An Overview of the Indian NBFC Sector Performance in 2010, prospects in 2011

Nidhi Bothra, ACS
nidhi@vinodkothari.com

&

Kamil Sayeed, BA.LLB.
kamil@vinodkothari.com

Legal Updates

Significance of NBFCs in India:

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. 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.

In the multi-tier financial system of India, importance of NBFCs in the Indian financial system is much discussed by various committees appointed by RBI in the past and RBI has been modifying its regulatory and supervising policies from time to time to keep pace with the changes in the system.

NBFCs have turned out to be engines of growth and are integral part of the Indian financial system, enhancing competition and diversification in the financial sector, spreading risks specifically at times of financial distress and have been increasingly recognized as complementary of banking system at competitive prices. The Banking sector has always been highly regulated, however simplified sanction procedures, flexibility and timeliness in meeting the credit needs and low cost operations resulted in the NBFCs getting an edge over banks in providing funding.
Since the 90s crisis the market has seen explosive growth, as per a Fitch Report[1] the compounded annual growth rate of NBFCs was 40% in comparison to the CAGR of banks being 22% only.
NBFCs have been pioneering at retail asset backed lending, lending against securities, microfinance etc and have been extending credit to retail customers in under-served areas and to unbanked customers.

Meaning and Types of NBFCs:

Section 45I of the Reserve Bank of India Act, 1934 defines ''non-banking financial company'' as–

(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;

---

[1] Non-Bank Financial Institutions in India: Performance Trends and Outlook, Fitch Friday Presentation, Ananda Bhoumik & Arshad Khan, December, 2008 Report

Legal Updates

(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;

Hence in short an NBFC may be defined as a company registered under the Companies Act, 1956 and also registered under the provisions of Section 45-IA of the Reserve Bank of India Act, 1934 and which provides banking services without meeting the legal definition of bank such as holding a banking license. NBFCs are basically engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principle business is that of agricultural activity or any industrial activity or sale, purchase or construction of immovable property.

NBFCs vs. Conventional Banks:

- An NBFC cannot accept demand deposits, and therefore, cannot write a checking facility.
- It is not a part of payment and settlement system which is precisely the reason why it cannot issue cheques to its customers.
- Deposit insurance facility of DICGC is not available for NBFC depositors unlike in case of banks.
- SARFAESI Act provisions have not currently been extended to NBFCs. Besides the above, NBFCs pretty much do everything that banks do.

A table comparing the functions/limitations of Banks with NBFCs is as follows:

	BANKS	**NBFCS**
Definition	Definition: banking is acceptance of deposits withdrawable by cheque or demand; NBFCs cannot accept demand deposits	NBFCs are companies carrying financial business

Legal Updates

Scope of business	Scope of business for banks is limited by sec 6 (1) of the BR Act	There is no bar on NBFCs carrying activities other than financial activities
Licensing requirements	Licensing requirements are quite stringent. Transfer of shareholding also controlled by RBI	It is quite easy to form an NBFC. Acquisition of NBFCs is procedurally regulated but not approval required
Major limitations on business	No non-banking activities can be carried	Cannot provide checking facilities
Major privileges	Can exercise powers of recovery under SARFAESI and DRT law	Do not have powers under SRFAESI or DRT law
Foreign investment	Upto 74% allowed to private sector banks	Upto 100% allowed
Regulations	BR Act and RBI Act lay down stringent controls over banks	Controls over NBFCs are relatively much lesser
SLR/CRR requirements	Banks are covered by SLR/ CRR requirements	NBFCs have to maintain a certain ratio of deposits in specified securities; no such requirement for non-depository companies
Priority sector lending requirements	Certain minimum exposure to priority sector required	Priority sector norms are not applicable to banks

Classification of NBFCs based on the Nature of its business:

The NBFCs that are registered with RBI are basically divided into 4 categories depending upon its nature of business:

- equipment leasing company;

- hire-purchase company;
- loan company;
- investment company;
- Infrastructure finance company.

Reclassification of NBFCs w.e.f. 6th December, 2006:

However in terms of the NBFC Acceptance of Public Deposits (Reserve Bank) Directions, 1988 with effect from December 6, 2006 the above NBFCs registered with RBI have been reclassified as:

➢ Loan Company (LC)

Loan company means any company which is a financial institution carrying on as it's principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

➢ Investment Company(IC)

Investment Company is a company which is a financial institution carrying on as it's principal business the acquisition of securities.

Investment Companies are further divided into following sub-categories:

- **Core Investment Companies:**

The Reserve Bank of India vide its Notification No. DNBS(PD)CC.No. 197/03.10.001/2010-11 dated August 12, 2010, a new class of NBFCs by the name of 'Core Investment Companies' (CIC) was added

Core Investment Companies in terms of RBI's Notification means:

a non-banking financial company carrying on the business of acquisition of shares and securities and which satisfies the following conditions as on the date of the last audited balance sheet:-

(i) it holds not less than 90% of its net assets in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies;

(ii) its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its net assets

Net assets, for the purpose of this proviso, would mean total assets excluding –

- cash and bank balances;
- investment in money market instruments and money market mutual funds
- advance payments of taxes; and
- deferred tax payment.

(iii)it does not trade in its investments in shares, bonds, debentures, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;

(iv) it does not carry on any other financial activity referred to in Section 45 I (c) and 45 I (f) of the Reserve Bank of India Act, 1934 except:

a) investment in

i. bank deposits,
ii. money market instruments, including money market mutual funds,
iii. government securities, and
iv. bonds or debentures issued by group companies;

b) granting of loans to group companies; and

c) issuing guarantees on behalf of group companies.

- **Other Companies**

Legal Updates

➢ Asset Finance Company (AFC)

AFC would be defined as any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive / economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines. Financing of physical assets may be by way of loans, lease or hire purchase transactions.

Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60% of its total assets and total income respectively.

➢ Mutual Benefit Financial Company (MBFC)

Mutual Benefit Financial Company means a company which is a financial institution notified by The Central Government under section 620A of The Companies Act 1956.

The above-mentioned types of NBFCs may be further classified into:

- NBFCs accepting public deposit (NBFCs-D) and
- NBFCs not accepting/holding public deposit (NBFCs-ND).

Operating leasing entities:

Operating leasing companies do not come under the RBI definition of NBFCs since operating lease is not “equipment leasing” business as defined by the RBI. Only financial leasing is included in the RBI definition of equipment leasing.

Further Classification of NBFCs-ND based on the Size of its Asset:

NBFCs-ND may also be classified into **(i)** Systematic Investment and **(ii)** Non-Systematic Investment NBFCs based on the size of its asset.

Legal Updates

➢ Systemically Important NBFCs-ND

An NBFC–ND with an asset size of Rs.100 crore and more as per the last audited balance sheet
is considered as systemically important NBFCs–ND (NBFC-ND-SI). However NBFCs–ND– SI are required to maintain a minimum CRAR of 10 per cent. No NBFC–ND–SI is allowed to:

a) lend to any single borrower/group of borrowers exceeding 15 per cent / 25 per cent of its owned fund;
b) invest in the shares of another company/ single group of companies exceeding 15 per cent /25 per cent of its owned fund; and (iii) lend and invest (loans/investments taken together) exceeding 25 per cent of its owned fund to a single party and 40 per cent of its owned fund to a single group of parties.

➢ Non-Systematically Important NBFCs-ND

A NBFC–ND whose asset size does not exceed Rs.100 crore as per the last audited balance sheet may be considered as Non-systemically important NBFCs–ND (NBFC-ND-SI).

Number of NBFCs registered with the RBI:

The following table shows the number of NBFCs registered with the Reserve Bank of India and the trend of registration of companies as NBFC since the last decade. The table as given below also indicates registration of deposit accepting NBFCs of the total NBFCs registered with RBI.

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

Funding sources of NBFCs:

Funding sources of NBFCs include debentures, borrowings from banks and FIs, Commercial Paper and inter-corporate loans. Table below provides for funding sources of Non Banking Financial Companies – Non Deposit Taking – Systematically Important:

Major Sources of Funds of NBFCs-ND-SI

Source of Fund	March 2008 (Percentage to total liabilities)	March 2009 (Percentage to total liabilities)
1. Debentures	21.7	28.3
2. Commercial Paper	4.9	4.5
3. Borrowings from Banks and FIs	19.8	18.5
4. Inter-corporate Loans	5.4	2.8
5. Others	14.1	15.2

Source: RBI Report on Trend & Progress of Banks.

Source: http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=586#CH5

Banks are also a major source of funding for NBFCs either directly or indirectly. So in a way NBFCs have a dependence on banks making them vulnerable to systemic risks in the financial system.

Funding by NBFCs:

Historically, banks have played the role of intermediaries between the savers and the investors. However, in the last few decades, the importance and nature of financial intermediation has undergone a dramatic transformation the world over. The dependence on bank credit to fund investments is giving way to raising resources through a range of market based instruments such as the stock and bond markets, new financial products and instruments like mortgage and other asset backed securities, financial futures and derivative instruments like swaps and complex options. Besides transferring resources from savers to investors, these instruments enable allocation of risks and re-allocation of capital to more efficient use. The increase in the breadth and depth of financial markets has also coincided with a pronounced shift among the ultimate lenders who have moved away from direct participation in the financial markets to participation through a range of intermediaries. These developments in international financial markets have been mirrored in the financial market in India.

NBFCs account for 11.2% of the assets of the total financial system[2]. NBFCs have emerged as an important financial intermediary especially in the small scale and retail sector. There are a total of 12,630 NBFCs (end of June 2010) registered with RBI consisting of NBFCs-D and NBFCs-ND. Of the 11.2%, asset finance companies held the largest share of assets of nearly 74.5% and also held the largest share of deposits amongst the NBFCs-D segment by end of March, 2010.

NBFCs are typically into funding of:

- Construction equipment
- Commercial vehicles and cars
- Gold loans
- Microfinance
- Consumer durables and two wheelers
- Loan against shares, etc.

List of major products offered by NBFCs in India:

- Funding of commercial vehicles
- Funding of infrastructure assets
- Retail financing
- Loan against shares
- Funding of plant and machinery

[2] Economic Survey 2010-11 http://indiabudget.nic.in/es2010-11/echap-05.pdf

- Small and Medium Enterprises Financing
- Financing of specialized equipment
- Operating leases of cars, etc

Types of instrument generally executed:

- Loans
- Hire purchase
- Financial lease
- Operating lease

Performance of the NBFC Sector during 2009-10

Hire purchase and loans and advances by NBFCs witnessed a growth of 7.6% and 42.7% respectively during 2009-10 as compared to 6.8% and 14.7% respectively in the previous year.

Total assets/ liabilities of NBFCs-D (excluding RNBCs) expanded at the rate of 21.5 per cent during 2009-10 as compared to 3.4 per cent during 2008- 09. Borrowings, a major source of funds for NBFCs-D, increased by 23.6 per cent, while public deposits increased by 38.4 per cent. Total investments of NBFCs-D increased by 23.3 per cent during 2009-10 primarily on account of rise in Non-SLR investments. The asset size of NBFCs-D varies significantly between less than 25 lakh to above 500 crore. NBFCs-D with asset size of above 500 crore were holding 97.5 per cent of total assets of all NBFCs-D, while the remaining 213 held about 2.5 per cent in end-March 2010.

The financial performance of NBFCs-D in 2009-10 witnessed moderate deterioration which also reflected in the decline in the operating profits. This was due to increase in expenditure over income. The cost to income ratio declined from 74 per cent in 2008-09 to 81.8 per cent in 2009-10. Non-interest cost at 97.4 per cent continued to constitute the dominant share in total cost of the NBFCs-D during 2009-10 while interest cost accounted for a smaller share.
There was a decline in the gross NPAs to gross advances ratio of NBFCs-D in 2009-10 as well. Gross NPA and net NPA ratios of AFCs and loan companies declined during 2009-10 as compared to the previous year.
Capital to risk-weighted assets ratio (CRAR) norms were made applicable to NBFCs-D in 1998, whereby every NBFC-D is required to maintain a minimum capital, consisting

of Tier I and Tier II capital, not less than 12 per cent (15 per cent in the case of unrated deposit-taking NBFCs) of its aggregate risk-weighted assets. As at the end of March 2010, 212 out of 216 reporting NBFCs-D had CRAR of more than 12 per cent as against 221 out of 225 in end-March 2009. It may be pointed out that the NBFC sector has been witnessing a consolidation process in the last few years, wherein the weaker NBFCs are gradually exiting, paving the way for a stronger sector.

The total assets of deposit-taking NBFCs-D sector registered a significant growth during 2009-10 mainly on account of increase in the assets of asset finance companies. As at end-March 2010, around three-fourths of the total assets of the NBFCs-D sector were held by assets finance companies.

On the other hand, in case of NBFCs ND-SI secured loans continued to constitute the largest share (44.3 per cent of total assets), followed by unsecured loans (17.8 per cent), hire purchase assets (7.4 per cent), investments (17.4 per cent), cash and bank balances (4.5 per cent), and other assets (8.4 per cent) during the year ended March 2010.

The balance sheet of NBFCs-ND-SI stood at Rs. 5,63,476 crore in end-March 2010 as compared to Rs. 4,82,907 crore in end-March 2009 thereby registering a growth of 16.7 per cent during 2009- 10. This significant increase in balance sheet size of NBFCs-ND-SI is mainly attributed to sharp increase in owned funds, debentures, bank borrowings, commercial paper, and other liabilities. Owned funds (which accounted for 25.8 per cent of total liabilities) increased by 11.3 per cent during 2009-10. Total borrowings (secured and unsecured) by NBFCs-ND-SI increased by 19.6 per cent to Rs. 3,81,850 crore and formed 67.7 per cent of total liabilities. During the period ended June 2010, total borrowings further increased by 8.3 per cent to Rs. 4,13,476 crore.

The pattern of deployment of funds by NBFCs-ND-SI in the year ended March 2010 remained broadly in line with that witnessed during the previous year. Secured loans continued to constitute the largest share (44.3 per cent of total assets), followed by unsecured loans (17.8 per cent), hire purchase assets (7.4 per cent), investments (17.4 per cent), cash and bank balances (4.5 per cent), and other assets (8.4 per cent) during the year ended March 2010.

The financial performance of the NBFCs-ND-SI sector improved marginally as reflected in the increase in net profit of Rs. 10,897 crore during 2009- 10 over the previous year. However, their net profit to total assets declined during the same period.

Gross and net NPA ratios of the NBFCs-ND-SI sector deteriorated marginally during the year ended March 2010. However, these ratios showed some improvement in the quarter ended June 2010. Similarly, there was further diminution in value of investments between March 2009 and March 2010.

Legal Updates

The Consolidated Balance Sheet of NBFCs-ND-SI is as below:

Table VI.36: Consolidated Balance Sheet of NBFCs-ND-SI

(₹ crore)

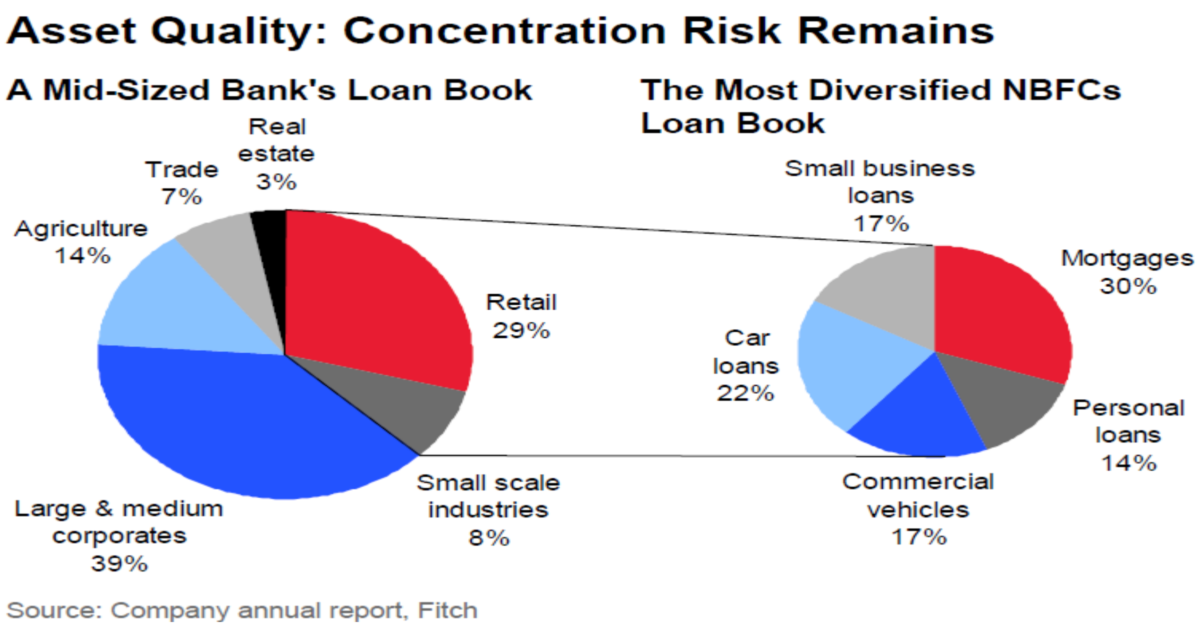
Item	March 2009	March 2010	June 2010	Percentage variation
1. Share Capital	31,756	33,576	33,734	5.7
2. Reserves & Surplus	99,011	1,11,967	1,15,091	13.1
3. Total Borrowings (A + B)	**3,19,175**	**3,81,850**	**4,13,476**	19.6
A. Secured Borrowings	**1,49,569**	**1,74,803**	**1,87,112**	**16.9**
A.1. Debentures	48,833	56,913	63,009	16.5
A.2. Borrowings from Banks	36,263	47,404	48,995	30.7
A.3. Borrowings from FIs	5,749	7,844	7,313	36.4
A.4. Interest Accrued	2,897	3,506	3,686	21.0
A.5. Others	55,828	59,136	64,109	5.9
B. Un-Secured Borrowings	**1,69,606**	**2,07,047**	**2,26,364**	**22.1**
B.1. Debentures	64,570	82,529	92,469	27.8
B.2. Borrowings from Banks	42,430	42,364	40,702	-0.2
B.3. Borrowings from FIs	2,687	3,064	3,378	14.0
B.4. Borrowings from Relatives	2,230	1,784	2,041	-20.0
B.5. Inter-Corporate Borrowings	13,829	19,136	21,660	38.4
B.6. Commercial Paper	22,337	33,580	34,262	50.3
B.7. Interest Accrued	3,198	3,729	7,844	16.6
B.8. Others	18,326	20,860	24,007	13.8
4. Current Liabilities & Provisions	32,966	36,082	37,087	9.5
Total Liabilities / Total Assets	**4,82,907**	**5,63,476**	**5,99,388**	**16.7**
Assets				
1. Loans & Advances	2,86,555	3,50,470	3,75,052	22.3
1.1. Secured	1,95,335	2,49,895	2,76,326	27.9
1.2. Un-Secured	91,221	1,00,575	98,727	10.3
2. Hire Purchase Assets	35,682	41,746	43,568	17.0
3. Investments	90,242	98,170	1,11,488	8.8
3.1. Long Term Investments	60,569	65,999	67,001	9.0
3.2. Current Investments	29,673	32,171	44,488	8.4
4. Cash & Bank Balances	28,934	25,407	20,748	-12.2
5. Other Current Assets	32,119	36,270	35,834	12.9
6. Other Assets	9,376	11,413	12,697	21.7
Memo Items				
1. Capital Market Exposure	81,865	1,05,514	1,10,761	28.9
Of which				
Equity Shares	34,952	38,670	38,945	10.6
2. CME as % to Total Assets	17.0	18.7	18.5	
3. Leverage Ratio	2.69	2.87	3.03	

Note: 1. Data presented above pertaining to ND-SIs which have consistently reported from March 2009 to June 2009.
2. These ND-SI Constitutes More Than 98 % of Total Assets of All ND-SI.

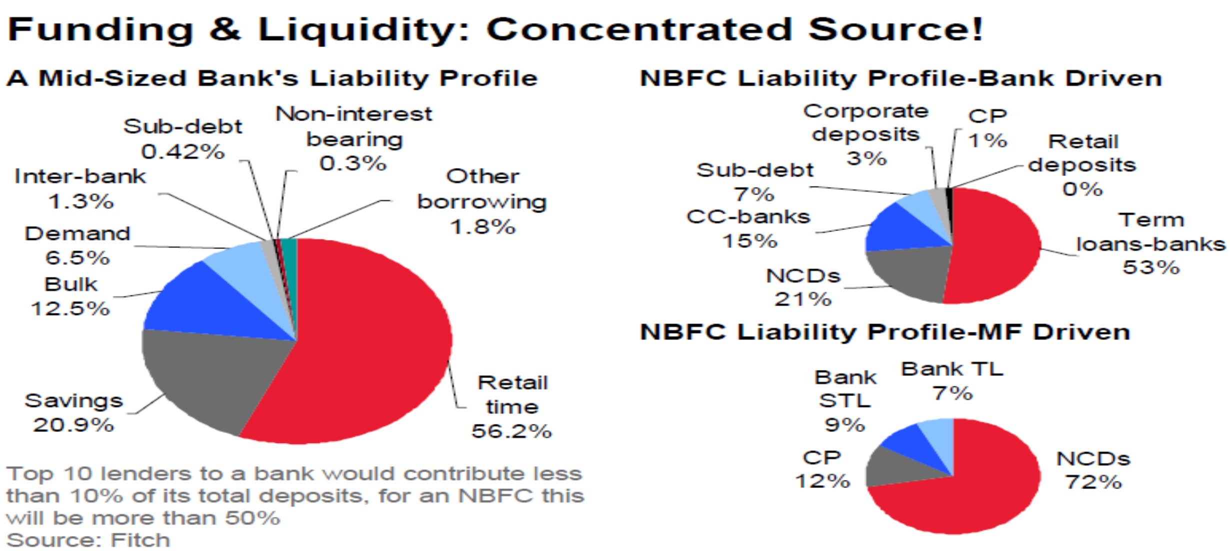
Source: Monthly Return on ND-SI (₹100 crore and above).

Legal Updates

In case of NBFCs the benefit is that in most of the funding transaction there is exposure on the asset and not on the corporate, unlike in case of banks. Also NBFCs have been able to provide funding to un-banked regions or where banks are not aggressive on providing financial assistance. Thus, NBFCs have an edge over banks. NBFCs are more diversified in their exposures unlike banks, the charts below provide a comparison between the loan book and funding & liquidity sources of a bank vis-à-vis NBFCs:



Legal Updates



Future prospects of NBFC sector:

NBFCs have been playing a very important role both from the macro economic perspective and the structure of the Indian financial system. NBFCs are the perfect or even better alternatives to the conventional Banks for meeting various financial requirements of a business enterprise. They offer quick and efficient services without making one to go through the complex rigmarole of conventional banking formalities. However to survive and to constantly grow, NBFCs have to focus on their core strengths while improving on weaknesses. They will have to be very dynamic and constantly endeavour to search for new products and services in order to survive in this ever competitive financial market.

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.

***