CHAPTER – I

INTRODUCTION

1.1 Background

Monetary transactions are facilitated by financial institutions such as banks, financial markets, finance instruments and services provided by the financial system. These institutions act as saving mobilisers and finance purveyors. Different types of financial services are provided by these institutions to serve the community. Furthermore, financial institutions act as intermediaries to investors and savers. Financial institutions are categorised into two types: banking and non-banking institutions based on the types of services offered. Banking institutions are characterised as creator of credit whereas non-banking institutions are highlighted as credit purveyors. Indian banking system comprises of two different types of banks: commercial and co-operative banks. Financial institutions in India such as Life Insurance Corporation (LIC), Unit Trust of India (UTI), and Industrial Development Bank of India (IDBI) (Pathak, 2011) are examples of non-banking institutions.

The services provided by financial markets include acquisition and sales of financial products and claims. The major participants involved in the supply and demand sides of these markets include agents such as dealers, brokers, lenders, borrowers and savers. Other parties include actors of law, contracts, communication agents and covenants. Furthermore, these markets are categorised as primary and secondary markets. In general, primary and secondary markets are also known as direct and indirect markets respectively. Primary or direct markets operate dealing with the issue of new financial claims or securities; hence, these markets are also known as new issue markets. Savings are mobilised in primary markets and supply
fresh capital to business units. On the contrary, secondary or indirect markets deal with the existing or issued or outstanding securities. These markets indirectly render securities that are issued on the primary markets, hence they contribute indirectly to additional capital supply (Cochrane, 2008).

Furthermore, financial markets are also categorised as capital and money markets wherein capital markets deal with long term capital claims with a maturity period above one year and money market dealing with short term claims with a maturity period less than a year. In the context of commercial banks, these financial institutions belong to both short and long term markets. Examples of money markets include Treasury Bills Market, Call Money Market, and Commercial Bills Market while capital market examples include Stock Market and Government Bonds Market. The assets of finance represent the payment of a sum as a claim in future and/ or periodic payment of the interest or the dividend. Payment of the sum also involves the repayment of the principal (Sewell, 2011).

The detailed list of Indian Financial system consisting of Financial Institutions is as under:

1.2 Financial Institutions (Intermediaries)

i) **Banking:** Reserve Bank of India (RBI), Commercial Banks, Co-operative Credit Societies, Co-operative Banks, Post-office Saving Banks,

ii) **Non-Banking:** Provident and Pension Funds, Small Savings Organizations, Life Insurance Corporation (LIC), General Insurance Corporation (GIC), Unit Trust of India(UTI), Mutual Funds, Investment Trusts, Investment Companies, Finance Corporations, Nidhis, Chit Funds, Hire-Purchase Finance Companies, Lease Finance
Companies, National Housing Bank (NHB), Housing and Urban Development Corporation (HUDCO), Housing Development Finance Corporation (HDFC), and other housing finance companies, Manufacturing companies accepting public deposits, Venture Capital Funds and National Cooperative Bank of India (NCBI) (Syal & Goswami, 2012).

1.3 Non-Banking Financial Companies (NBFC)

The growth rate of Indian economy is rising in an exponential scale and the requirements of the nation are increasing commensurately. The tremendous growth of the nation is vitalised by the growth of the industrial sector which always possess insatiable financial needs. This led to the emergence of Non-Banking Financial Companies (NBFCs) and has become an important finance segment in the country. These companies are heterogeneous group of institutions which perform as finance intermediaries in the provision of services such as accepting deposits, making loans and advances, leasing, hire purchase, etc. These intermediaries acquire funds as deposits or raise funds from public directly or indirectly and lend them to business units that require capital funds. Loans are lent to different trading units such as traders, small and medium scale industries and self-employed professionals. Financial sector in India is broadened with the advent of NBFCs and the products and services that are offered by these companies. The services offered by these companies are simpler than those offered by commercial financial institutions. Simple procedures, attractive return rate of deposits, flexible services, and timeliness in meeting all credit requirements are other advantages of NBFCs. Furthermore, these companies have now become the backbone of the nation in regulating the mission of finance inclusive of the given time (Ministry of Finance, 2012).
1.4 Statutory Definition under the RBI ACT

NBFI is defined under Sec. 45-I (f), Reserve Bank of India Act, 1934. As per the RBI Act, a “non-banking financial company” means,

(i) a financial institution which is a company;

(ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner or lending in any manner;

(iii) such other non-banking institution or class of such institutions, as the bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify (Khan, 2005).

Organisations (excluding commercial and cooperative banks) which offer financial services such as fund facilitation and act as monetary intermediaries between savers and investors are called as Non-banking financial institutions or companies. These institutions also offer products such as mutual funds (Khan, 2005). Any company that facilitates financial products such as hire-purchase finance, loan or mutual benefit finance and an equipment leasing fall under the category of NBFC; however, insurance or stock exchange or stock broking company and merchant banking companies are not NBFCs. The RBI (Amendment) Act, 1997 defines NBFC as an institution or a company whose principal business is to accept funds in the form of deposits under any scheme, arrangement or in any other manner, and to lend the same in any manner. Since, the amended definition provided insights for fund investments many loan and investment companies which were registered under the Companies Act are also included as NBFCs. In the Indian financial system, the financial intermediaries are classified as public owned, monopoly or oligopoly or monopolistic market structure and these systems are centralised. However, NBFCs are
small sized financial intermediaries other than commercial and cooperative banking institutions. In addition, these NBFCs are owned as private concern and are decentralised with relatively less competitive market. Some NBFCs are based on fund facilitation whereas others are based on providing financial services. In general, an NBFC company should belong to any of the following companies (Figure 1):

1) Loan Companies (LCs)
2) Investment Companies or ICs
3) Hire-Purchase Finance Companies or HPFCs
4) Lease Finance Companies or LFCs
5) Housing Finance Companies (or) HFCs
6) Mutual Benefit Financial Companies or MBFCs
7) Residuary Non-Banking Companies or RNBCs
8) Merchant Banks
9) Venture Capital Funds
10) Factors
11) Credit Rating Agencies
12) Depositories and custodial services (Pathak, 2011).
1.5 Differences between NBFCs and Banks

The nature of the liabilities and the asset structure differentiate NBFCs from banking financial institutions. In commercial banks, liabilities consist of demand and time deposits wherein in NBFCs; ordinary demand deposits are not included. Demand deposits pertain to withdrawal of the same through cheques. Cheques are identified to be components of money and hence the degree of liabilities is the main differentiating
factor. In the context of assets, commercial banks hold credits in the range of short and long term and instruments such as cash credits, overdrafts and bills are used. On the contrary, the assets held by NBFCs are more specific in terms of the type of service required. For example, housing finance companies are specific towards provision of loans for housing purposes whereas hire finance companies operate mainly on financing to transport operations and requirements. However, the difference in the type of assets held by NBFCs and commercial banks does not clearly delineate the areas of operation of both since even commercial banks also provide loans for consumer credits and transport operations which were considered to be not the purview of these banks earlier (Lumpkin, 2009).

However, some functions and operations of both banks are NBFCs share similarities which blur the distinction between the two different types. Unlike banks, it is revealed that NBFC are not a part of payment mechanism. Similar to banks, they cannot generate money; however, due to several advantages over commercial banks, these NBFCs act as alternatives to commercial and cooperative banks (Onnela et al., 2006). Albeit the similarities existing in NBFCs and banks based on their operations, some differences still prevail which include: (i) Demand deposits are not accepted by NBFCs; (ii) An NBFC is not a part of the payment and settlement system and as such an NBFC cannot issue cheque drawn on itself; and (iii) NBFC depositors are void of deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation which are facilitated by banks.

1.6 Current Scenario of NBFCs

The global economic crisis shook the entire world and India is no longer an exception. The striking rate of interests during the period October and November 2008 spread economic havoc. The collapse of the Lehman Brothers has inflicted some
damage to the ideas of investors. The serious economic downfall has impacted the NBFCs in India which is evidenced by the fall in finance demand as expansion plan for several businesses deferred. With the stock prices of many NBFC crashed, many companies terminated their operations in the finance sector. Many international NBFCs are closing down till date or selling their operation units in India (Dungey et al., 2003).

Though the conditions of NBFCs worsened, the operational strategies of these NBFC companies have improved over the years after the financial crisis. Economic and industry level experts claim that their operations have improved and are mature than they were in the previous decades. The intervention of RBI in this context further aided the mitigation of the negating effect of the credit crunch on NBFCs and other banks. In addition, it is also stated that the new strategies adopted by LIC Housing Finance aided in attracting new potential customers which further increased its share in the national mortgage market. The profitability was maintained at around 37% in the year 2009. However, HDFC a largest NBFC in the country witnessed a slow customer growth which is reasoned by competitive market, especially as the company had LIC Housing Finance as a competitor. Other reason includes the tight monetary conditions. Some companies which stood stable even during the credit crunch period, are Infrastructure Development Finance Company (IDFC) Power Finance Corporation (PFC) and Rural Electrification Corporation (REC). Though the country is evidenced by acute power shortages and increased demand for infrastructure projects, the growth rate of NBFCs is increasing. Vehicle financing was drastically affected during the economic crunch wherein the number of potential customers reduced. Since vehicle financing is based on asset-type businesses, the quality of asset did not suffer against other consumer financing businesses. However, once an NBFC named Shriram
Transport Finance maintained a steady growth which is contributable to the business model that is more stable than other companies of same sort (Bajpai, 2011).

In India, around 41,000 NBFCs were in operation in the year 1997. Both public and private limited companies were part of the NBFSCs. However, only very few companies report or file returns to the RBI/NHB. The reasons for the growth of these companies include,

a) Tailor made services to the clients;

b) Comprehensive regulation of NBFSCs;

c) High level of customer-orientation, lesser post sanction requirements, simplicity and speed of their services;

d) The monetary and credit policies have created an unsatisfied fringe of borrowers, i.e. the borrowers outside the purview of banks. The NBFSCs have catered to the needs of this section of borrowers;

e) High interest rates on deposits (Nath, 2013).

1.7 The Resources of NBFCs

Regulated deposits, exempted deposits, and net-owned funds form the primary resources of NBFCs. These deposits include any money that is received from a non-banking organisation in the form of deposit or loan. Other than usual loans and deposits, interoperates loans and sum borrowed from shareholders are also resources of NBFCs. Regulated deposits are acquired through some restrictions that are imposed by regulators. This type of deposits includes nonconvertible debentures, deposits received by companies from their shareholders, deposits guaranteed by directors, fixed deposits, and interoperates deposits. On the contrary, exempted type of deposits does not fall within the scope of regulatory measures. Such borrowings/deposits are exempted from regulations and include borrowings from banks and specified financial
institutions, money received from central/state/foreign governments, security deposits, advances received against orders and convertible debentures. Net-owned funds means the aggregation of paid up capital and free reserves.

1.8 Role of NBFCs

The operations of NBFCs as financial intermediaries are similar to that of financial institutions such as banks. NBFCs serve as intermediaries between investors and savers. In an economy, it is deemed that both surplus and deficit units exist. Transfer of funds with some rate of interest is brought by financial intermediaries where direct lending of surplus to deficit units is not feasible. Efficient flow of funds is not facilitated in direct transfer of surpluses to deficit units. High degree of risks involved in such transfers is mitigated by financial institutions and NBFCs which act as financial intermediaries and aid in the efficient allocation of resources in the economy. The advantage of financial intermediation lies with the fact that the expertise of these companies helps mitigate risks of finance by spreading the risks over large number of units. Hence, high return with low risk and liquidity is facilitated by the operation of NBFCs which benefits the saver (Aggarwal, 2015). The choice of loan is diverse with the borrowers when loan products of financial intermediaries are considered. It is considerable that the loan types offered by commercial and cooperative banks are for industrial, commercial and agricultural purposes. Small scale requirements such as transport, trading, acquisition of durable consumer goods, purchase and repair of houses or just for plain consumption are facilitated through loans offered by NBFCs. Since the activities of NBFCs are not regulated by the monetary authorities of the government, these companies do not necessarily be in consonance with the priorities of the nation. However, since these companies aid in the transfer of surplus to deficit units, the economy of the country is further enhanced.
Hence, NBFCs aid in the development of economy by transferring unproductive surplus into productive assets. These companies in this context have been termed as the economic measure for the development of the country (Bajpai, 2011).

The Reserve Bank of India expert committees identified the need of non-banking financial companies in the following areas:

- Development of transport and infrastructure sector
- Substantial employment generation
- Help and increase wealth creation
- Broad base economic development
- Irreplaceable supplement to bank credit in rural segments
- Major thrust on semi-urban, rural Areas and first time buyers/users
- Finance deficit units
- Huge contribution to the state exchequer

1.9 Regulation of NBFCs

The services offered by NBFCs are diverse and positively regulates Indian economy; however, several unhealthy practices were observed over the years of operation of these companies in the finance sector. This idealised the necessity for RBI to devise regulations for all NBFCs except HFCs. The enactment of RBI (Amendment) act 1997 stated that companies with net owned funds of Rs. 25 Lakhs and above have to register with the RBI. The BFS with the supervisory department of RBI began monitoring the operations of NBFCs from July 1995. However, the exempted HFCs are monitored by NHB (Mondal, 2015; Amutha, 2013). The major regulatory provisions are,
i. The minimum net worth funds of 25 Lakh and the NBFC should achieve the minimum net worth norm in 3 years or extended 3 years more at the discretion of RBI.

ii. 10% and 15% should be maintained by NBFCs as deposits in liquid assets.

iii. They have to create reserve fund and transfer not less than 20% of their net deposits to it every year.

iv. The RBI directs them on issues of disclosures, prudential norms, credit, investments etc.

v. Nomination facility is available to depositors of these companies.

vi. Unincorporated bodies engaged in financial activity cannot accept deposits from the public from April, 1997.

vii. They have to achieve a minimum capital adequacy norm of 8% by March, 1996.

viii. They have to obtain a minimum credit rating from any one of 3 credit rating agencies.

ix. A ceiling of 15% interest on deposits has been prescribed for MBFCs or Nidhis.

x. The interest rate ceiling on deposits as also the ceiling on quantum of deposits for NBFCs (other than Nidhis) have removed, subject to compliance with the RBI directions and guidelines.

In order to protect the interests of the depositors, regulations were devised which primarily focuses on the NBFCs which accept public funds in the form of deposits (NBFS-D). However, significant amendments in the regulations on the operations of NBFCs further emphasised upon non-deposit taking NBFCs (NBFCs-ND). Systematic complications in the maintenance of balance sheet of a number of
companies necessitated such amendments. Systematically important NBFCs are subjected to limited regulations wherein the asset size of these companies should be above 100 crores. Regulatory policies were changed considering the activities of asset creating NBFCs. In December 2006, a reclassification was made wherein the new terms and conditions classified a new category of NBFC namely Asset Finance Companies (AFC). Companies which finance real/physical assets for productive/economic activity fall under this category. The norms of AFCs are different from the actual norms specified for other NBFCs. The revised classification includes loan and investment companies instead of equipment leasing, hire purchase, loan companies and investment companies earlier (Mondal, 2015).

1.10 Problem Statement

Non-Banking Financial institutions undertake financial operations but their resources are not directly acquired from the savers as debts. Rather public savings are mobilised and are rendered for finance related services which includes investment. These financial institutions are hence known as non-banking financial intermediaries (NBFIs) or investment institutions as they act as intermediaries to finance related activities. Other than these financial intermediaries, the financial system of India also possesses a large number of decentralised, small sized and privately owned financial intermediaries which operate in different and relatively small niches thereby enlarging the market and competition. While some companies limit their scope to fund-based business, others offer various types of financial services. In general, these companies are known as "non-bank financial companies (NBFCs)"; however, companies providing financial services are known as "Non-Bank Financial Services Companies (NBFSCs)" and companies restricting themselves to fund-based business are called "Non-Bank Financial Companies (NBFCs)" in specific (Agarwal, 2014). The Reserve
Bank of India, post 1996 has implemented regulations and supervisory measures to maintain transparency and discipline in decision making on NBFCs. These regulations are reviewed by the RBI most of the time and are amended whenever the sector requires a change. It is deemed that in the forthcoming years, there could be a cooperative functioning between both commercial banks and NBFCs due to the emergence of e-commerce and internet banking sector. The RBI is involved in the regulation of NBFCs that are engaged in finance activities such as Equipment leasing, hire purchase finance, loan and investment, Residuary Non-Banking Companies (RNBCs) and the deposit taking activity of miscellaneous non-banking Companies (chit funds) (Reserve Bank of India, 2015). As evidenced above, the role of NBFC is quite evident but also much understudied. For this purpose, the present study evaluates the financial performance of NBFCs (Bothra & Sayeed, 2011).

1.11 Research Objectives

1. To examine the financial viability of different types of NBFCs in India
2. To measure the operating and X-efficiency of NBFCs in India
3. To compare the financial performance of different categories of NBFC in India
4. To forecast the financial viability of NBFCs in India

1.12 Research Questions

1. What is the financial viability of different types of NBFCs in India?
2. What is the operating and X-efficiency of NBFCs in India?
3. What is the financial performance of different categories of NBFC in India?
4. What is the future of the financial viability of NBFCs in India?
1.13 Hypotheses

The following hypotheses are tested in the present study.

\[ H_0 (1) \] - There is no significant relationship between NPR, OPM CR, DER, FATR, ATR and ROA of loan companies

\[ H_0 (2) \] - There is no significant impact of NPR, OPM CR, DER, FATR, ATR on ROA for loan companies

\[ H_0 (3) \] - There is no significant relationship between NPR, OPM CR, DER, FATR, ATR and ROA of investment companies of NBFCs

\[ H_0 (4) \] - There is no significant impact of NPR, OPM CR, DER, FATR, ATR on ROA for investment companies of NBFCs

Where, NPR - Net profit ratio, OPR - Operating profit ratio, CR - Current Ratio, DER – Debt equity ratio, FATR – Fixed asset turnover ratio, ATR – Asset turnover ratio, ROA – Return on assets

1.14 Statistical Methods

i. Regression analysis: For the present study, regression analysis will be employed in order to identify the factors that account for the failure or success of NBFCs with respect to the viability, profitability, granting loans and advances, recovery of loans and amount of NPA.

ii. Data Envelopment analysis (DEA): Data envelopment analysis is a linear technique and non-parametric method that measures the performance of organisational units like banking and non-banking financial institutions. The DEA in this regard identifies three types of efficiencies namely the technical,
cost and allocative efficiencies. Efficiency here may be defined as the success with which one organisation uses its resources to produce an output. Cost efficiency is attempting the same amount of output at a reduced cost, while technical efficiency is the ability to reduce variable inputs to produce the same level of output. Allocative efficiency is defined as the ability to choose the right mix of input required.

1.15 Scope of the Study

The present study focuses on the financial performance of Non-banking Financial Companies (NBFCs). This is analysed by the data obtained from governmental reports of the for the period 2001 to 2015 in order to derive and determine the role that NBFCs play in the economic development of India. The study also forecasts the financial viability of these NBFCs by measuring the financial performance of 50 companies from this sector. The study further measures each main subset of this sector. The scope of the study thus remains to enable to add to the limited existing body of literature on the overall viability of NBFCs on the future of the Indian economy.

1.16 Data and Variables

Obtaining the data sets for the purpose of the study involved a comprehensive search of the databases of IBA, website of RBI and SEBI bulletins, data bank of CMIE, reports and statistical data and tables published on NBFC’s in different journals. The study proposed to use the (balance sheet) data for 15 years from the year 2001 to 2015. This period was chosen to represent the upward trend of NBFC’s which occurred most in this period of time.
For analysing the data considered in the present study, the following variables have been used.

Operating profit margin, Net profit ratio, Current ratio, Debt equity ratio, Fixed asset turnover ratio, Asset turnover ratio, Return on assets.

1.17 Significance of the Study

The study bears significance that the non-banking sector has not been given importance that it is rightfully deserved in the performing and operating economy. This may be attributed to the attention that was focused on the banking sector. The findings of the study will enable to shed light on the existing structure, role and contribution of the NBFCs towards the economic development of the nation. The findings also bear significance to the contribution of previous literature. The literature on the role of these NBFCs in India is limited at present. The findings of the study bear implication to future research in the same aspect.

1.18 Chapterization

The research study report is structured as follows:

Chapter I: Introduction: this section contain the introduction to the topic along with the background of the study, the problem statement, research objectives, research questions, hypothesis, the statistical methods of analysis and the scope and significance of the study. The chapter also contains a note on the chapter divisions of the study.

Chapter II: Literature Review: the chapter discusses the previous literature that has been presented by different authors within the context of the role and evaluation of NBFCs in India.
**Chapter III: NBFCs in India: An Overview:** This chapter presents a detailed overview of the functioning of the banking as well as the non-banking financial companies within the purview of India. The chapter also assesses the regulatory framework which surrounds the governance of these NBFCs and their growth.

**Chapter IV: Data and Methodology:** this chapter details the research design and strategy adopted. In addition, the research philosophy is also included through which the nature and type of data collected are determined. The chapter also encloses the manner in which the data is analysed and how the findings may be derived.

**Chapter V, VI, VII:** Financial performance of NBFCs using regression analysis, DEA, and comparative analysis: this chapter very specifically encloses the results of the data collected. The results are presented in tabular and graphical format along with the interpretation of data

**Chapter VIII:** Summary and Conclusion: this chapter discusses the findings of the present study in comparison with the previous studies. From the findings, conclusions are drawn and recommendations to the future role of NBFCs are discerned.