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# NBFCs: A Step Ahead to Assist Financial Inclusion Policy of RBI

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**Abstract—***An emerging economy like India has huge economic and social obligations to be fulfilled for its citizens. The financial system is an adage in meeting these targets. In India the Banking set up has the herculean responsibility of financial inclusion and economic empowerment. As the banks are practically limited to the growth of urban areas and the educated community, non-banking financial institutions along with regional rural banks, self-help groups and microfinance institutions can take the lead in mitigating the gap between rich and poor and also work on moderating the rural urban divide. Financial empowerment for the poor requires more generous treatment by the banking officials and easy terms and conditions. Though this may raise the risk of default by the customers, its importance cannot be nullified in context of the huge rural and poor population who require immediate education and assistance about banking facilities. This will also reduce the role of unorganized financial sector among poor people. Holding a bank account is just the preliminary issue. The main concern should be to make the banking and non-banking set-up easily approachable to the poor population so that they are not exploited for loans, investments, hire purchase finance, investment lease finance etc.*

*In the above context NBFCs has always been an important supporting system to empower the rural and urban poor. Hence this paper will focus on the scope of NBFCs and its relevance in India. The basic objectives will be to analyze: A) the profit trends of NBFCs. B) the loan and deposit issues and C) Funding of NBFCs.*

## 1. INTRODUCTION

India is an emerging economy and the good financial health is a strong requirement for sustaining the economic growth of the nation. As per RBI definition Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property. A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company). [i]According to the Economic Survey 2010-11, it has been reported that NBFCs as a whole account for 11.2 per cent of assets of the total financial system.

[ii]With the growing importance assigned to financial inclusion, NBFCs have come to be regarded as important financial intermediaries particularly for the small-scale and retail sectors. Non-Banking Financial Companies (NBFC) have rapidly emerged as an important segment of the Indian financial system. Moreover, NBFCs assume significance in the small business segment as they primarily cater to the credit requirements of the unorganizedsector such as wholesale & retail traders, small-scale industries and small borrowers at the local level. NBFC is a heterogeneous group of financial institutions, performing a wide range of activities like hire-purchase finance, vehicle financing, equipment lease finance, personal loans, working capital loans, consumer loans, housing loans, loans against shares and investment, etc. NBFCs are broadly divided into three categories namely (i) NBFCs accepting deposits from banks (NBFC-D); (ii) NBFCs not accepting/holding public deposits (NBFC-ND); and (iii) core investment companies (i.e. those acquiring share/securities of their group/holding/subsidiary companies to the extent of not less than 90% of total assets and which do not accept public deposits.). It has innovative marketing strategies, customer oriented services, attractive rate of returns on services provided by it, easy documentation proceduresetc. Therefore we can say that NBFCs have grown as an integral part to the financial sector especially due to competitive prices and low cost operations for small scale sectors. The points below better defines the major functions of NBFCs.

**Table 1: Showing the Number of NBFCs.**

| End June | Number of Registered NBFCs | Number of NBFCs-D | Number of NBFCs-ND-SI |
|---|---|---|---|
| 2005 | 13,261 | 507 | - |
| 2006 | 13,014 | 428 | 149 |
| 2007 | 12,968 | 401 | 173 |
| 2008 | 12,809 | 364 | 189 |

| | | | |
|---|---|---|---|
| 2009 | 12,740 | 336 | 234 |
| 2010 | 12,630 | 308 | 260 |
| Source: RBI | | | |

The above figures clearly state that there is a declining trend in the extension of NBFCs in recent year. The major reasons could be long term profit trends and the regulation as well as sustainability issues. NBFCs typically have several advantages over banks due to their focus on niche segment, expertise in the specific asset classes, deeper penetration in the rural and unbanked markets. However, on the flip side, they depend to a large extent on bank borrowings, leading to high cost of borrowings and face competition from banks which have lower cost of funds. Financial institutions and there customer base play an important role in maintaining the functioning of NBFCs.

**Table 2: Showing Impact Analysis of Key Changes.**

| Change in Norm | Impact |
|---|---|
| NBFCs registered prior to April, 1999 to raise their Net Owned Funds NOF to Rs.2 crore by March, 2017 | Brings in parity for NBFCs formed prior to and after April, 1999<br>Ensures only serious and competitive players with minimum NOF remain in the market |
| Limit on deposit acceptance reduced to 1.5 times of Owned Funds from 4 times of Owned Funds for Deposit taking AFCs and mandatory investment grade credit rating for accepting public deposits | Mandatory investment grade credit rating helps to safeguard depositors<br>limit on deposits improves safety for public depositors<br>However, majority of deposit taking NBFCs are already compliant |
| Revision in threshold for defining systemically important NBFC to asset size of Rs.500 crore from Rs.100 crore | Larger NBFCs subjected to more stringent norms. However, regulatory compliance requirement reduced for NBFCs having assets size between 100 crore to 500 crore |
| Multiple NBFC that are part of a corporate group or floated by common set of promoters will not be viewed on standalone basis | To help regulate groups having multiple small NBFCs and bring them under more regulatory supervision |

## 2. LITERATURE REVIEW

According to the legal updates of ***An Overview of the Indian NBFC Sector Performance in 2010, prospects in 2011***, since NBFCs have been kept outside the purview of SARFAESI Act, a reform in this area is quite urgently needed. A suitable legislative amendment extending the operation of the said Act to NBFCs too would go a long way in fortifying the faith of the investors and which in turn would greatly contribute to the growth of this Sector. The coming years will be very crucial for NBFCs and only those who will be able to face the challenge and prove themselves by standing the test of time will survive in the long run.

As per the research paper ***The Growth of a Shadow Banking System in Emerging Markets: Evidence from India***, Shadow banking is an emerging financial set up in developing countries and is quite different from the developed economies financial institutions. Also since these NBFCs are relatively well regulated on the capital front, it is primarily their linkage to the banking sector that stands out as a potential concern for systemic risk considerations.

Another article of ***India Ratings and Research Report, 2014 Outlook: Major Non-Bank Finance Companies***, NBFCs have strong dependence on bank fundings. NBFCs had increased capital market funding in FY13 and the trend was expected to continue in 2014 as the major NBFCs could raise debt from the market at 50-70 basis points lower than banks' base rates. However, due to the tight liquidity conditions in 2QFY14 following RBI's decision to hike short-term interest rates (to protect the falling rupee), the market access of most NBFCs was impacted for some time and the bank borrowings became a preferred channel. The low corporate loan demand at banks has also supported NBFCs' bank borrowings.

Further the ***Report of the Key Advisory Group on the Non-Banking Finance Companies (NBFCs)*** says NBFCs over the years have played a very vital role in the economy. They have been at the forefront of catering to the financial needs and creating livelihood sources of the so-called unbankable masses in the rural and semi-urban areas. Through strong linkage at the grassroots level, they have created a medium of reach and communication and are very effectively serving this segment. Thus, NBFCs have all the key characteristics to enable the government and regulator to achieve the mission of financial inclusion in the given time.

## 3. LOAN AND DEPOSIT ISSUES

All NBFCs are not entitled to accept public deposits. Only those NBFCs to which the Central Bank had given a specific authorization are allowed to accept/hold public deposits. Yes, there is a ceiling on acceptance of Public Deposits by NBFCs authorized to accept deposits. An NBFC maintaining required minimum NOF/Capital to Risk Assets Ratio (CRAR) and complying with the prudential norms can accept public deposits as follows:

**Table 3: Showing Deposits of NBFCs Limit.**

| Category of NBFC having minimum NOF of Rs. 200 lakhs | Ceiling on public deposit |
|---|---|
| 1. AFC* maintaining CRAR of 15% without credit rating | 1. 1.5 times of NOF or Rs 10 crore whichever is less |
| 2. AFC with CRAR of 12% and having minimum investment grade credit rating | 2. 4 times of NOF |

| | |
|---|---|
| 3. LC/IC** with CRAR of 15% and having minimum investment grade credit rating | 3. 1.5 times of NOF |
| * AFC = Asset Finance Company | |

*Source*: *http://rbi.org.in/scripts/FAQView.aspx?Id=71*

[iii]Ind-Ra (INDIA RATINGS AND RESEARCH:A FITCH GROUP COMPANY) has estimated that the gross non-performing loan ratio of the eight NBFCs to reach 4.20% at FYE15 (FYE13: 2.53%). The credit costs could reach 2.3% of loans in FY15(FY13:1.82%), but will be well covered by the pre-provision operating profit (PPOP) of 6.17% (6.55%). However, if the collateral values were to decline sharply and the industrial/economic growth does not pick up as envisaged, the credit costs could spike and impact NBFCs with high unseasoned portfolios in particular, though this is not Ind-Ra's base case. Also Ind-Ra expects the moderate loan growth witnessed in 1HFY14 at these NBFCs to continue and management focus to shift more on improving recoveries and collection efficiency, and control operating costs. The disbursements are likely to remain subdued till 3QFY15 in various key segments, such as commercial vehicles (CV) – heavy and medium CVs (HMCVs), light CVs (LCVs), construction equipment (CE), and in passenger vehicles (PVs). Agricultural equipment (AE), mainly tractor financing, is expected to remainsteady, although the 2014 monsoon will determine the outlook for 2015.

[iv]Some of the important regulations relating to acceptance of deposits by NBFCs are as under:

i. The NBFCs are allowed to accept/renew public deposits for a minimum period of 12 months and maximum period of 60 months. They cannot accept deposits repayable on demand.
ii. NBFCs cannot offer interest rates higher than the ceiling rate prescribed by RBI from time to time. The present ceiling is 12.5 per cent per annum. The interest may be paid or compounded at rests not shorter than monthly rests.
iii. NBFCs cannot offer gifts/incentives or any other additional benefit to the depositors.
iv. NBFCs (except certain AFCs) should have minimum investment grade credit rating.
v. The deposits with NBFCs are not insured.
vi. The repayment of deposits by NBFCs is not guaranteed by RBI.
vii. Certain mandatory disclosures are to be made about the company in the Application Form issued by the company soliciting deposits.

[v]On October 10, 2000, the Reserve Bank issued guidelines for issue of commercial paper by companies, inter alia, exempting money received by NBFCs by issue of commercial paper (CP) in accordance with these guidelines, from the purview of public deposits. The Reserve Bank announced ALM (*Asset Liability Management*) guidelines for NBFCs for effective risk management. All NBFCs with asset size of Rs.100 crore or above or with public deposits of Rs.20 crore or above, as per their balance sheet as on March 31, 2001, were instructed to have ALM systems in place. These NBFCs were advised to constitute an ALM Committee, under the charge of Chief Executive Officer or other Senior Executive and other specialist members, for formalizing ALM systems. The number of companies likely to be covered by the guidelines is about 70 and they account for 75-80 per cent of total public deposits held by reporting NBFCs. The ALM system is required to be implemented by NBFCs by March 31, 2002. In the case of NBFCs holding public deposits of Rs.20 crores or above, the first ALM return, comprising of statements on structural liquidity, short-term dynamic liquidity and interest rate sensitivity, as on September 30, 2002, should be submitted to the Reserve Bank by October 31, 2002. NBFCs not holding public deposits, but having asset size of Rs.100 crore or above would be advised of the supervisory framework in due course of time. The companies have been advised to conduct trial runs during the half-year ending September 30, 2001 and half-year beginning October 1, 2001, and report operational difficulties in implementing the system for rectification. The Chit Funds and Nidhi companies have, for the present, been kept out of the purview of these guidelines. NBFCs not qualifying presently have also been advised to put in place an ALM system, as it is the endeavor of the Reserve Bank to extend these guidelines to all NBFCs in future.

The number of NBFCs has decreased from 13,014 in FY06 to 12,409 in FY11however thesector has grown by 2.6 times between FY06 and FY11 at a CAGR of 21%. It accounted for 10.8% in terms of outstanding advances and 13% in terms of assets of the banking system in FY06. This share has risen to 13.2% and 13.78% respectively in FY11. In terms of deposits the share of public deposits held by NBFCs as compared to deposit base of banks has decreased from 1.05% in FY06 to 0.22% in FY11.

Public deposits held by NBFCs have shown a falling trend, decreasing by approximately 48% in the last 5 years, while owned funds (reserves & surplus and capital deployed) have gone up by 195%. The outstanding advances have grown approximately 3 times in the last 5 years to reach Rs.536, 074 crores in FY11. Banks' exposure to NBFCs has increased from Rs.62,308 crore in FY06 to Rs.183,839 crore in FY11, an increase of approximately 3 times growing at a CAGR of 24% during the period FY06-FY11 and a 37% increase over FY10.

**Table 4: Showing Comparison with Banking Sector.**

| | **FY06 (Rs.Cr)** | **FY10 (Rs.Cr)** | **FY11 (Rs.Cr)** |
|---|---|---|---|
| No. of NBFCs | 13,014 | 12,630 | 12,409 |
| Bank credit of all Scheduled Banks* | 1,572,780 | 3,337,659 | 4,060,843 |
| NBFC advances as a % of Bank credit | 10.77% | 12.57% | 13.02% |

| | | | |
|---|---|---|---|
| Assets of all Scheduled Banks* | 2,531,462 | 5,258,495 | 6,146,590 |
| NBFC assets as a % of Bank assets | 13.06% | 13.33% | 13.78% |
| Deposits of all Scheduled Banks* | 2,185,809 | 4,635,224 | 5,355,160 |
| NBFC Public Deposits as a % of Bank Deposits | 1.05% | 0.37% | 0.22% |

*Scheduled Banks include Scheduled commercial banks and Co-operative Banks
For FY06 - 218 and 71, Total – 289,
For FY11 - 163 and 69, Total – 232
Source: *Report of the Key Advisory Group on the Non-Banking Finance Companies (NBFCs)*

[vi]At present, every NBFC is required to make a provision for standard assets at 0.25% of the outstanding. On a review of the same, the provision for standard assets for NBFCs-ND-SI and for all NBFCs-D, is being increased to 0.40%. The compliance to the revised norm will be phased in as given below:

- 0.30% by the end of March 2016
- 0.35% by the end of March 2017
- 0.40% by the end of March 2018

## 4. CAPITAL FUNDINGS

The Indian economy has been witnessing high rates of growth in the last few years. Financing requirements have also risen commensurately and will continue to increase in order to support and sustain the tremendous economic growth. NBFCs have been playing a complementary role to the other financial institutions including banks in meeting the funding needs of the economy. They help fill the gaps in the availability of financial services that otherwise occur in bank-dominated financial systems. The gaps are in regards the product as well customer and geographical segments.

Ind-Ra expects the NBFCs to maintain adequate capital buffers in view of their high asset concentrations. The moderating loan growth will benefit their capitalization. All the major NBFCs had Tier I ratios above 10% in 1HFY14 and at FYE13.

Ind-Ra does not expect any material change in the NBFCs' funding profile in 2014. The dependence on bank financing is expected to remain high, as the Indian debt capital market remains underdeveloped and lacks depth. Regulatory changes in the last two years, along with tight liquidity conditions in 2QFY14/ 3QFY14 have also created challenges for the NBFCs to move away from bank financing. In addition, the uncertain regulatory stance, following unfavourable regulatory changes in the last two years, has underlined the importance of bank borrowing for NBFCs. In FY13, the Securities & Exchange Board of India introduced a sectoral cap of 30% on mutual funds' debt investment, and in 2QFY14, RBI introduced rules that included limiting the number of investors in private issuances, a floor on minimum subscription and a prerequisite for debenture issues to be fully secured.

The capital adequacy norms were made applicable to NBFCs in 1998. The norms relating to capital adequacy ratio (CAR) stipulate that every NBFC shall maintain a minimum capital ratio consisting of tier I and tier II capital that shall not be less than (a) 10 per cent on or before March 31, 1998; and (b) 12 per cent on or before March 31, 1999, of its aggregate risk-weighted assets and of risk-adjusted value of off-balance sheet items. The total of tier II capital, at any point of time, shall not exceed 100 per cent of tier I capital. Table V.12 presents CAR of the reporting companies for the years ended March 1999 and March 2000, respectively.

## 5. PROFIT TRENDS

Different credit rating agencies have come up with their reports on the expansion and financial health of the NBFCs. The NBFC sector has been gaining systemic importance in the recent years and the share of NBFC has steadily grown from 10.7% of banking assets in 2009 to 14.3% of banking assets in 2014. On the profitability front, as per CARE's estimates ROTA will see an impact in the range of 35-45 bps due to rise in standard asset and NPA provisioning upon complete implementation of the revised framework. The revised regulatory framework for non-banking finance companies (NBFCs) would have a short-term impact on profitability due to the increased provisioning and on account of the revised asset classification norms, but the phased introduction of the norms is likely to cushion any adverse impact on them, said R Gandhi, deputy governor, Reserve Bank of India.

According to Fitch research group the rising credit costs and elevated funding costs will impact NBFCs' profitability, but it will still remain adequate. Ind-Ra expects return on assets (ROA) of 2.20% in FY15 (FY13: 2.70%) and return on equity (ROE) of 15.60% (18.57%).The Reserve Bank of India's (RBI) new norms for NBFCs may reduce the risk they pose to the financial system, but it will reduce profitability and increase non-performing assets (NPAs) of the industry with only 20% of the NBFCs adopting 90-day NPA recognition norm.The revised regulatory framework for non-banking financial companies will slice around 40 basis points of their profitability gradually over the next four years till March 31, 2018, according to a report by rating firm Crisil. RBI has stipulated 90-day NPA recognition norm. Retail NBFCs that have not implemented the 90-day NPA recognition norm so far would see a change in their gross NPAs. Such NBFCs currently account for 63% of the total managed advances of Rs 3.7 trillion, in Icra's estimates.

## 6. CONCLUSIONS

The cyclical stress on asset quality and profitability of NBFCs is covered by strong capital adequacy, secured lending and lower ALM risk. With increased importance of NBFC sector Structural support expected from regulator is higher. The NBFCs have maintained stable asset quality, although cyclical pressures have started to push up delinquencies. A stable operating performance has facilitated their access to funding from banks and capital markets. A protracted and sharp contraction in industrial activities (and overall economic growth) can adversely impact their credit quality. The asset quality pressuresin such a scenario could exceed Ind-Ra's assumptions and lead to negative rating actions. Conversely, a strong through-the-cycle operating performance, stable asset quality, robust capital buffers and diversified funding profile can lead to positive rating actions. Non-banking Financial Institutions carry out financing activities but their resources are not directly obtained from the savers as debt. Instead, these Institutions mobilize the public savings for rendering other financial services including investment. All such Institutions are financial intermediaries and when they lend, they are known as Non-Banking Financial Intermediaries (NBFIs) or Investment Institutions. Apart from these NBFIs, another part of Indian financial system consists of a large number of privately owned, decentralized, and relatively small-sized financial intermediaries. Most work in different, miniscule niches and make the market more broad-based and competitive. While some of them restrict themselves to fund-based business, many others provide financial services of various types.

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All NBFCs (excluding Primary Dealers)