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An Overview of the Indian NBFC Sector: Performance in 2011, prospects in 2012

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NBFCs upbeat

NBFCs have been playing a complimentary role to the banking sector, catering to the unbanked sectors and promoting financial inclusion; NBFCs have been vital to the growth of the economy by providing financial support to some of the important segments of the economy. NBFCs account for 12.3%[1] of assets of the total financial system. Due to the global economic slowdown and its impact on the domestic economy, NBFC sector faced significant stresses on asset quality, liquidity and funding costs. With the recovery of Indian economy over the last few quarters, demand side of NBFCs has also improved. 2011 has been strong for NBFCs.

With earlier three categories of NBFCs – loan companies, asset finance companies and investment companies, RBI during the recent times has introduced further new categories of NBFCs as Infrastructure finance companies, core investment companies and the most recent addition with recommendation from the Malegam Committee report being NBFC-MFIs catering to microfinance sector.

The recent times have also witnessed consolidation of several smaller NBFCs and the number of registered NBFCs has declined from 12,630 at end June 2010 to 12,409 at end June 2011 (See data on Registered NBFCs with RBI below).

Table 5.14 : Number of NBFCs Registered with the RBI

End June	Number of Registered NBFCs	Number of NBFCs-D	Number of NBFCs-ND-SI
2005	13261	507	-
2006	13014	428	149
2007	12968	401	173
2008	12809	364	189
2009	12740	336	234
2010	12630	308	260
2011	12409	297	330

Source : RBI.

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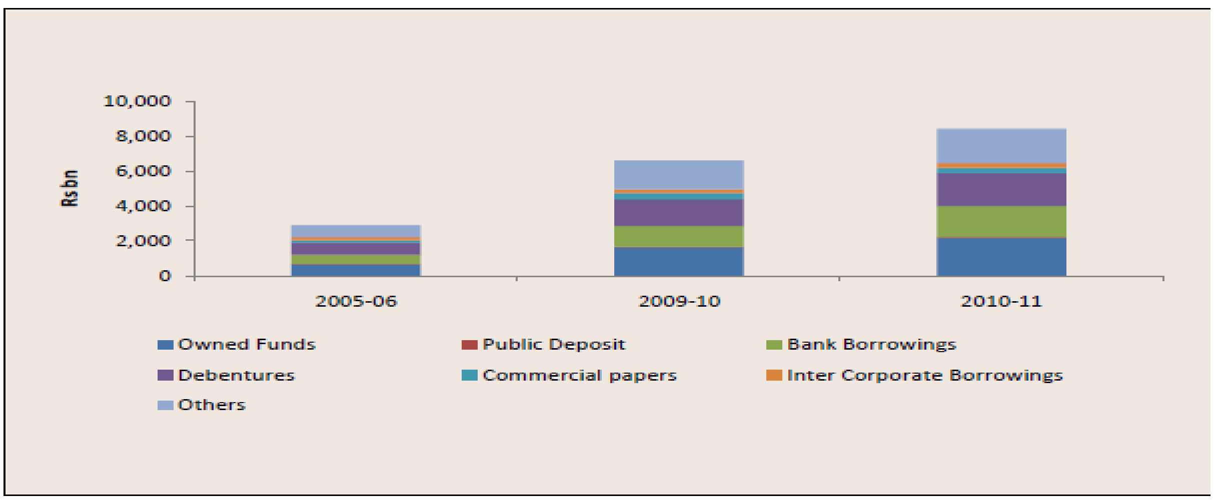
The total assets of the NBFC sector witnessed good growth by the end of FY 2011 and recovered after a difficult year in FY09-10[2] that was on account of the global financial crisis. As per RBI's report on trends and progress of banking in India (2009-10), total assets of NBFCs (excluding non systemically important non-deposit small NBFCs that account for less than 10% of the sector) increased from Rs. 5.60 lakh crore to Rs. 6.57 lakh crore witnessing a YoY growth of 17.3%.

The consolidated balance sheet of NBFCs-D (excluding RNBCs) recorded 11.9 per cent growth for the year ended March 2011 (22.2 per cent in the previous year). Borrowings, which is the major source of funds for NBFCs-D, increased by 9.0 per cent during the year, while public deposits increased sharply by 43.5 per cent largely due to increase in public deposits of three NBFCs-D. Bank borrowings and debentures have remained the prominent source of funding for NBFCs. (See data below):

Funding source of NBFC sector



Source:RBI and D&B Research

On the assets side, loans and advances witnessed a growth of 9.5 per cent while investments increased by 14.1 per cent (primarily on account of increase in SLR investments) for the year ended March 2011.

[1] See the Overview of the Indian NBFCs Sector Performance in 2010, prospects in 2011 [here]

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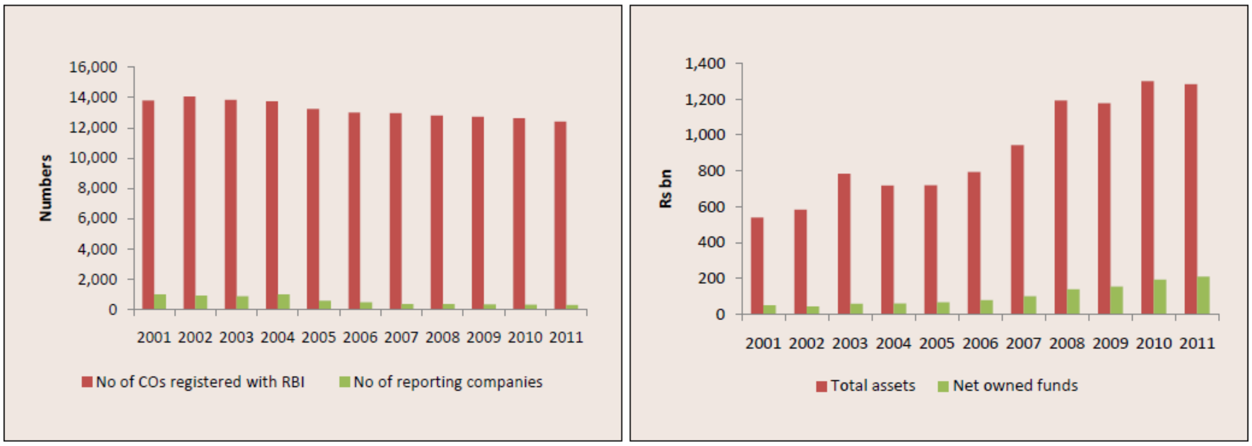
Size and Growth of NBFCs



Source:RBI and D&B Research

Committee Recommendations on NBFCs Sector

Usha Tharot Committee Recommendations

RBI on 29th August, 2011 published the *Report and Recommendations of the Working Group on the Issues and Concerns in the NBFC sector*. The working group reviewed the risks in the NBFCs sector in the present scenario and gave its recommendations on the regulatory and supervisory measures to address these risks to create a strong financial sector and economic growth of the country.

Some of the recommendations of the working group are:

- **Registration requirements:** The working group recommends minimum asset size of Rs. 50 crores for registering a new NBFC. Existing NBFCs below this limit may deregister or seek fresh certificate of registration at the end 2 years. However, NBFCs-ND with an asset size of less than Rs. 1000 crores may be exempted from registration. This would not strangulate the small NBFCs, yet ensure that the NBFCs are well regulated.
- **Change in shareholding/ control requires prior approval:** The group recommends that any transfer of shareholding, direct and indirect of 25% and above, change in control, merger or acquisition of any registered NBFC should have prior approval of RBI. There are a lot of cases of companies being acquired but no certificate of registration being taken, which circumvents the criteria of

banks of fit and proper management. Prior approval of RBI is required in case of any mergers or acquisitions.

- **Principality of Business:** The group recommends that the criteria for principality of business based on percentage of assets and income should be raised to 75% of total assets and income and a time period of 3 years be provided for fulfilling revised principal business criteria. While the regulatory criteria have become stringent, the companies that have been included in the ambit of NBFCs on the basis of total assets and income have been increased to ensure no companies carrying out non-financing activities have been included in the ambit of RBI's regulations. However, all the companies whose income and financial asset lies between 50% to 75% of the total income and asset respectively, would cease to be an NBFC, even though they have a substantial share in carrying out financing activities put together.
- **Merge loan/ investment class of NBFCs:** Need for separate class of loan and investment company should be done away with as most of the NBFCs are a mixture of loan and investment companies.
- **Convergence of regulations applicable to NBFCs with that of banks:** It is proposed that the asset classification, provisioning norms, income tax deductions for provisions, accounting norms as applicable to banks may be introduced for NBFCs in a phased out manner. Internationally, NBFCs or shadow banks are debated to be regulated on the basis the activity carried out and not on the basis of their structure. Hence, as the products provided by NBFCs are similar to those of the banks, need for similar regulations to be introduced was felt. However, the working group recommendations are not to replicate the regulations for NBFCs, as applicable to banks, but to use some of the banking best practices to ensure that the risks are well dealt with. While, NBFCs and banks are complimentary entities, however, NBFCs are more borrowers friendly and their outreach is much better than that of banks, specifically their contribution to the SME sector and the microfinance sector.
- NBFCs to be given the benefit of Sarfaesi Act, 2002, including NBFCs in this purview would be great for the NBFCs sector.
- All NBFCs with an asset base of more than Rs. 1000 crores whether listed or not to comply with the Clause 49 of the Listing Agreement including disclosure requirements. Such NBFCs would also be required to be inspected comprehensively on an annual basis with annual stress test to ascertain their vulnerability. From point of view of Corporate Governance, this is a welcomed recommendation.
- Other recommendations:
    - The Tier I capital for Capital to Risk Weighted Assets Ratio (CRAR) may be specified at 12% to be achieved in 3 years

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- Liquidity ratio to be introduced for NBFCs to take care of asset liability mismatched
- Risk weights for NBFCs may be raised to 150% for capital market exposures and 125% for Commercial Real Estate exposure, however in case of bank sponsored NBFCs, the risk weights applicable would be the same as applicable to banks.
- The report recommends that captive NBFCs should not exist and if they exist, supervisory risk assessment should take into account the risk of parent company on the captive NBFC.

Though most of the recommendations of the Committee are very thoughtful and well placed, if the recommendations come into place, the small NBFCs segment may see several consolidations. The regulatory changes would make it difficult for smaller NBFCs to survive and the coming times may see consolidation of small NBFCs with other NBFCs.

Regulatory changes

The regulatory changes in the recent times in the sector have been dynamic and impact the operational environment for NBFCs.

The regulatory and supervisory framework of NBFCs continued to focus on prudential regulations with specific attention to the systemically important non-deposit taking companies (NBFC-ND-SI). Some of the important developments are given below:

(i) A Sub-Committee of the Central Board of the RBI (Chairman : Shri Y. H. Malegam) was constituted to study issues and concerns in the MFI sector. It was announced that the broad framework of regulations recommended by the Committee had been accepted by the Bank and it had been decided to create a separate category of NBFCs, viz; Non Banking Financial Company-Micro Finance Institution (NBFC-MFI). Consequently there would be seven categories of NBFCs namely Asset Finance Company (AFC), Investment Company (IC), Loan Company (LC), Infrastructure Finance Company (IFC), Core Investment Company (CIC), Infrastructure Debt Fund- Non- Banking Financial Company (IDFNBFC) and Non-Banking Financial Company - Micro Finance Institution (NBFC-MFIs). Directions to such companies were issued on 2 December 2011. An NBFC-MFI is defined as a non-deposit taking NBFC (other than a company licensed under Section 25 of the Companies Act, 1956) that fulfils the conditions like (i) Minimum Net Owned Funds of 5 crore, (For NBFC-MFIs registered in the North Eastern Region of the country, the minimum NOF requirement shall stand at 2 crore), (ii) not less than 85 per cent of its net assets are in the nature of 'qualifying assets'.

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(ii) Entry-point norms, prudential norms for capital requirement, and asset classification and provisioning norms have been prescribed for NBFCs-MFI. NBFCs- MFI were also advised about pricing of credit, i.e. to maintain an aggregate margin cap of not more than 12 percent. The interest cost will be calculated on average fortnightly balances of outstanding borrowings and interest income is to be calculated on average fortnightly balances of outstanding loan portfolio of qualifying assets. Interest on individual loans will not exceed 26 per cent per annum and will be calculated on reducing balance basis. Processing charges shall not be more than 1 per cent of gross loan amount. Processing charges need not be included in the margin cap or interest cap. Instructions related to fair practices in lending and transparency in interest rates was also issued.

(iii)Multiple-lending, over-borrowing and ghost borrowers have been prohibited. NBFCs-MFI have been advised to follow non-coercive methods of recovery of loan. Further, corporate governance related instructions have also been issued. NBFC-MFIs have been advised to review their back office operations and make the necessary investments in information technology and systems to achieve better control, simplify procedures, and reduce costs.

(iv)For off-balance sheet items already contracted by NBFCs, risk weights shall be applicable with effect from the financial year beginning 1 April 2012. For all new contracts undertaken including credit default swaps, the new risk weights shall be applicable from 26 December 2011.

Outlook for 2012

Fitch in its recent report on 2012 Outlook: Major Indian Non Banking Finance Companies published on 27th February, 2012, expressed that the outlook for NBFCs was stable, but the industry should expect bumpy roads ahead. The regulatory changes on priority sector status, minimum capital requirement and introducing a liquidity ratio requirement will have an impact on the profitability, shrinking NIMs, leverage and access to funding for NBFCs. Almost 60%[3] of the debt of NBFCs came from bank funding in FY 2011. The significant 55% growth in bank credit to the broad NBFC sector in FY11 (compared with 23% overall credit growth) and the RBI's subsequent revised guidelines, under which bank loans to NBFCs are not classified as priority-sector loans from 1 April 2011, reduce the banks' motivation for fresh direct lending to NBFCs. Together with

[3] Date from 2012 Outlook: Major Indian Non Banking Finance Companies; Fitch Report, available on http://www.fitchratings.com/

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other proposed and potential regulatory changes, this may reduce their appetite for lending to NBFCs.

A strong banking and financial sector is very crucial for facilitating higher economic growth and NBFCs have a definite and very important role in the financial sector, particularly in a developing economy like ours.