PRESENT CHALLENGES OF NON-BANKING FINANCIAL INTERMEDIARIES IN INDIA: AN OVERVIEW

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Abstract

For a large and diverse country like India, ensuring financial access to penetrate growth and entrepreneurship is a critical priority. In this scenario, the Non-Banking Finance Companies (NBFCs) sector has scripted a story that is remarkable. It speaks 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. To its credit, the industry has also responded positively to regulatory efforts to better understand risks and to address such risks through regulations. 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. In the light of this, the present study encompasses the role and challenges faced by NBFCs in Economic Development of India

Keywords: non- Banking FINANCIAL INTERMEDIARIES IN INDIA: AN OVERVIEW, Performance, Productivity, Profitability, Liquidity.

Introduction

Of late, the Indian economy has been going through a lot of turbulence, which has been affecting almost all the sectors that drive growth. The finance sector has been at the core of this, thus, having ripple effects on the real GDP, growth and investor sentiment. Our emphasis here is to study the NBFC crisis, in the light of recent events, package announcements and try to find out plausible solutions for the same. It started in 2018, when IL&FS reported its inability to meet the repayment obligations. The company had taken up several infrastructural projects but a glitch in land acquisition made it difficult to take them to culmination. The total debt squared off to INR 91,000 crore. Subsequently, it sparked tension amongst the several banks and Mutual Funds that had their money tied up in various investments with the company. The credit extension and investment activity has been tightened since then, thus disrupting the flow of funds. This, coupled with the languid buying by the customers, increasing conservatism and protectionism at the global level, falling automobile demand, reducing salaries, low employment and instability was reminiscent of another 2008 crisis repeating itself, after a decade, but to only hit India more this time. In 2008, credit in India was expensive so corporates found lending from abroad a more viable option. But with the growth of financial sector back home, the situation had improved and inland financing was a significant source of credit nowadays. Thus, any sort of problem was bound to have ripple effects on the entire economy.

Following graphs aim to capture the essence of the role NBFCs have played in the economy-

LITERATURE REVIEW: Banking being the centre of economic activity and a major determinant of economic growth and development of a nation; strong and efficient banking system is imperative. In this regard, a large number of studies have been carried out on the measurement and analysis of bank performance, from country to country and from time to time. A number of studies have also focused in specific on profitability, productivity, and liquidity aspects of bank performance in India. The purpose of this section is to discuss the research endeavor and output of some of these studies. Sarkar et al (1998) studied the Indian banking industry from the perspective of ownership-performance relationship in a developing economy.

They examined the effect of ownership type on different efficiency measures for two specific years – 1993-94 and 1994-95. Regression analysis was employed in the study for analyzing impact of ownership on profitability and efficiency of banks. The results suggest a weak ownership effect of private banks over public banks. Another important finding was that foreign banks were superior to domestic banks at both profitability and efficiency fronts. Ram Mohan (2002) evaluated the performance of public sector banks both in absolute and relative terms, in order to understand the factors behind their improved performance. The study was carried out for the bank deregulation phase after reforms set into the banking industry in India. It was observed that the efficiency of the banking system as a whole measured by declining spreads had improved during the analysis period. The performance of public sector banks had improved both in absolute and relative terms. Das et al (2004) measured the efficiency of Indian banks using data envelopment analysis for the period 1997- 2003. They found that despite liberalization measures undertaken in the economy, Indian banks hardly differed in terms of technical and cost efficiencies. However, they did differ in terms of revenue and profit efficiencies.

Shanmugan and Das (2004) examined the performance between different categories of Indian scheduled commercial banks for the post-reform decade from 1992 to 1999. They established that the State Bank group and foreign banks performed better in comparison to others. Singla (2008) examined the role of financial management in the growth of banking industry. Profitability position of 16 banks was studied for the period 2001-2006. The study found that the profitability position of the banks was relatively reasonable as compared to earlier years. Azhagaiah and Gejalakshmi (2012) analyzed the financial performance of banking sector in India. 17 private sector banks and 19 public sector banks were assessed using simple regression analysis for estimating the impact of asset management, operational efficiency, and bank size on financial performance. The study concluded that banks with higher deposits, assets and capital do not necessarily imply better financial performance.

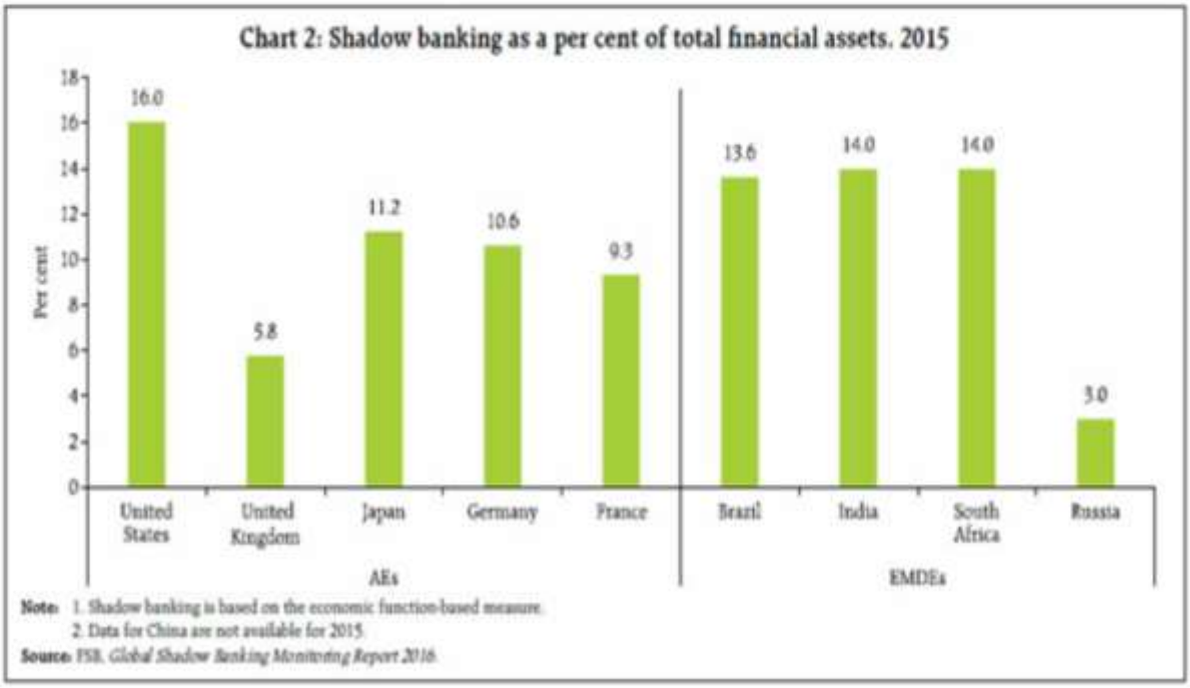
Makkar and Singh (2012) employed ratio analysis to compare the profitability and productivity performance of private and public sector banks. They found that though there is no significant difference in profitability of private and public sector banks, the same is not true in case of productivity of these banks. Rani et al (2013) studied the performance and growth of different commercial bank groups in India for the period 2009-2012, post global economic crisis. In the aftermath of the crisis, the Indian commercial banks were found to show steady positive trends in their performance. The SBI group and private banks were observed to have performed better than other public sector banks. Rao (2013) primarily examined and compared the productivity, cost and profitability performance of traditional banks against modern banks for the period 2005-2011. The study found the gap between the two to have significantly reduced during the analysis period.

Tripathi et al (2014) undertook a comparison of the financial performance of two private sector banks - Axis Bank and Kotak Mahindra Bank. The CAMELS analysis and t-test were employed for the purpose. The study International Journal of Management Studies ISSN(Print) 2249-0302 ISSN (Online)2231-2528 http://www.researchersworld.com/ijms/ Vol.–V, Issue –4(1), October 2018 [3] could not arrive at any major difference between the financial performance of the two banks. Narwal and Pathneja (2015) discussed the determinants of productivity and profitability of public and private sector banks in India. The performance has been measured over two different time periods – 2003 to 2008 and 2009 to 2013.

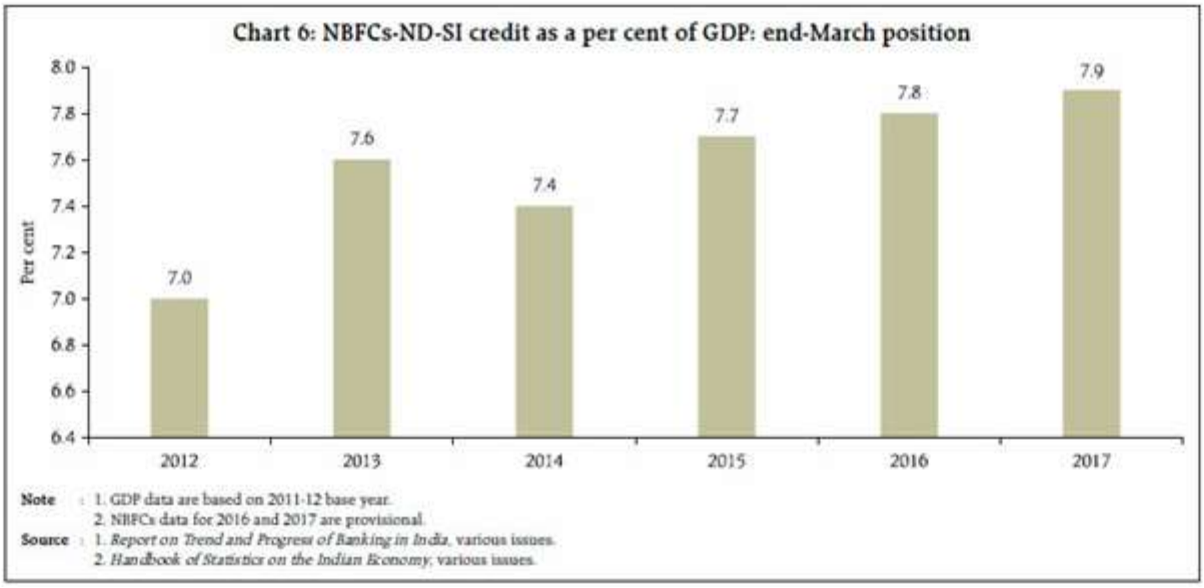
The results of the study reveal that private sector banks are more productive than public sector banks, mainly on account of better usage of technology. However, no significant difference was observed in case of profitability of the bank groups. Yadav and Garima (2015) tried to gauge the overall efficiency and productivity of banks in India.

The study analyzed the employee productivity in the Indian banking sector by undertaking a comparative analysis of the same for five different groups of banks using a number of employee productivity parameters, for the period 2008-2012. Taqi and Mustafa (2018) made an attempt to measure and compare the financial performance of Punjab National Bank and HDFC Bank. The study examined the growth and performance of the two banks for a period of ten years from 2006-2015. Various financial ratios related to banks' efficiency, liquidity and profitability were assessed for both banks. It was found that Punjab National Bank surpassed HDFC Bank in terms of financial soundness, but in the context of deposits and expenditure, HDFC Bank exhibited better management efficiency.

Vadrale and Katti (2018) investigated the profitability performance of selected Indian public and private sector banks during 2001-2015. On the basis of various indicators or ratios of profitability, the study concluded that public sector banks were more stable while private sector banks were more profitable during the period considered for the study.



Source: RBI[1]



Source: RBI[2]

But as soon as the crisis began getting the attention of the policy makers, the blow by pandemic-induced lockdown made the situation grim, as the demand, which was already weak, hit another low, production halted and finance for production dried. At this time, there were no takers and providers for the shadow banks' credit; the commercial banks were way too cautious in their lending operations. As expected, the government had to step in with its largesse consisting of full guarantee (INR 30,000 crore) and partial guarantee schemes (INR 45,000 crore) for keeping the NBFCs afloat. But this support falls short by a huge margin against the lending abilities of NBFCs, roughly totalling INR 27 lakh crores, as pointed out by Abizer Diwanji, Partner, Financial Services at EY. Along with this, the debtors of Microfinance Institutions who are largely the MSMEs are also receiving collateral free loans along with moratorium periods. This indirectly helps the situation of NBFCs somewhat, but not entirely.

The fundamental drawback of all these reform measures is that they choose to ignore the already tattered state of economy before the lockdown and expect the industries to emerge from the ashes like a phoenix. The V-shaped recovery becomes especially impossible in the light of blatant ignorance of demand side reforms by the government. Unsold inventories were the highlight of the story before the lockdown also, causing automobile industry to reduce activity much before the lockdown. In such a situation, the takers of finance will be defaulters, wilful or not. Therefore, the situation of all lenders becomes worse, if not the same because of COVID-19.

Regulation of NBFCs – present situation

The NBFCs are established under the Companies Act, 2015. They are primarily governed by Reserve Bank of India (RBI), except for some NBFCs which are governed by other statutes or relevant institutes, for instance: the insurance companies are regulated by the Insurance Regulatory and Development Authority (IRDA); Venture Capital and stock broking companies are regulated by the Securities and Exchange Board of India (SEBI); Nidhi companies by the relevant provisions of the Companies Act; and Stock Exchanges, Mutual Benefit companies and Chit Fund companies by the Chit Funds Act 1982. The aim is to ensure there is no overlap or dual regulation for the NBFCs. The NBFCs are required to have INR 2 Crores as net owned funds[3]. Essentially, before the crisis hit the town, NBFCs weren't as strictly regulated as they are now, because of their nature, as they aren't exactly banks since they do not accept demand deposits and are not part of the payment and settlement systems. But after the NBFC-HFC (Housing Finance Company) sector showed signs of collapse, it served as a clarion call and several steps were taken to increase the scope of scrutiny. Government granted RBI the power to supersede the board of NBFCs (other than those owned by the government) and work out the resolution of financially distressed entities by either mergers or splitting them up into viable and non-viable units called bridge institutions as well as decide the remuneration of senior management. It also has the powers to conduct the audit of any NBFC, when it deems necessary and remove auditors. Hence, the systematically important NBFCs will be watched closely now. Also, RBI has been entrusted with power to regulate the HFCs (as against the previous arrangements). Apart from these, certain changes were brought to ensure safety of debt, for instance, mandatory maintenance of Debenture Redemption Reserve (DRR), in addition to a special reserve required by RBI, for public debt and on-boarding NBFCs on the Trade Receivables Discounting Systems (TReDS) platform. TReDS is an electronic platform for facilitating the financing / discounting of trade receivables of Micro, Small and Medium Enterprises (MSMEs) through multiple financiers. Last year also, the Finance Minister had announced INR 70,000 crore capital infusion scheme for capital market and dropped the surcharge on FPI (Foreign Portfolio Investment).

Challenges and concerns

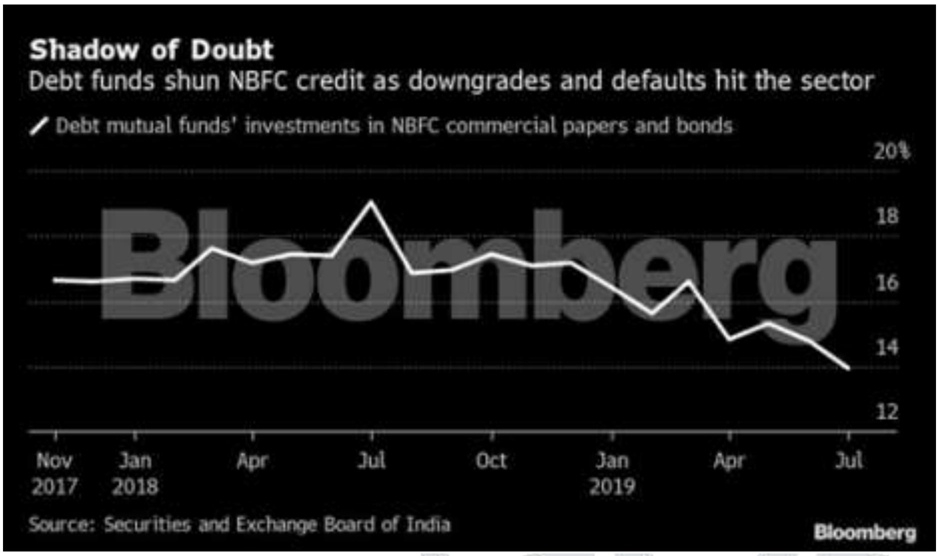
The Financial Stability Report of RBI brings out some key learnings about the NBFC sector, which can be summarised as follows –

Table 2.7: Aggregated balance sheet of the NBFC sector: y-o-y growth[38]

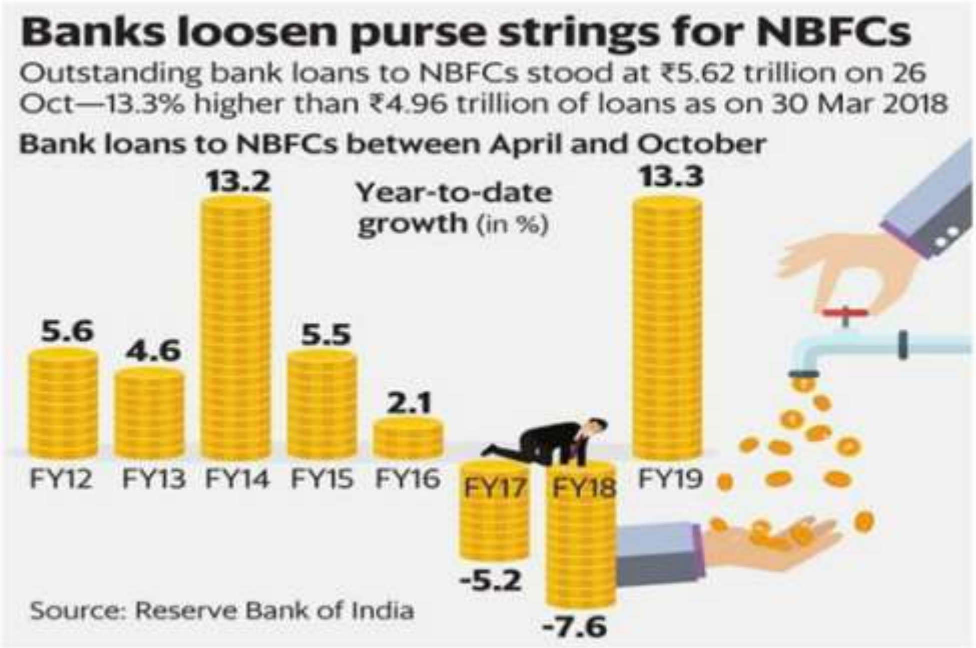
(per cent)

Particulars	Mar-18	Mar-19
1. Share capital	6.0	6.3
2. Reserves and surplus	18.7	14.6
3. Total borrowings	19.6	19.6
Of which 3.1 Debentures	13.1	5.2
3.2 Bank borrowings	34.4	47.9
3.3 Commercial paper	13.3	4.0
4. Current liabilities and provisions	22.4	48.7
Total Liabilities / Assets	17.9	20.6
1. Loans and advances	21.1	18.6
2. Investments	12.9	24.4
3. Others	26.7	-2.0
Income/Expenditure		
1. Total income	11.4	17.8
2. Total expenditure	9.6	17.8
3. Net profit	27.5	15.3

Source: The Reserve Bank's Supervisory Returns.



- In the above table and picture, it can be seen that because of the eroding confidence in NBFCs, the growth of share of commercial papers in total borrowings has declined drastically, which has been compensated by bank borrowings. This was because of swift actions taken by the government by increasing the exposure of banks to NBFCs from 15% to 20%.



Source: Livemint

Table 2.9: Select ratios of the NBFC sector

(per cent)

	GNPA Ratio	NNPA Ratio	CRAR
2014-15	4.1	2.5	26.2
2015-16	4.5	2.5	24.3
2016-17	6.1	4.4	22.1
2017-18	5.8	3.8	22.8
2018-19	6.6	3.7	19.3

Source: The Reserve Bank's Supervisory Returns.

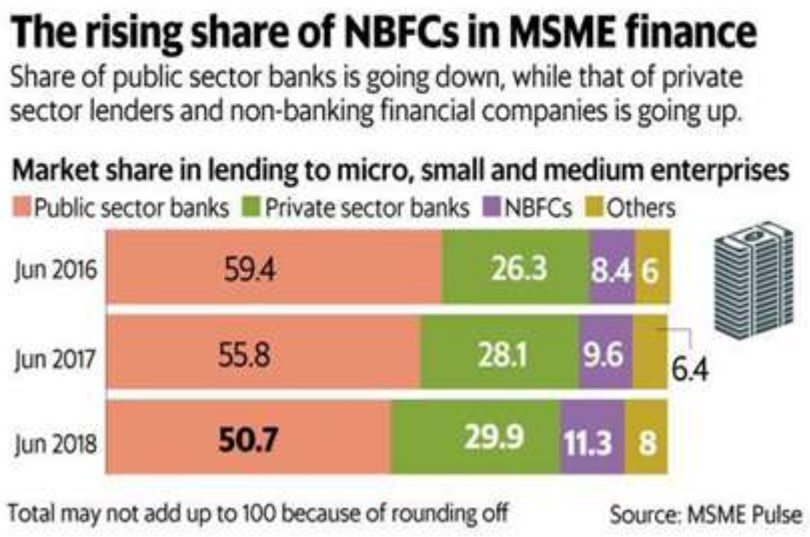
- Gross Non-Performing Assets (GNPA), excluding interest receivable) has been seen an upward trend while Net Non-Performing Assets (NNPA, calculated as GNPA-Interest Suspense Account, DCGC, ECGC claims, part payment received and total provisions held) increased substantially in 2016-17 and decreased marginally only in the last year. On the other hand, major concern is Capital to Risk Assets Ratio (CRAR) has been decreasing since 2014, which is a cause of concern. It is still above the adequacy ratio of 15% for banks, but a constant fall calls for action.
- The crisis is taking a hit on the real estate sector as the supply of funds had reduced by 80% during the period from September 2018 to May 2019. The banks are also hesitant in lending to this sector, which could be detrimental for the economic health of the country.

Recommendations

There are a slew of regulatory and institutional measures which can be taken to stead fasten the slipping NBFC sector' growth.

- Carrying out regular inspections and audits of NBFCs and cancelling the licenses of those who do not comply with the norms. RBI cancelled the licenses of 1,701 NBFCs in FY 2019, as against only 26 the previous year.
- The image of NBFCs catering to huge corporate clients and handling big projects at mass scale needs to be shaken off. A sincere effort needs to be made to expand the market share

and enter into newer customer segments, through innovative products and kits, made for each segment. This will ensure sustainable growth for the NBFC sector as a whole. NBFCs had been stealing the market share of public banks steadily over two years as in the diagram below, but during 2019 their share declined from 13.7% to 12.6% from March'19 to June'19, also the period when their NPAs rose (according to a report on MSMEs by SIDBI).



Source: Livemint

- Introducing Quality Reviews for various asset classes of NBFCs will function as stress tests to ascertain the loss taking ability of an NBFC. RBI has still not incorporated Asset Quality Reviews in the mandate however rating agencies take this parameter into account.
- In 2009, RBI had set up a SPV to channelize funding to the NBFCs, wherein the vehicle received direct funding from RBI and this was used to lend to NBFCs through commercial papers and debentures. The same move can be used again to bolster the confidence in NBFCs.
- More emphasis needs to be laid on microfinance institutions. Following matrix talks about access and sustainability. The NBFCs need to identify their target clients, assess whether they are able to reach them and ascertain where they lie in the matrix and work accordingly.

- The depositors, creditors and borrowers could be made shareholders to ensure that they have sufficient incentive and most importantly, to ensure that interests of both are adequately represented and taken care of.
- The efforts of promoters could also be rewarded by monetising their contribution to the NBFC. This will serve the twin purpose of accountability and ownership.
- Introducing a slab rate for requirement of Net Owned Funds to ensure penetration of NBFCs to all levels, instead of having a blanket figure of INR 2 Crore will be instrumental in revolutionising the NBFCs.
- Cross institutional and industrial learning should be promoted, so that best practices are replicated everywhere and default risks are minimised.
- The importance of having financial history and records of the population of country needs to be realised. This will enable in assigning a credit score to individuals. A study by PWC in association with Assocham says that a mere one-fifth of Indian population has credit score, thus restricting their access to organised credit.

Conclusion

The failure of IL&FS and Dewan Housing Finance Corporation Limited (DHFL) served as a clarion call for the regulatory authorities to spring to action to correct the lackadaisical attitude of NBFC-HFC sector in the country. This was important because finance vertical is the most important pillar of any economy as all other sectors are related to it. The crisis led to a significant crunch in liquidity of the NBFCs, but with the combined effort of government and banks, these were bailed out temporarily. The blow from COVID-19 served to erode the temporary effects whatsoever. Appropriate action calls for long term solutions to the problem. This can be done by repackaging the entire NBFC element and sell it with a fresh outlook and clean slate to make the rebuilding process easier.

[1] The per cent of total financial assets occupied by shadow banking, a term used to collectively refer to financial institutions except banks and post offices, is 14%, which is significantly close to that of developed nation like US. It signifies their importance in the development of economy.

[2] India's external debt to GDP ratio growth has been at par with the growth of NBFC credit to commercial sector as shown here. With increasing uncertainty in the global trade and subsequent currency rates, it is important to shift the locus of credit to inland sources.

[3] Net owned funds comprise the paid-up equity capital, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of assets but not reserves created by revaluation of assets.

PRIVATE SECTOR AND FOREIGN BANKS: The performance analysis has been carried out for three bank groups, namely public sector banks (PSBs), private sector banks (PvtSBs), and foreign banks (FBs). The performance of bank groups has been measured on the basis of three parameters – Productivity, Profitability, and Liquidity. Various ratios have been developed for each of these parameters. The relative performance of bank groups would be observed on the basis of these parameters in the present section. The performance evaluation of bank groups has been carried out for the period 2010 – 2017. This period also coincides with the post global economic crisis phase. Despite the resilience of Indian banking industry, there is greater possibility that the recession that followed the financial crisis of

2008 did affect the banking performance to a certain extent. This is to be seen and analyzed in the ensuing results and discussions. Productivity: The productivity performance of the three bank groups under study has been analyzed on the basis of selected productivity ratios.

Ratios Selected:

The ratios selected for measuring the productivity performance of bank groups are: i. Deposits per Employee: Total Deposits as a ratio of Total No. of Employees

ii. Advances per Employee: Total Advances as a ratio of Total No. of Employees iii. Business per Employee: Total Business as a ratio of Total No. of Employees In this study, Total Business has been calculated as sum total of deposits and advances; for each bank group.

iv. Deposits per Office: Total Deposits as a ratio of Total No. of Bank Offices

v. Advances per Office: Total Advances as a ratio of Total No. of Bank Offices

vi. Business per Office: Total Business as a ratio of Total No. of Bank Offices; where Total Business is the sum total of deposits and advances.

Profitability:

Various profitability ratios have been measured to determine the profitability of public sector, private sector, and foreign bank groups for the period 2010-11 to 2016-17.

Ratios Selected:

The ratios selected for measuring the profitability of bank groups are:

i. Return on Equity: Net Income as a ratio of Total Equity Capital

ii. Return on Assets: Net Income as a ratio of Total Assets

iii. Net Interest Margin: Net Interest (Interest Earned – Interest Expended) as a ratio of Total Assets

iv. Profit/Loss Ratio: Profit/Loss as a ratio of Total Assets Results:

Discussion:

The return on equity of FBs and PSBs has been falling over the analysis period. However, it is relatively increasing to stable for PvtSBs. The average of return on equity is the highest at 14.7% for PvtSBs, followed by FBs at 10.9% and then 6.6% for PSBs. PvtSBs also witness the highest average return on assets at 1.5%. The net interest margin average is 3.3% for both PSBs and PvtSBs but only 2.8% for FBs. Average profit ratio of FBs is four times that of PSBs. PvtSBs have arrived at a profit ratio of 1.4% on an average. CAGR of return on equity is falling for all bank groups during the period under study, which coincides with the phase after financial crisis and the issue of rising NPAs. As compared to PSBs and PvtSBs, FBs show better CAGR for return on assets and net interest margin. The profit of FBs as a ratio of total assets grows at a CAGR of 0.3%. The competing bank groups witness a fall in their CAGR. Private sector banks and foreign banks achieve higher profitability than public sector banks due to factors such as limited exposure to priority sector lending, broader client base in urban areas, optimum financial services, adoption of advanced technology, extremely competitive environment, government's policies post-liberalization, and greater involvement in highly profitable activities.

Liquidity:

The liquidity status of bank groups has been evaluated on the basis of liquidity ratios computed for all the three bank groups for the seven years analysis period, 2010 - 2016.

Ratios Selected:

The ratios selected for measuring the liquidity position of the bank groups are:

i. Liquid Asset Ratio: Liquid Assets expressed as a ratio of Total Assets International Journal of Management Studies ISSN(Print) 2249-0302 ISSN (Online)2231-2528 http://www.researchersworld.com/ijms/ Vol.–V, Issue –4(1), October 2018 [9] Here, for the purpose of the study, Liquid Assets has been calculated as sum of cash in hand, balance with RBI, balance with banks in India, money at call and short notice, and balance with banks outside India; for each bank group.

ii. Liquid Asset - Deposit Ratio: Liquid Assets expressed as a ratio of Total Deposits

iii. Current Ratio: Current Assets expressed as a ratio of Current Liabilities Here, Current Assets are same as Liquid Assets. Current Liabilities have been computed as sum of bills payable, inter-office adjustments, interest accrued, subordinate debt, deferred tax liabilities and others including provisions; for each bank group.

CONCLUSIONS AND OBSERVATIONS:

i. Labor productivity for FBs is the highest followed by PSBs and PvtSBs. Foreign banks have witnessed substantial jump in deposits per employee, advances per employee, as well as the total business generated per employee between 2010-11 to 2016-17.

ii. The productivity performance per branch or office of bank groups reveals a similar picture. In fact, per branch productivity of FBs is outstanding. All the three indicators of productivity show that FBs have far surpassed their competitors, with total business per office amounting to 19799 mn, over the period of study.

iii. The profitability indicators of bank groups point towards a better performance by PvtSBs as compared to its competitors. PvtSBs have outperformed the PSBs and FBs in terms of return on equity, return on assets and net interest margin, over the analysis period. However, when it comes to average profits as a ratio of total assets, it is the FBs that achieve the highest at 1.6%.

iv. The measures of liquidity position of bank groups reveal that PSBs have a current ratio of 2.3, followed by 1.4 for PvtSBs and 0.7 for FBs. PSBs are following prudential norms and set standard policies, sufficing to the requirement of 2:1 for current ratio. International Journal of Management Studies ISSN(Print) 2249-0302 ISSN (Online)2231-2528 http://www.researchersworld.com/ijms/ Vol.–V, Issue – 4(1), October 2018 [10]

v. Although FBs show high ratio of liquid assets to total assets as well as to deposits, their current ratio (0.7 average) is skewed. They are holding lesser proportion of liquid assets in relation to their current liabilities, indicating over lending and poor safety margin standards followed by FBs. On the other hand, FBs have a large customer base, efficient working and operations, and impressive customer service. Their presence is largely prominent over the urban landscape with creditors from industry and elite backgrounds. They work on the model of lost cost to income ratio. With relatively low operating costs, they are able to manage high profits.

vi. The performance analysis of Indian bank groups reveals that at the productivity front, the foreign banks have been leading the industry. In terms of the profitability indicators, private sector banks as well as foreign banks have shown outstanding performance. The status of liquidity of bank groups shows that foreign banks hold high quantum of liquid assets to total assets and to total deposits, yet their current ratio is poor indicating non-compliance of standard prudential measures.