CHAPTER 1

1.1 INTRODUCTION

The existence of the non-banking finance companies can be traced from pre-independence period but they were functioning in the unorganized sector. It was only in the late fifties, the non-banking finance companies were promoted in the organized sector. Although the Non-Banking Finance Companies (NBFCs) in India have survived for a long time but they shot into prominence only in the late 1980s (Ingres 2005). In the sixties, the reach of institutional financial intermediaries was quite limited. The magnitude of deposits with banks and NBFCs was of a small order to the tune of Rs.2, 494.80 Crores and Rs. 54.9 Crores respectively as on 31.3.1966. Inspite of operating for quite a long time in India, an attempt to regulate them started only in the sixties.

1.2 NON-BANKING FINANCE COMPANIES - AN OVERVIEW

In 1961, the NBFCs were brought into loose yet legalized regulatory framework from largely unregulated framework. The regulation of these institutions was found to be necessary for ensuring efficacy of credit and monetary policy, safeguarding depositors’ interests and ensuring healthy
growth of this sector (Vasudev 1998). The government constituted various committees to suggest the regulatory framework for the non-banking financial sector. The Bhabatosh Datta Study Group (1971), James Raj Study Group (1975), Chakravarthy Committee (1987) and Narashimham Committee (1991) were the important committees to suggest transformation of unregulated non-banking financial sector into regulated one. The inherent strengths of NBFCs such as high-level customer contact and satisfaction, geographical proximity, strong recovery mechanism were the drivers of their performance. Higher rates of interest on deposits offered by them afforded better opportunity of channelizing domestic savings into the financial markets (Ingres 2005). NBFCs had, practically, not been subjected to entry barriers, limitations on fixed assets and holding inventories in the form of gilt investments as they are now (Thiyagarajan, Arulraj 2005). Moreover, the NBFCs are in a consolidation phase now.

As the financial stability was threatened with many of the NBFCs offering unimaginable rates of interest of public deposits, their financial viability was adversely affected because of unrestricted lending even in the case of group exposure. The Narashimam committee on banking sector reforms (Narashimam 1991) suggested the guidelines for banking
system should be extended to bring the non-banking finance companies within the ambit of an effective regulatory framework. Khanna Committee (Khanna P.R.1997) and Vasudev Committee (Vasudev 1998) have recommended exclusive regulatory framework for these companies such as mandatory registration, capital adequacy, linking of net owned funds\(^1\) to deposits and application of prudential asset classification and income recognition norms. Non-Banking Financial Companies are reclassified broadly as Asset Finance Companies\(^2\), Loan Companies and Investment Companies (Reserve Bank 2006).

With the application of the tighter regulations through Reserve Bank of India Directions 1998 (applicable to NBFCs), the advantages enjoyed by NBFCs vis-à-vis banks have eroded (Khan M.Y 2002). The purpose of the study is to focus on the trends in earnings and business profile on a macro level and to identify the factors affecting the performance of Asset Finance Companies (AFC, Equipment and Leasing NBFCs).

Further from the literature, it is discernible that the NBFCs have started

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\(^1\) Net owned funds is equal to paid equity capital plus free reserves less accumulated loss balance, deferred revenue expenditure, other tangible assets (A) less investment in group, subsidiaries and in the sector and also book value of debentures, bonds, outstanding loans and advances with subsidiaries and group companies (B) (amount in excess of 10% of A).

\(^2\) Asset Finance Companies are the non-banking finance companies, which primarily has business focus on equipment leasing, hire-purchase finance and whose lending to physical asset creation is at least 60% of its total assets.
feeling the heat in the form of increased competition. In order to ward off the competition, they have been resorting to innovation in lending, diversification and exploration of new markets. From various studies published by the Reserve Bank of India (RBI), it is clear that the regulations have affected the financial strength of non-banking finance sector with many smaller finance companies have wound up their activities or merged with viable non-bank finance companies. Hence, the study focuses on the key drivers of performance and their emerging trends.

Researchers have paid little attention to the non-banking sector in India than on banking sector. Therefore, it is necessary to develop a sound model to capture the drivers of financial performance and the trends. The critical objective of the study is to identify the mediating effects of the key financial drivers of performance.

1.3 STATEMENT OF THE PROBLEM

Non-Banking Financial Companies (NBFCs), especially the leasing and hire purchase companies, have recorded marked growth in recent years reflecting evolution of a vibrant, competitive and articulate financial system (Khan.M.Y.2003). Non-Banking Finance Companies are
heterogeneous in their ownership patterns and regulations affect unevenly even within the broad category. Financial performance is impacted by regulations, competition and fund mobilization, deployment (Narasimhan.C.R.L.2006). The numbers of deposit taking Non-Banking Finance Companies are coming down as a result of erosion of investor’s confidence, cost of operations (Narasimhan.C.R.L.2004). Contagion is less limited to non-banking financial sector than banking sector as far as its effect on economy is concerned in UK (Mathew Corder 2004). The restrictions on bank finance and group exposure will also have a marginally adverse impact on the resource profile of the Non-Banking Finance Companies (Krishnan Sitaraman 2007).

Banks have lower cost of funds than Non-Banking Finance Companies and the rising borrowing cost has resulted in contraction of their profitability. Asset Finance Companies’ market share in truck financing has declined substantially, which has affected their business (Somasehar Vemuti 2007). The key drivers of performance of financial institutions are the riskiness of assets, demography and geographical spread and also affect the profitability (Krishnan Sitaraman 2004). Which are the drivers of performance of the financial institutions? Whether is it
management strategy and its execution, environment (regulation, economy) that affects the performance? (Patrick T Harker, Stavros A Zenios.1998). Spreads are likely to reduce in capital market financing as a result of increasing competition (Megha Gupta 2007). There has been a significant shift in asset deployment away from the business of leasing, hire purchase towards loans, ICDs and investments. Overall cost of funds is higher for Non-Banking Finance Companies than for banks and returns have shrunk and operating cost have sharply increased resulting in closure of number of finance companies (Ingres 2005).

Delivery channels are crucial for cost and profit efficiency of financial institutions (Klumpes 2004). Operational reforms such as deregulation of bank finance, movement to loan financing have helped efficiency of the financial sector (Jayanth R Varma 2001). The asset turnoverability, return on funds deployed and return to investors is the useful guide to companies to decide about diversification or continuation (Amita S Kantawala 2004).
From the above and the industry publications, the problems\(^3\) that these companies are facing today are

- Highly competitive asset financing environment
- Reduced return on lending
- Lack of business strategy to ward off competition.
- Economic factor viz., inflation, impacts the operations, and the performance.
- Regulations on income recognition, and prudential norms affect the earnings and profitability

Since, the previous researchers have not dealt with the above factors sufficiently, the present research attempts to identify factors internally affecting the operation of Asset Finance Companies (Formerly, equipment leasing and hire purchase finance companies) and suggests an appropriate model to understand the mediating factors affecting the performance of these companies.

\(^3\) Refer various publications of the Equipment Leasing and Hire Purchase Association of India, industry comments contained in the publications of Ingres of Investment and Credit Rating Agency of India and Reserve Bank of India.
1.4 RESEARCH OBJECTIVES

The main objective of this study is to identify factors affecting the financial parameters and thereby the efficiency of the Asset Finance Companies in an era of regulation and suggest a model to capture the constraining factors in a better way.

Several specific goals are formulated to achieve this main objective. Based on the literature review and gaps, such as lack of in-depth study of the factors, effects of regulations on performance, following specific objectives are formulated to study the impact of various financial factors on the operations of the asset finance companies.

- To identify the internal earnings factors impacting the performance, and profitability
- To identify impact of the critical cost factors on the returns generation, and the performance
- To suggest a suitable model capturing the critical factors affecting overall earnings, i.e., the performance
1.5 RESEARCH QUESTIONS

The following research questions are quite relevant to the crucial purpose of the study and seeking to understand the effectiveness of management of cost and earnings factors and existence of relationship between these factors and with the returns generated.

1. What are the financial parameters that affect the increase in shareholder wealth (Shareholders’ Funds)?

2. What are the relationships among the various dimensions of financial parameters?

3. What are the effects and relationship between the various dimensions of financial parameters, inflation with the shareholders’ wealth (shareholder funds) available to the investors with the mediating factor income?

Based on these questions the following conceptual model is derived by the researcher.
1.6 CONCEPTUALIZED RESEARCH MODELS

1.6.1 MODEL FOR MEASUREMENT OF PERFORMANCE

![Graph showing Research Model I with nodes labeled Cost, Income, Profit, Equity, and Wealth, and arrows indicating the relationships between them.]

**Fig. 1.1**
1.6.2 CONCEPTUALIZED PERFORMANCE EVALUATION
MODEL – DEFLATOR

RESEARCH MODEL II

![Diagram]

Fig. 1.2
1.7 SIGNIFICANCE OF THE STUDY

It is essential to understand that the key drivers of performance of financial institutions; that are strategy, execution of strategy and environment and the firm's internal factors (Patrick T Harker & Stavros A Zenios 1998). The performance of Non-Banking Financial Companies is influenced by the domestic profitability, asset management, and returns to scale (Amita S Kantawala 2004). In order to understand the cost efficiency and profit efficiency, it is essential to use non-parametric, econometric tools and avoid extensive use of accounting ratios (Robert DeYoung 2000).

Since the regulations have affected the performances of these companies, the understanding of the regulations and firm centric factors are quite demanding. These have compelled the companies to move from traditional business line (Khan M.Y. 2003). The share of the business of the asset finance companies has sharply came down with the deregulation of entry and banks entering in that business (Narasimhan.C.R.L 2004). The rising borrowing cost and declining lending rates have affected the business and profit margins (Krishnan Sitaraman 2007). But due to regulatory arbitrages, these companies can continue in their sphere of business (Somasehar Vemuti 2007). There is
no comprehensive work to portray the business profile of these companies (Ingres 2005). Companies have diversified the product lines into consumer durables, used car finance, capital market financing yet their core profitability will be lower in the years to come.

With a robust credit appraisal, geographical proximity, strong risk management mechanisms and buoyancy in capital markets will ensure asset finance companies continued viability (Megha Gupta 2007). New business avenues are extended up by the regulations such as credit card, asset management companies, insurance business are showing positive results. Companies having in-house subsidiaries are successful in improving business margins (Ingres 2005). Even the large-sized companies could not successfully manage the credit risks but the smaller ones can successfully manage it due to personalized service (Rakesh Mohan 2004).

Hence, in this research, the aim of the researcher is to conceptualize various financial factors in evaluating the performance of asset finance companies. Very little empirical studies are done in this area, except use of financial ratios and absence of application of non-parametric tools, which require better understanding of key financial factors and implementation of a model to capture and evaluate it. The purpose of
the present study is to throw more light on the factors affecting the performance of the Asset Finance Companies that can guide the investors, lenders, company executives and other stakeholders to have a comprehensive knowledge of the functioning of these companies before investing their funds.

1.7.1 RATIONALE BEHIND USING INCOME AS THE MEDIATING VARIABLE IN THE NETWORTH OF EQUITY SHARES (SHAREHOLDERS’ FUNDS) IN NON-BANKING FINANCE SECTOR IN TAMIL NADU, INDIA

There is a dearth of integrated bank performance analyses that use an interdisciplinary and multivariate perspective. Bank performance analysis has been implemented commonly through budgeting, measuring total deposits, and branch profits; the latter two measures generate retrospective information which cannot be used to gauge the potential of a bank to generate retail banking business. Budgeting is criticised for placing too much emphasis on items that are outside the management's sphere of influence, and focusing on expense items rather than overall earnings (Smith III and Schweikart 1992).
In its widest sense, a firm's performance objective can be interpreted as maximising the value of its shareholders' investments at sustainable levels; thus, in the long term, the critical measure of overall bank performance should be business earnings (Gup, Fraser, and Kolari 1989). Hence, the concept of wealth maximisation is reviewed first. Hempel and Yawitz who have addressed the principle of equity value maximisation in the context of financial institutions, start off from the premise that "Wealth maximisation is the maximisation of the discounted cash benefits (earnings) to shareholders" (Hempel and Yawitz 1977). They, then, proceed to identify the key variables in cash benefits as gross receipts from assets, cost of liabilities, overhead costs, taxes, earnings are expected to be examined for the different ways they may interact with these key variables.

With measurement of overall performance in mind, they produce four categories of key variables influencing the equity value, namely, spread management, control of overhead, liquidity management, capital management, and net interest income, NII. These categories are explained in the works of Hempel and Yawitz (1977) and De Lucia et al. (1987). It involves lot of efforts to control the overhead costs or non-interest expenses, which deals with the ability of the bank to hold down
such expenses even while maintaining a reasonable spread. It is not always true that control of overhead costs if business mix decisions for increasing the net interest income are not closely scrutinised for their impact on earnings.

The constraint of containing the overhead costs is in the context of non-interest income (that is, fee income), constraint is defined as the net non-interest income (that is, difference between non-interest income and non-interest expenses). The accounting method decisions interact with other key firms decisions such as mix of business, financing, and operating decisions. The diversity in the accounting in the treatment of depreciation, deferred taxes, and provisioning may result in distortion of profitability than less diverse income recognition standards (Foster George 2002). The treatment of expenses such as research and development, pension, and many others seriously affect the comparability of the financial statements of the same company (Dawson 1975). From 1997, the companies are required to report the comprehensive income plus net income to reflect fairness in income recognition. Comprehensive income includes net income plus several

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4 Net interest income is the difference between the interest income and interest expense. The interest spread is calculated on the net interest income.
comprehensive income items\(^5\) in the income statement (Brigham Eugene 2004) & (RBI 1998). Hence, the income (mainly, the business income) is used as mediating variable in this study.

1.8 VARIOUS DIMENSIONS IN MEASURING THE OVERALL PERFORMANCE (NETWORTH) IN NON-BANKING FINANCE COMPANIES IN INDIA CONTEXT

1.8.1 EARNINGS – COMPREHENSIVE NET INCOME (C-NI)

The following critical indicators of earnings have been identified as core to this criterion after consultation with previous research work, financial advisors, and industry executives: Regarding the earnings in the business, which includes core business income like lease rental, hire-purchase charges, non-core business income like other fee-based income such as consultancy fees, service charges and other fees, Regarding the earnings from investing activities, which includes income in the form of dividend, interest on bonds, deposits, securities, income from the investment in subsidiaries and other non-business decisions.

\(^5\) Examples of the Comprehensive income items are unrealized gain or loss on sale of securities marked-to-market.
1.8.2 COMPREHENSIVE EXPENSES (C-EXP)

The crucial indicators have been identified as quintessential under this criterion after consulting reputed auditors, tax consultants, and literature: Regarding the business expenses which are important for the operational and promotional activities; promotional activities include commission, advertisement and underwriting etc and operational activities include funding, staffing, and maintenance cost etc, Regarding the non-business expenses which are core to meet the riskiness of the assets through provisioning for non-performing assets, unrealized loss on sale of asset or securities marked-to-market, and other incidental recurring expenses such as audit fees, board expenses.

1.8.3 NET EARNINGS – NET PROFIT (NP)

The following core indicators have been identified under this criterion as critical success factors for the profitability; Regarding the operating profit from the operating activities, Regarding the non-operating profit from investing and funding activities which includes loans and advances to subsidiaries, investments in the issues of subsidiaries and other statutory requirements. According to the literature the profitability is affected by the increase in non-operational cost.
1.8.4 NON-PERFORMING ASSETS (NPA)

According to Reserve Bank of India, “a non-performing asset is an asset, in respect of which, interest has remained overdue for a period of six month or more. NPA includes term, demand or call loans, a bill, interest receivable from current assets and other loans, advances. It can be classified as substandard and loss asset” (Taxmann 2004). Substandard asset is an asset, which remained unpaid for more than 24 months, and loss asset is an asset, which remained unpaid for more than 36 months, which has been adversely affected by a potential threat of non-recoverability due to erosion in the value of security. Valuing NPAs is a difficult task and a NPA has a potential of wiping out entire earnings. However, the provisioning on the non-performing assets cushions the finance companies from reporting loss in future on this count.

1.9 LIMITATIONS OF THE STUDY

It is important that the findings of this empirical research be evaluated in the background of certain limitations carried along, since acknowledgement of these limitations could suggest new directions for future research.
✓ The present study was confined to a particular financial services sector, namely, non-banking finance companies operating in a single state, thus some of the results particularly dimensions of performance may be specific to the orientation in operational decision-making of the particular financial service sector setting.

✓ Data on both dependent and independent variables were collected from the published reports and from public domain. Findings, therefore, will represent a casual approach.

✓ Some researchers argue that adjustments to the financial statements may lack comparability, but such adjustments indeed acceptable by the accounting professionals and also for cross-industry comparison. It is a useful and effective methodology to employ such an approach, as statues bar publication or dissemination of company sensitive information.
1.10 ORGANIZATION OF THE THESIS

Chapter I: This chapter deals with a general introduction/background of the study tracing the evolution of Non-Banking Financial Companies. Besides the above, this chapter gives a brief account of the regulatory framework within which the firms are operating at present. It also presents the significance of the study, statement of problem of the study, limitations of the present study, and finally outlines the structure of the study.

Chapter II: Reviews literature with respect to the regulatory framework, evolution of the non-banking finance sector. Presents various important factors affecting the performance of the sector contained in works of several researchers, identifies the gap in past research, outlines the objectives of the study, the previous empirical findings and models developed to analyze the efficiency and performance parameters are thoroughly examined.

Chapter III: Presents a detailed discussion on research design, the research hypotheses to be tested, and the methodology used to test the critical factors affecting performance and its hypotheses, presents a simple conceptual model for testing the critical dimensions.
Chapter IV: Summarizes the outcomes of the statistical and econometric analysis that are used to test the hypotheses.

Chapter V: Identifies the findings of the study pertaining to the hypotheses, the implications, for the sector as a whole and individually, drawn from the findings of the research, the limitations of the study, recommendations for future research, and conclusions of the study.

1.11 CONCLUSION

This chapter examined the key income and expense dimensions and the shareholders' Value Factor (ESW-NW). The background for the research is discussed and the research questions in this study raise the propositions to be tested. Research problem is discussed with the objective for the study and the variables associated with conceptual model, significance of the study are defined and the following chapter will review the literature of previous studies and the propositions are hypothesized to capture the criticality of the study.