the Banking Laws (Miscellaneous Provisions) Act, 1963 was introduced to regulate the NBFCs. Subsequently, to enable the regulatory authorities to frame suitable policy measures, several committees were appointed from time to time to conduct in-depth study of these
intermediaries; and make suitable recommendations for their healthy growth within a given regulatory framework. Such committees include:

- Bhabatosh Datta Study Group (1970)
- James Raj Study Group (1974)
- Chakravarty Committee (1985)
- Vaghul Committee (1987)
- Narasimham Committee (1991)
- Shah Committee (1992)

The process of evolution of the regulatory framework for NBFCs has, to a great extent, been the result of the recommendations of these Committees/Groups. While each committee has made recommendations considering the contemporary financial scenario, all the committees have uniformly recognised the importance of the role of NBFCs; and emphasised the need for a well-established and vibrant non-banking financial sector.

The present regulatory framework governing NBFCs in general and finance companies in particular is largely based on the recommendations made by the Narasimham Committee and Shah Committee. The salient features of the current regulatory framework (as at the time of writing) are reviewed in the following section:

**Current Regulatory Framework**

Based on the recommendations of the Shah Committee, the Reserve Bank of India has phased in a number of changes in the regulatory framework governing NBFCs during the late nineties. Taking into account all these changes, a consolidated new regulatory framework effective from January 1998 has been put in place, which directs regulatory-cum-supervisory attention primarily on the NBFCs, which accept deposits from the public. There have been a few amendments to this regulatory framework during 1999. The discussion on the present regulatory framework is organised under the following heads:

- Objectives
- Classification of NBFCs
- Registration Requirement
- Credit Rating Requirement & Ceiling on Public Deposits
- Capital Adequacy Requirement
- Liquid Asset Requirement
- Prudential Norms
- Proposed Changes
Objectives: The principal objectives underlying the current regulatory framework are

- to ensure healthy growth of the financial companies.
- to ensure that these companies function as a part of the financial system with in the policy framework, in such a manner that their existence and functioning do not lead to systemic aberrations.
- to attune the quality of surveillance and to the developments that take place in the non-banking financial sector of the financial system; and
- to provide greater indirect protection to depositors’ interest.

Classification of NBFCs: The regulatory framework classifies NBFCs into three broad categories as follows:

- NBFCs accepting public deposits.
- NBFCs engaged in loan, investment, hire purchase finance and equipment leasing activities but not accepting public deposits.
- Special investment companies – those NBFCs which have acquired shares/securities of their group/holding/subsidiary companies to the extent of not less than 90 per cent of total assets; and which do not trade in such shares/securities; and which do not accept public deposits.

While NBFCs, which accept public deposits, are subjected to all the prescribed regulations, those NBFCs not accepting public deposits are outside the purview of most of the regulations.

NBFCs, which accept public deposits, are further sub-classified into two categories:

- Equipment Leasing/Hire Purchase Finance Companies (referred to as “finance companies” in this study)
- Loan/Investment Companies

A NBFC having not less than sixty per cent of its assets; and deriving not less than sixty per cent of its income from equipment leasing and hire purchase activities taken together will qualify as an equipment leasing/hire purchase finance company. A NBFC, which doesn’t fulfil these criteria, will qualify as a Loan/Investment company. These classification criteria are based on the latest audited balance sheet and profit & loss account of the NBFC.

This distinction is important because equipment leasing/hire purchase finance companies are entitled to higher borrowing limits than/loan/investment companies. To reiterate, this study focuses on the evaluation of the financial policies of equipment leasing/hire purchase finance companies, which accept public deposits.
Registration Requirement: All the NBFCs are required to seek registration with RBI irrespective of whether or not they accept public deposits. A NBFC cannot commence business until it has been granted a Certificate of Registration by RBI. The principal eligibility criterion for registration of a NBFC is that it should have a minimum NOF (Net Owned Funds) of Rs. 25 lakhs (Rupees twenty-five lakhs only).

Credit Rating Requirement & Ceilings on Public Deposits: Since 1996, the NBFCs have been subject to mandatory credit rating for the purpose of accepting public deposits. Upto December 1998, a NBFC without a minimum investment grade credit rating was not allowed to raise public deposits. Infact the quantum of public deposits that can be accepted was linked to the level of credit rating as shown in the following table:

Table 2.6
Ceilings on Acceptance of Public Deposits

<table>
<thead>
<tr>
<th>Level of Credit Rating</th>
<th>Ceiling on Public Deposits (as a multiple of NOF)</th>
<th>Finance Companies</th>
<th>LC/IC</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td></td>
<td>4.0</td>
<td>2.0</td>
</tr>
<tr>
<td>AA</td>
<td></td>
<td>2.5</td>
<td>1.0</td>
</tr>
<tr>
<td>A</td>
<td></td>
<td>1.5</td>
<td>0.5</td>
</tr>
<tr>
<td>A- [CRISIL &amp; ICRA] }</td>
<td></td>
<td>0.5</td>
<td>Nil</td>
</tr>
<tr>
<td>BBB [CARE] }</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BBB- [DCR India] }</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes: Finance Companies: Equipment Leasing/Hire Purchase Companies
LC/IC: Loan Companies/Investment Companies
NOF: Net owned funds
CRISIL: Credit Rating Information Services of India Limited
ICRA: Investment & Credit Rating Agency Limited
CARE: Credit Analysis & Research Limited
DCR India: Duff & Phelps Credit Rating India Private Limited

With effect from December 18, 1998, these guidelines have been relaxed as shown in Table 2.7 on the following page.
Table 2.7
Modified Guidelines on Acceptance of Public Deposits (w.e.f Dec 18, 1998)

<table>
<thead>
<tr>
<th>Net Owned Funds (NOF)</th>
<th>Quantum of Public Deposits for Finance Companies</th>
<th>Quantum of Public Deposits for Loan and Investment Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Below Rs. 25 lakhs with or without credit rating</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Rs. 25 lakhs and above without credit rating</td>
<td>Public Deposits not exceeding 1.5 times of NOF or Public Deposits up to Rs. 10 crores, whichever is less provided the company has a CAR of 15% or above with immediate effect</td>
<td>Nil</td>
</tr>
<tr>
<td>Rs. 25 lakhs and above with minimum investment grade credit rating</td>
<td>4 times of NOF provided the company has a CAR of 10% or above as on 31.03.1998; and shall have a CAR of 12% or above as on 31.03.1999</td>
<td>Public Deposits not exceeding 1.5 times of NOF provided the company has a CAR of 15% or above with immediate effect</td>
</tr>
</tbody>
</table>

Notes:
1. Finance Companies denote Equipment Leasing/Hire Purchase Finance Companies.
2. NOF denotes Net Owned Fund
3. CAR denotes Capital Adequacy Ratio
4. The minimum investment grade rating (referred to in the above table) differs across rating agencies. It is A(-) in the case of CRISIL & ICRA; BBB (FD) in the case of CARE; and BBB(-) in the case of DCR India.

For the purpose of regulation, the term “public deposit” includes:

- Fixed deposit, recurring deposit, daily deposit, etc. received from the members of the public, which will include shareholders of a public limited company; and relatives and friends of the directors of both private and public limited companies.
- Moneys raised by issue of unsecured debentures/bonds.

Therefore funds raised by way of inter-corporate deposits (ICDs); secured debentures/bonds; deposits from directors; deposits received from foreign citizen/person; and
deposits raised by private limited companies from their shareholders fall outside the ambit of the regulations applicable to public deposits.

The other important restrictions applicable to public deposits are

- the initial term to maturity of public deposits cannot be less than twelve months; and cannot be more than sixty months.
- the interest rate on public deposits cannot exceed 16 percent per annum; and cannot be compounded at intervals less than a month.
- the payment of brokerage cannot exceed two percent of the face value of the deposits raised.

**Capital Adequacy Requirement (CAR):** A fairly detailed discussion on the concept and mechanics of CAR are contained in Chapter 3 and Appendix 3A. Broadly, the concept of CAR refers to the minimum level of permanent and quasi-permanent capital that must be maintained by a financial intermediary primarily to absorb the credit risk inherent in its asset portfolio. There is a three-step procedure to calculate CAR.

**Step-1:** Calculate the (credit) risk weighted values of the assets and the off-balance sheet exposures of the financial intermediary. Aggregate these values (as at a balance sheet date). This aggregate is referred to as Total Risk Weighted Assets.

**Step-2:** Calculate the aggregate amount of capital (as at the balance sheet date) raised by way of sources of capital such as equity share capital, share premium, free reserves & surplus, preference share capital and sub-ordinated debt. This is further sub-divided into Tier I and Tier II Capital – the former representing the more permanent sources of capital than the latter. Assets such as unamortised expenditures and group company investments are netted against the aggregate amount of capital to arrive at the Total Capital Fund.

**Step-3:** The Capital Adequacy Ratio (CAR) is defined as the ratio of Total Capital Fund to Total Risk Weighted Assets.

The RBI has issued detailed guidelines on (a) the risk weightages to be assigned to the assets and off-balance sheet exposures of a NBFC; (b) the sources of capital that can be included under total capital fund; and (c) the methodology for calculating the capital fund. (See Appendix 3A).

**Liquid Asset Requirement:** The Liquid Asset Requirement, also referred to as the Statutory Liquidity Ratio (SLR) requires a stipulated percentage of “public deposits” to be held in the form of “approved securities” which broadly means Government securities and Government guaranteed bonds. With effect from April 1, 1999 the SLR requirement for
NBFC’s is 15 percent of outstanding amount of public deposits (including the amount of interest accrued but not paid). The primary purpose of this requirement is to ensure that the NBFC has immediate recourse to secure and readily marketable assets in order to meet expected and unexpected deposit withdrawals. This aspect is covered in greater detail in Chapter 5 (Liquidity Policy).

**Other Prudential Norms:** The other prudential norms relate to the following:

- Income Recognition Norms pertaining to recognition of lease income, HP income, and interest incomes pertaining to other forms of financial assistance.
- Valuation of quoted and unquoted investments in equities, bonds and mutual fund units.
- Credit concentration norms or exposure limits (expressed as a percentage of the owned funds of the NBFC) applicable to a single borrower or to a single group of borrowers.
- Classification of loan assets (such as lease receivables, HP receivables and bills receivable) into standard asset, sub-standard assets, doubtful assets and loss assets; and the provisioning requirements applicable to these assets.
- Disclosures in the financial statements.

**Proposed Changes:** During 1998, the Government of India appointed a Task Force on NBFCs under the Chairmanship of Shri C M Vasudev, Special Secretary (Banking) to

- Examine the adequacy of the prevailing legislative framework.
- Devise improvements in procedure relating to customer complaints.
- Assess the need for a separate regulatory agency.
- Consider the involvement of the State Governments in regulating the NBFCs.
- The Committee submitted its report in October 1998. The recommendations of the Committee regarding Capital Adequacy Requirement and Ceilings on Acceptance of Public Deposits have been accepted and implemented by the RBI (see section on Credit Rating Requirement & Ceiling on Public Deposits). The other major recommendations (which are to be implemented in phases) are:
- Impose ceilings on exposures to real estate, investment in capital market especially in unquoted shares; and exposures to connected companies in which directors are interested.
Increase the liquid asset ratio requirement to 25% of public deposits; and introduce a statutory provision that unsecured deposits be given a first charge on these liquid assets.

Appoint a Depositors’ Grievance Redressal Authority with adequate legal strength to resolve depositors’ grievances expeditiously.

Disclose additional information in advertisements (soliciting public deposits) on dues from group companies; business ventures in which the directors are interested; and the amount of exposures (including non-fund-based facilities) to such parties.

Set up a separate regulatory body under the aegis of the RBI to regulate and supervise NBFCs.

The Task Force has recommended against the introduction of a deposit insurance scheme (a mechanism meant to safeguard the depositors of NBFCs) because of the moral hazard issues. This issue has been examined in greater detail in Chapter 5 (Liquidity Policy).

**Implications for Financial Policies**

The regulatory framework as described in the preceding section has a bearing on the financial policies of finance companies in the following ways:

- The CAR requirement impacts both the solvency and the profitability of finance companies. The prescription of an uniform CAR regardless of the credit quality of the underlying asset portfolio; and the prescription of uniform risk weightages regardless of the credit quality of the assets within an asset class have important implications for both the financing policy and credit policy. These implications are explored in Chapters 3 and 6.

- The liquid asset requirement (statutory liquidity ratio requirement) affects both the liquidity policy and the investment policy. The linkages are examined in Chapters 5 and 7.

- The credit and investment concentration norms affect the design of the credit policy and the investment policy. These aspects are covered in Chapters 6 and 7.

- The provisioning requirements applicable to the different categories of assets (based on credit quality) have a definite impact on the design of the credit policy. These requirements also affect the “build-up” of internally generated funds (internal equity); and thus affect the ability of the finance company to meet the minimum CAR requirement. (See Chapter 3).
STRUCTURAL ANALYSIS

Our discussion on the operating environment of finance companies will be incomplete without an understanding of the competitive forces present in the environment. A commonly used framework to understand these forces is the framework evolved by Michael Porter as shown in Figure 2.1.

![Figure 2.1 Forces Driving Industry Competition](image)

A. Threat of New Entrants
B. Bargaining Power of Suppliers
C. Threat of Substitute Products or Services
D. Bargaining Power of Buyers
E. Rivalry among Existing Firms

The collective strength of the five forces displayed in Figure 2.1 determines the ultimate profit potential in the industry, where profit potential is measured in terms of the long run return on invested capital. While all the five competitive forces jointly determine the intensity of industry competition and profitability, different forces take on prominence in shaping competition in each industry. Our objective is to identify the key competitive forces impacting the finance companies as a whole.

➢ Threat of Entry

The key question is: Is the non-banking financial sector (with particular reference to finance companies) characterised by strong entry barriers? According to the researcher, this sector has reasonably strong entry barriers emanating from the sources displayed in Figure 2.2.
Economies of Scale & Scope: Fairly well diversified and large finance companies enjoy substantial economies of scale and scope because of the fact that they can share functions like distribution, resource mobilisation and data administration across different lines of business such as leasing, hire purchase and short term financing (e.g. bill discounting).

Product Differentiation: This serves as a barrier to entry particularly on the dimension of resource mobilisation. Established finance companies have corporate brand identification and entrenched depositor loyalties stemming from efficient service mechanism; and prompt payment record. This creates a barrier to entry by forcing entrants to spend heavily to overcome existing depositor loyalties.

Capital Requirements: Although any finance company with net owned funds of Rs.25 lakhs or more qualifies for registration with the RBI, there appears to be a minimum economic size which facilitates a finance company (a) to access long term sources of finance such as bank borrowings or term loans on favourable terms; and (b) to obtain better credit ratings for public deposit schemes.

This study reveals that finance companies with investment grade ratings for their borrowing programmes tend to have total funds (equal to net owned funds plus total debt) in excess of Rs.100 crores\(^8\). Given an average debt/equity ratio of 4:1, this translates to a minimum equity (net owned funds) requirement of Rs.25 crores. [See Chapter 8].

Government Policy: The regulatory requirements in the form of (a) minimum level of net owned funds (NOF); (b) need to have a minimum investment grade rating to access public deposits; and (c) capital adequacy requirements tend to deter entry. Also tax asymmetries\(^9\)
across different groups of players in the non-banking financial sector tend to be an entry barrier for those groups which have a tax disadvantage.

Taken together, the above sources of entry barriers can effectively deter small and medium sized entrants from entering the industry.

➤ **Rivalry Among Existing Competitors:**

According to the researcher, the intensity of rivalry among existing competitors is influenced by the following factors:

![Diagram of Sources of Rivalry Among Existing Competitors]

➤ **Diverse Competitors:** An important feature of the non-banking financial sector is the diversity in terms of competitor profiles. Broadly, we can identify three groups of players in this industry. The first group consists of banks and financial institutions, which compete with finance companies by offering asset, based financing plans in addition to conventional financing products such as term loans. This group enjoys a “low cost advantage” achieved through a lower cost of funds and differential tax benefits vis-à-vis the finance companies.

The second group consists of finance companies with a financially strong parentage. These companies enjoy a “low cost advantage” achieved through concessional lines of credit made available by the parent company. These companies are also engaged in providing financing packages (lease, HP and short term financing) to the customers and suppliers of the parent company. This group also includes few stand-alone large finance companies with first (early) mover advantages.

The third group consists of the small and medium finance companies operating either as stand-alone entities or as captive finance companies of financially weak corporate groups.
These companies have both funding and deployment constraints. The funding constraint takes the form of their inability to compete for long-term sources of finance like bank borrowings and term loans – typically banks and financial institutions have a marked preference for large finance companies. Hence these companies are predominantly dependent on promoters’ equity (which increases the overall cost of funds); or on short term sources of finance such as one year public deposits (which increases the likelihood of liquidity and solvency problems).

The deployment constraint of small and medium finance companies takes the form of the inability to compete with large finance companies, banks and financial institutions in relatively low credit-risk segments (e.g., blue chip corporate borrowers’ segment) which are price-sensitive segments. Hence these companies are forced to venture into riskier segments of financing (e.g.: financing taxis and second hand cars) and take on substantial exposures to borrowers with dubious credit standing.

In terms of numbers, the size of the second group of players is significantly less than the third group of players. In a study conducted by the RBI in 1998, it has been found that out of the 9000 NBFCs registered with the RBI, there are just 150 NBFCs with total funds (or total assets) in excess of Rs.100 crores. Put differently, the non banking financial sector is characterised by a large number of small players vulnerable to conditions of financial stress.

Exit Barriers: The exit barriers for the (financially) weak finance companies are fairly high due to the following reasons:

- A substantial proportion of the investment of finance companies is in the form of assets highly specialised to the businesses of lessees which tend to have low liquidation values or high costs of transfer or conversion.
- Despite a weak financial position captive finance companies can continue to hang on in order to support the activities of the group companies.
- The regulatory restrictions on exit have been tightened in the recent years in order prevent finance companies from closing down without repaying public deposits.

Consequently many finance companies that lose the competitive battle do not really give up. Rather, they grimly hang on. Because of their weaknesses, they often resort to extreme tactics, which affects the profitability of the entire industry; and raises more regulatory concerns about the industry as a whole.
Pressure from Substitute Products
The substitutes for the fund based products offered by the finance companies are the conventional loan products offered by banks and financial institutions. While the loan products typically carry lower rates of interest than the interest rates implicit in fund-based products such as lease and HP, the latter offers the following advantages:

- The repayment obligations associated with lease and HP can be tailored to meet the cash flow profiles of the borrowers. Conventional loan products carry an equated debt-servicing pattern, which can cause liquidity problems for borrowers with non-uniform cash flow patterns.

- The tax benefits associated with lease are different from the tax benefits associated with borrowing and buying the asset. For example, a prospective borrower with a low tax appetite would prefer to transfer the depreciation tax shields to the lessor, and share in the resulting tax benefit by paying a lower lease rental.

- Compared to conventional loan products the lease and HP products are more amenable to financial engineering. For example there are innovative variants of leasing like sale and lease back, leveraged lease and upgrade lease.

Of course, some of the above features can be built into the conventional finance arrangements. To the extent such features can be replicated, there is a ceiling on the interest rates which finance companies can built into their fund based products. In practice most finance companies plan their competitive strategy with “substitutes” as a key force to reckon with.

Bargaining Power of Buyers
The buyers in the context of the finance companies are the borrowers (e.g. lessees); and the important “buyer group” is the group of high credit quality borrowers. Clearly this group has multiple financing options ranging from accessing the capital market to raising term loans to lease financing. Therefore they have ability to shop for a favourable terms.

It is also important to note that the fund-based products offered by most finance companies are standard or undifferentiated. So, the borrowers tend to be price sensitive. Of course there are borrower segments which are less price sensitive but these segments carry higher levels of default risk.

Bargaining Power of Suppliers
In the context of finance companies, the suppliers are lenders of long term and short-term funds. Long term lenders such as banks and financial institutions favour large finance companies with a financially strong parentage. The recent years have also witnessed a
heightened concern on the part of depositors about “safety” of their deposits. This has resulted in a trend towards shifting deposits to high investment grade finance companies albeit at lower rate of interest.

Therefore the suppliers of funds have limited bargaining power with respect to the high investment grade finance companies. On the other hand, suppliers of funds exert enormous bargaining power over the lower quality finance companies which are invariably the small and medium sized companies with weak parental support. This results in such companies having a poorly diversified funding mix.

**Emerging Trends**

The above analysis of the competitive forces in the operating environment of finance companies reveals that the competitive strategies for survival and growth are cost leadership and focus. The analysis also reveals that the large finance companies with a strong parentage are better placed to pursue these strategies more effectively. Given these business realities, the following trends are gaining strength:

- **Finance companies with a weak parentage and/or are of a smaller size** seem to be going down the merger route to become part of larger finance companies (e.g.: merger of India Equipment Leasing Limited with Sundaram Finance Limited). Alternatively, the management control of such companies is being transferred to promoters of larger finance companies through the takeover route. (e.g: the takeover of Investment Trust of India Limited by the TCK Finance Group & Citicorp Securities).

- **Finance companies with a strong parentage and of a large size** are more aggressively competing for long-term funds (in the forms of raising term loans, issuing convertible fixed income securities; and securitisation of lease/HP receivables) so as to create a diversified funding mix. Such a funding mix offers the advantages of a lower cost of funds; and a better tenor match between assets & liabilities. Using the low cost position as the competitive strategy, these companies are focusing on borrowers groups characterised by strong repayment record. In the current context, the focus is more on the vehicle-financing segment due to the better recovery experience in this segment than the equipment-financing segment.

- Another emerging trend seems to be the realisation on the part of the banks and financial institutions that the finance companies have a competitive edge over them in catering to the credit needs of certain borrower segments (e.g.: small road transport operators) in terms of credit appraisal, monitoring and recovery. If this trend gathers strength, the
likely scenario will be one where banks will lend wholesale to select finance companies (characterised by strong parentage and strong collection/recovery capabilities) for on-lending to the retail borrower segment. In fact, the Reserve Bank of India (RBI) has recently decided to classify bank loans to finance companies for on-lending to small transport operators as priority sector lending (from the banks' point of view). This implies a concessional rate of interest being charged on the amount lent by the banks to the finance companies; in order to enable the finance companies to on-lend these funds at an off-market rate of interest. This move of RBI appears to signal its inclination for promoting a wholesaler-retailer relationship between the commercial banks and select finance companies.

**SUMMARY**

- The "typical" product mix of finance companies consists of lease, hire purchase and short term financing. The lease and HP plans are so designed as to recover the cost of the investment plus an acceptable rate of return over the lease/hire term. The exposure to cancellable short-term (operating) leases is insignificant. The short term financing is primarily in the form of discounting trade bills.
- The financing mix of the finance companies had a fairly pronounced tilt towards public deposits up to 1996-97 and the public deposit portfolios of these companies were heavily tilted in favour of one-year deposits.
- In the recent years i.e., post 1996-97, there has been a progressive shift in the financing mix from public deposits to long term sources of finance such as equity, compulsorily convertible preference shares (CCPS), redeemable preference shares, optionally fully convertible debentures (OFCDs) and non-convertible debentures. Many finance companies have also resorted to securitisation of their lease and HP portfolios.
- The product mix and the financing mix of finance companies expose these companies to three principal sources of risk: credit risks, interest rate risk and liquidity risk. These risks need to be addressed through appropriate financial policies.
- The Reserve Bank of India (RBI) is the regulatory body responsible for administering the regulatory framework applicable to finance companies. The present regulatory framework covers, interalia, the following aspects:
  - Classification of NBFCs
  - Registration Requirement
  - Credit Rating Requirement & Ceilings on Public Deposits
• Capital Adequacy Requirement
• Liquid Asset Requirement (or Statutory Liquidity Ratio)
• Prudential Norms

➢ The regulatory framework applicable to finance companies has a bearing on the formulation of the following financial policies of these companies:
  • Financing Policy
  • Credit Policy
  • Liquidity Policy
  • Investment Policy

➢ The operating environment of finance companies is characterised by
  • strong entry barriers created by economies of scale & scope; government policy;
    strong corporate brand identification; and capital requirements.
  • diversity of competitors
  • reasonably strong exit barriers
  • presence of substitute products like term loans
  • bargaining power of high credit quality borrowers.
  • bargaining power of lending institutions particularly with respect to the small and medium finance companies.

An analysis of the competitive forces present in the operating environment of finance companies reveals that the competitive strategies for survival and growth are cost leadership and focus. The analysis also reveals that the large finance companies with a strong parentage are better placed to pursue these strategies more effectively.

➢ The emerging trends in the operating environment of finance companies include
  • mergers and acquisitions of small and medium finance companies
  • shift in the funding mix of large finance companies toward long term sources of finance
  • focus on (credit) quality driven growth in asset portfolio
  • evolution of a wholesaler-retailer relationship between commercial banks and select finance companies.
A common classification of equipment lease transactions is to classify them into the categories of finance lease and operating lease. A finance lease involves a substantial transfer of the risks and rewards of ownership from the lessor to the lessee. A lease, which is not a finance lease, is classified as an operating lease. The Financial Accounting Standards Board (FASB) has laid down the following criteria for classifying a lease as a finance lease:

i) The lease transfers ownership of the asset to the lessee by the end of the lease term; (or)

ii) The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair market value at the date the option becomes exercisable that, at the inception of the lease it is reasonably certain that the option will be exercised; (or)

iii) The lease term exceeds seventy five percent of the useful life of the asset. The title may or may not eventually be transferred; (or)

iv) The present value of the minimum lease payments exceeds ninety percent of the fair market value of the asset at the inception of the lease. The title may or may not be transferred. For the purpose of determining the present value the discount rate to be used by the lessor will be the rate of interest implicit in the lease; and the discount rate to be used by the lessee will be the incremental borrowing rate.

In the Indian context, a finance lease, which provides for either transfer of ownership or a bargain purchase option [condition (i) or (ii) stipulated by FASB] will qualify as a hire purchase transaction. A lease, which doesn’t fulfil conditions (i) or (ii); but satisfies conditions (iii) or (iv) will qualify as a finance lease transaction. The format of the hire purchase plan is similar to that of the finance lease plan in the sense that the hire charges are structured in such a way so as to recover the cost of the asset plus an acceptable rate of return the hire period.

The distinction between a finance lease transaction and hire purchase transaction is very important from a tax angle. A finance lease transaction results in a transfer of depreciation tax shields (capital allowances) from the lessor to the lessee. On the other hand a hire purchase transaction entitles the hirer (lessee) to claim the depreciation tax shields. In a lease transaction, the lessee can claim the lease rental as a tax-deductible expense. In a hire purchase transaction, the hirer can claim the interest component of the hire charges as a tax-deductible expense.

A bill drawn by the seller and accepted by the buyer under a letter of credit arrangement with the (buyer’s) bank is referred to as a L/C (Letter of Credit) backed bill. A bill, which has no such backing, is referred to as a clean bill. Since a clean bill carries a higher degree of credit risk than a L/C backed bill; the discount rate applicable to a clean bill tends to be higher than that of a L/C backed bill.

The regulatory framework defines a NBFC to include a mutual benefit financial company (otherwise known as “Nidhi”). However, the regulatory mechanism for governing such companies is significantly different from the regulatory mechanism that applies to equipment leasing/hire purchase finance/loan /investment companies. Since mutual benefit financial companies do not fall within the scope of this study, the regulatory framework applicable to such companies has been excluded from our discussion.

Certain categories of NBFCs viz., insurance companies, stock broking companies, chit fund companies, companies notified as “nidhis” under section 620A of the Companies Act and companies engaged in merchant banking activities (subject to certain conditions) are exempted from the requirement of registration under the Reserve Bank of India Act. There is another category of NBFCs popularly known as Residuary Non-Banking Companies (RNBCs) which do not fall within the scope of the regulatory framework discussed in this chapter. These
RNBCs are governed by the provisions of the Residuary Non-Banking Companies (Reserve Bank) Directions, 1987. There are very few RNBCs in the country and most of them are poorly capitalised in terms of the net owned funds. There are ceilings on the deposits that can be raised by such companies; and these companies are required to invest not less than 80 per cent of their aggregate deposit liabilities according to the prescribed investment pattern. Only 20 per cent of the deposits or ten times the NOF, whichever is lower, can be deployed in other assets.

The credit rating is to be obtained from one of the approved credit rating agencies. At the time of writing, the approved rating agencies and the minimum investment grade rating to be obtained from these agencies are as follows:

<table>
<thead>
<tr>
<th>Rating Agency</th>
<th>Level of Minimum Investment Grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>CRISIL</td>
<td>A-</td>
</tr>
<tr>
<td>ICRA</td>
<td>A-</td>
</tr>
<tr>
<td>CARE</td>
<td>BBB (FD)</td>
</tr>
<tr>
<td>DCR India</td>
<td>BBB-</td>
</tr>
</tbody>
</table>


We will define “size” in terms of total assets (or total funds) of the finance company. Finance companies with total assets in excess of Rs.100 crores will be classified as large finance companies. Those finance companies with total assets less than or equal to Rs.100 crores will be classified as “medium & small” finance companies.

Financial institutions and select commercial banks enjoy concessional tax treatment with respect to provisioning for non-performing assets; and transfers to special reserves. Such concessions aren’t available to finance companies. Such tax asymmetries enable banks and financial institutions to price lease and ILP at levels, which are economically unviable for most finance companies. This aspect is examined in greater detail in Chapter 3.