EMERGENCE OF NBFCs AS GAME CHANGERS IN THE INDIAN FINANCIAL SYSTEM

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ABSTRACT

The role of NBFCs in the Indian financial system has undergone a seismic shift in recent years. From the shadows of banking system, they have evolved, transformed and have carved a niche on their own. It is a paradox that even when the entire world is looking upon NBFCs sceptically and dubbing them as shadow banking; NBFCs in India have proved themselves to be different. They have emerged as an alternative and a big competitor to mainstream banking in India. NBFCs are today passing through a very crucial phase where RBI has issued a revised regulatory framework with the objective to harmonize it with banks and Financial Institutions and address regulatory gaps and arbitrage. While the strengthening of regulatory mechanism is intended to bring the desired parity with banks and other financial institutions, fund raising has increasingly become difficult and challenging, specially, for the large number of small and medium sized NBFCs. This paper is an attempt to appreciate the multidimensional impact of NBFCs in Indian economy and their contribution towards financial inclusion. The paper also has an objective to contemplate the issues and challenges being faced by NBFCs (specifically considering the revised regulatory framework) and suggest measures that can be taken to optimize their contribution thereto.

Key words: NBFC, Shadow banking, financial inclusion
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Introduction

For a large and diverse country like India, ensuring financial access to fuel its growth engine is a critical priority. Banking penetration continues to be low, and even as the coverage is sought to be aggressively increased. In this scenario, the Non-Banking Finance Companies (NBFC) sector has scripted a remarkable success story. It is a testimony to the truly diverse and entrepreneurial spirit of India. From large infrastructure financing to small microfinance, the sector has innovated over time and found ways to address the debt requirements of every segment of the economy. The industry has also responded positively from time to time to the regulatory efforts of RBI. Over time, the sector has evolved from being fragmented and informally governed to being well regulated and in many instances, adopted best practices in technology, innovation and risk management as well as governance.

It is an established fact that many unbanked borrowers avail credit from NBFCs and over the years use their track record with NBFCs and mature to become bankable borrowers. Thus, NBFCs act as conduits and have furthered the Government’s agenda on Financial Inclusion. They have been to some extent successful in filling the gap in offering credit to retail customers in underserved and unbanked areas. NBFCs in India have recorded remarkable growth in recent years. They have proved to be useful and successful for the evolution of a vibrant, competitive and dynamic financial system in Indian money market. The success factors of their business has been by making the most of their ability to contain risk, adapt to changes and tap demand in markets that are likely to be avoided by their bigger counterparts in banking sector.

Statement of the problem

The canvas of Indian financial system portrays a vibrant picture of players of different hues and diverse opportunities. At the apex level are scheduled commercial banks which follow universal banking model. Next, there is the cooperative banking sector with two different strands. While the three Tier rural co-operative structure (State/District/grass root level outfits), takes care predominantly of agriculture and allied activities; the urban co-operative banking structure provides succour mainly to the small customers at the bottom of pyramid in
urban areas. On the other hand, Non-Bank Financial Companies (NBFCs) are largely involved in serving those classes of borrowers who are generally excluded from the formal banking sector. However, over the years, the exclusiveness between the banks and NBFCs has somewhat blurred. More recently, NBFCs are competing with banks in providing financial services such as infrastructure finance and housing finance among others.

Over a past decade the Non-Banking Financial Companies (NBFCs) have emerged as strong financial intermediaries and form an integral part of the Indian Financial system. NBFCs are today passing through a very crucial phase where RBI has issued a revised regulatory framework with the objective of harmonizing it with banks and address the issue of regulatory gaps and arbitrage. While the regulations, especially asset classification norms have been made more stringent so as to be at par with banks, what is now required is to equip NBFCs with tools like coverage under SARFAESI Act to recover their dues and income tax benefits on provisions made against NPAs. Fund raising has increasingly become difficult and challenging, specially, for the large number of small and medium sized NBFCs. It is of utmost benefit to the regulators, policy makers, players and investors in the Indian financial system to understand the implications of current regulatory overreach on NBFCs and how they are coping up with them.

**Objectives of the study**

1. To study the profile and business concentration of NBFC sector in India
2. To analyse the business trends of NBFCs in India
3. To contemplate the role of NBFCs in promoting financial inclusion
4. To suggest measures that can be taken to optimize their contribution.

**Methodology of the study**

The data used for this study is mainly secondary data that was collected from the websites of the following organizations, the Reserve Bank of India, The Associated Chambers of Commerce and Industry of India and The Credit Rating Information Services of India Ltd. Simple statistical tools such as percentages, Compounded annual growth rates are used to analyze the data.
Profile of NBFC Sector

A company is considered as an NBFC if it carries on as its business or part of its business, any of the activities listed in Section 45 I (c) of the RBI Act, 1934, viz., business of making loans/advances or acquisition of shares / securities, etc. or hire purchase finance or insurance business or chit fund activities or lending in any manner provided the principal business of such a company does not constitute any of the following non-financial activities viz. (a) agricultural operations (b) industrial activity (c) trading in goods (other than securities) (d) providing services (e) purchase, construction or sale of immovable property. Further in terms of section 45 I (f) of the RBI Act, a company would also be an NBFC, if its principal business is that of receiving deposits under any scheme or arrangement. Thus a company whose principal business is agricultural operations, industrial activity, trading or real estate business is not a financial institution.

Chart 1- NBFI Universe

Size of the Sector

The share of NBFCs’ assets in GDP (at current market prices) increased steadily from just 8.4 per cent as on March 31, 2006 to 12.5 per cent as on March 31, 2013; while the share of bank assets increased from 75.4 per cent to 95.5 per cent during the same period (Table 1).
Table 1: Assets of NBFC and Banking (SCBs) Sectors as a % to GDP

<table>
<thead>
<tr>
<th>YEAR</th>
<th>NBFC Assets to GDP (%)</th>
<th>Bank Assets to GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>8.4</td>
<td>75.4</td>
</tr>
<tr>
<td>2007</td>
<td>9.1</td>
<td>80.6</td>
</tr>
<tr>
<td>2008</td>
<td>10.1</td>
<td>86.8</td>
</tr>
<tr>
<td>2009</td>
<td>10.3</td>
<td>93.0</td>
</tr>
<tr>
<td>2010</td>
<td>10.8</td>
<td>93.0</td>
</tr>
<tr>
<td>2011</td>
<td>10.9</td>
<td>92.2</td>
</tr>
<tr>
<td>2012</td>
<td>11.9</td>
<td>92.7</td>
</tr>
<tr>
<td>2013</td>
<td>12.5</td>
<td>95.5</td>
</tr>
</tbody>
</table>

Note: Assets of NBFC sector include assets of all deposit taking NBFCs and Non-Deposit Taking NBFCs having assets size Rs. 100 crore and above (NBFCs-ND-SI)

Business Concentration of NBFCs

Unlike the banking sector, entities under NBFCs are diverse not only in terms of size and sophistication of operations but also in terms of activities they undertake. NBFC would include not only mammoth entities which are part of large multinational groups, but also small players with assets around Rs.25 lakhs.

The Herfindahl Index, also known as the Herfindahl-Hirschman Index (HHI) has been used to measures the market concentration of NBFC industry in order to determine if the industry
is competitive or nearing monopoly. The Herfindahl Index formula is calculated by squaring the market share for each firm (up to 50 firms) and then summing the squares. HHI result varies from 0 to 10,000, with 10,000 indicating monopoly and zero indicating perfect competition. If HHI result is less than 1,000 then the industry is considered as competitive; a result of 1,000-1,800 to be a moderately concentrated; and a result of 1,800 or greater to be a highly concentrated.

Table 2: Herfindahl–Hirschman Index

<table>
<thead>
<tr>
<th>Period</th>
<th>NBFC SECTOR</th>
<th></th>
<th>BANKING SECTOR</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total Assets</td>
<td>Total Credit</td>
<td>Total Assets</td>
<td>Total Credit</td>
</tr>
<tr>
<td>March 2012</td>
<td>372.4</td>
<td>591.8</td>
<td>508.5</td>
<td>545.2</td>
</tr>
<tr>
<td>March 2013</td>
<td>407.2</td>
<td>635.1</td>
<td>514.0</td>
<td>879.5</td>
</tr>
</tbody>
</table>

Source- Micro level data on NBFCs have been extracted from the department of Non Banking Supervision while bank level data has been collected from Statistical Tables Relating to Banks in India.

The business concentration in terms of total assets and total credit based on ‘Herfindahl–Hirschman Index (HHI) indicate that competition is greater in NBFC sector as compared with banking sector, as HHI for NBFC sector was found to be on lower side for the period ended March 2012 and March 2013.

**Business Trends of NBFCs**

**Balance Sheet Growth**

NBFC sector had phenomenal growth in the last ten years. The sector on an average, witnessed a Compound Annual Growth Rate (CAGR) of 22 per cent during the period between March 2006 and March 2013. NBFC sector grew faster than banking sector in most of the years. NBFC sector clocked a growth of 25.7 per cent in 2011-12 although GDP growth decelerated to 6.3 per cent in 2011-12 from 10.5 per cent in 2010-11.

**Credit Growth**

NBFC - credit grew more rapidly as compared with the banking sector. NBFC credit witnessed a CAGR of 24.3 per cent during the period between March 2007 and March 2013 as against 21.4 per cent by the banking sector.

**Infrastructure financing**
NBFC finance to infrastructure accounted for 35.8% of their assets as on March 31, 2013 while in case of banks it was 7.6%.

The quantum of infrastructure finance provided by the NBFC sector witnessed a CAGR of 26.2 per cent during the period between March 31, 2010 and March 31, 2013. In absolute terms, NBFC finance to infrastructure increased from Rs.2228 billion on March 31, 2010 to Rs. 4479 billion as on March 31, 2013

**Public Deposits**

In line with RBI directions, the public deposits of NBFC sector (including RNBCs) declined considerably from Rs. 247 billion as on March 2007 to Rs.106 billion as on March 2013

**Inter-connectedness with the Banking Sector**

Borrowings from banks is one of the major sources of funding for the NBFCs. NBFC borrowings from the banking sector increased manifold from Rs. 542 billion as on March 31, 2006 to Rs. 2508 billion in March 31, 2013 (an increase of more than 4 times) NBFC borrowings from the banking sector increased manifold from Rs. 542 billion as on March 31, 2006 to Rs. 2508 billion in March 31, 2013 (an increase of more than 4 times). However, growth of bank credit to NBFCs decelerated in March 2013 to 13.6 per cent from 32.5 per cent and 42.8 per cent recorded in September 2012 and March 2012. This deceleration is attributed to lower demand for auto and consumer loans, stricter norms on lending against gold, withdrawal of priority sector status for some loans given by banks to NBFCs for on-lending for specific purposes, etc.

**Profitability**

The Return on Assets (RoA) of NBFC sector is always found to be on the higher side as compared with that of the banking sector largely on account of lower operating costs and also, NBFCs do not have statutory requirements like CRR and SLR.

**Borrowings from the Markets**

Borrowings from the markets increased from just Rs. 1009 billion as on March 31, 2006 to Rs.4764 billion as on March 31, 2013, increased by more than 4.5 times during the period of 8 years.

**Role of NBFCs in Promoting Inclusive Growth**
NBFCs play a pro-active role in the development process of the country. Activities undertaken by the NBFCs for achieving inclusive growth in the country are described below:

**Credit to MSMEs (Micro, Small and Medium Enterprises)**

MSME sector has large employment potential of 59.7 million persons over 26.1 million enterprises and is considered as an engine for economic growth and promoting financial inclusion in rural areas. The outstanding credit provided by the NBFC sector to MSMEs stood at Rs.625 billion as at end March 2013 (Rs.464 billion in the previous year). The figures for banking sector were at Rs.22,302 billion as at end March 2013 (Rs.19,374 in the previous year). The fact that a large segment in the micro and small industries sector does not have access to formal credit provides a window of opportunity for the NBFCs to design suitable innovative products.

**Micro Finance Institutions**

NBFC-MFIs provide access to basic financial services such as loans, savings, money transfer services, micro-insurance etc. to poor people and attempt to fill the void left between the mainstream commercial banks and money lenders.

Over the last few years NBFC-MFIs have emerged as a fast growing enablers in providing the financial services to the poor people by providing capital inputs to poor which generates self-employment, and thereby promotes inclusive growth. As on 31 March 2013, the outstanding credit disbursed by the MFIs was Rs.144 billion.

**Monetisation of Gold**

NBFCs’ gold loans witnessed phenomenal growth due to their customer friendly approaches like simplified sanction procedures, quick loan disbursement etc. NBFC gold loans increased from just Rs. 39 billion as on March 31, 2009 to Rs.475 billion as on March 31, 2013.

**Second Hand Vehicle Financing**

NBFCs also engage in financing used/ second hand vehicles, reconditioned vehicle, three-wheelers, construction equipment besides secured/unsecured working capital financing etc. Incidentally, in India except NBFCs no other financial sector player finance second hand vehicles; which are very popular with road transport operators essentially in the self-employed segment.

**Affordable Housing**
Another area where NBFCs are participating in the inclusive growth agenda is affordable housing. Large NBFCs are setting up units to extend small-ticket loans to home buyers targeting low-income customers across the country. Firms are offering loans of Rs. 2-6 lakh to borrowers with monthly income of Rs.6000 – 12000 who find it difficult to borrow from the commercial banks. Firms offer easier know-your customer (KYC) norms such as relaxation in documentation requirements to facilitate easy access to low-income borrowers.

Imperative measures suggested for NBFCs to emerge as real game changers

- **Customer Protection** - Protection of customers against unfair, deceptive or fraudulent practices has to become the top priority of NBFCs. Charging of exorbitant interest rates, raising of surrogate deposits under the garb of non-convertible debentures, various types of preference shares, aggressive practices in re-possessing of automobiles in the case of auto loans, improper/opaque practices in selling the underlying gold jewellery are all valid accusations against NBFCs which has to be addressed immediately.

- **Adopting Corporate Governance Standards** - RBI has already prescribed a governance code for NBFCs as part of their best practices; these include constitution of Risk Management, Audit and Nomination Committees, disclosure and transparency. It is highly recommended for NBFCs to adopt those standards.

- **Capacity Building** - NBFCs on both individual and collective basis need to work towards building a responsive ecosystem for capacity building; since in the medium to long term, it is the quality of staff which to a large extent, determines the health of the sector.

- **Greater Innovation** - Although NBFCs have been designing innovative products to suit the client and market conditions, the sophistication of financial services has been gradually increasing in the recent past. There is an imperative need for NBFCs to aggressively involve in designing innovative products to become real game changers in the economy.

- **White Label ATMs** - As NBFCs already have significant business presence in semi-urban and rural centres, there is a case for them to explore business potential by establishing white label ATMs in such areas.

- **Need for a single representative body for the Industry** - In the case of NBFCs, there are multiple representative bodies such as ‘Finance Industry Development Council (FIDC) for Assets Finance Companies’, ‘Association of Gold Loan Companies (AGLOC) for Gold Loan NBFCs’, etc. In addition, RBI has recently
issued guidelines for ‘Self-Regulatory Organisation for Micro Finance Institutions’. At this stage of development of the NBFC sector, in the interests of harmonious development of all its segments, establishing one representative body for the entire sector would be an idea worth exploring by subsuming the existing bodies. However, care should be taken to ensure that all segments are adequately represented in such an apex body, to promote harmonious and balanced growth of the sector and avoid conflicts.

**Conclusion**

The way forward is to ensure that both the NBFC sector and all the concerned regulators play an active part in acting on the imperatives mentioned above. NBFCs have a special responsibility against the background of the need to improve the customer service by conducting their operations as per the best practices of corporate governance. Adhering to best corporate governance and ethical practices is the only way for NBFC in gaining the confidence of their customers in particular and the society in general. Consequently, the NBFC sector would be able to garner greater trust of both its customers and the society. NBFCs becoming true game changers would give a fillip for the financial inclusion efforts in our country.

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