Performance of Non Banking Financial Institutions In India

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Abstract

The financial sector in any economy consists of several intermediaries. Apart from banking entities, there are investment intermediaries (such as mutual funds, hedge funds, pension funds, and so on), risk transfer entities (such as insurance companies), information and analysis providers (such as rating agencies, financial advisers, etc), investment banks, portfolio managers and so on. All such entities that offer financial services other than banking, may be broadly called non-banking financial institutions. The non-banking financial companies (NBFC's) have emerged as substantial contributors to the Indian economic growth by having access to certain deposit segments and catering to the specialized credit requirements of certain classes of borrowers. A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme of arrangement of any other manner, or lending in any manner is also a non-banking financial company. While NBFCs have been rendering many useful services, several adverse, unhealthy features of their working also have been observed. The protection of savers from malpractices has been one of the important issues. The authorities have evolved an appropriate regulatory/statutory framework to oversee the operations of NBFCs. I may assure you that the Bank has an open mind for any suggestion within the framework of policy and basic postulate that the depositors' interest should be safeguarded. All these concerns were examined objectively and revised guidelines have been issued which would go a long way in the best interests of strengthening the NBFC sector

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Introduction:

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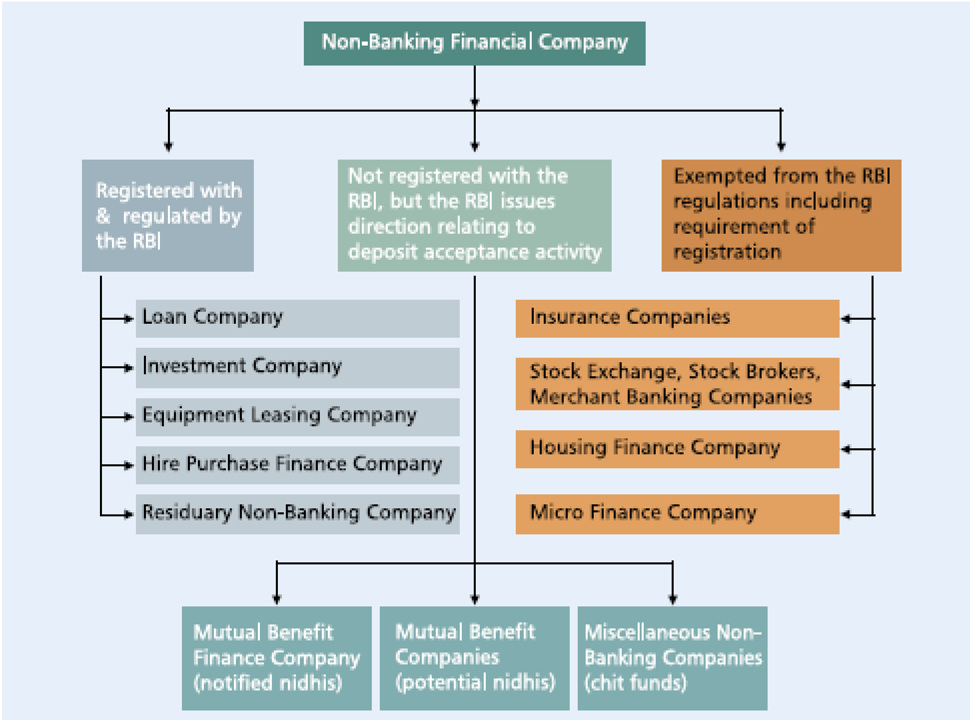
Exhibit 2.1: Industry Structure



Source: RBI

Regulatory Framework

The RBI Act was amended in 1997 to provide for comprehensive regulatory framework for NBFCs. As per the RBI (Amendment) Act 1997, the RBI can issue directions to NBFCs & its' auditors, prohibit deposit acceptance and alienation of assets by NBFCs and initiate action for winding up of NBFCs. The new regulations provide:

- Compulsory registration for all NBFCs, irrespective of their holding of public deposits, for commencing and carrying on business of a non-business financial institution
- The amended act also classified NBFCs into three broad categories i) NBFCs accepting public deposits; ii) NBFCs not accepting/holding public deposits; and iii) core investment companies (i.e. those acquiring shares/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.)
- Minimum entry point net-worth of Rs 2.5 million which was subsequently revised upwards to Rs 20 million
- Deposit mobilization linked to net-worth, business activities and credit rating
- Maintenance of 12.5% of their deposits in liquid assets
- Creation of a Reserve Fund and transfer of 20% of profit after tax but before dividend to the fund
- Ceiling on maximum rate of interest that NBFCs can pay on their public deposits
- NBFCs with an asset size of at least Rs 1 billion or a deposit base of at least Rs 200 million are required to have Asset-Liability Management systems and constitute an Asset-Liability Management Committee

Trends & Progress of the NBFCs' Business

Since late 1980s up to mid 1990s, the number of NBFCs increased substantially on the back of easy access of funds from capital market IPOs and deposits from the public. In 1981, there were 7,063 NBFCs. The number went up to 24,009 in 1990 and there were as many as 55,995 NBFCs by 1995. The high deposit rates offered by NBFCs led investors to invest their funds in NBFCs. The deposit base of the NBFCs grew at an average rate of 88.6% per annum between the period Apr-91 to Mar-97. However, strong growth in NBFCs could not be sustained as in the late 1990s several loans granted by the NBFCs turned sticky, leading some of the large NBFCs to default in repayment to their depositors. This led the RBI to introduce stringent guidelines in 1997-98 which hampered the ability of NBFC's to raise deposits. Banks also became wary of lending to NBFCs, which translated into high cost of funds for NBFCs. Moreover, increasing competition from the banking system that was opened up for private sector banks in early 1990s affected the NBFCs business. Given these developments, many NBFCs with asset base in excess of Rs 1 billion had to exit their operations. NBFCs, however, recovered from this phase and witnessed strong growth during 2000-02.

Recent Trends in Non Banking Financial Institution:

1. Regulatory changes and complexity

Since the financial crisis, regulatory pressures have increased the cost of capital, prompted banks to divest themselves of 'risky' or capital intensive businesses or departments, shaped bank attitude towards risk and redrawn the boundary between retail and wholesale banking. Banks have withdrawn from lending to certain constituents, such as SMEs and infrastructure, whilst investing and recruiting heavily in compliance to meet new regulatory requirements.

Amidst this regulatory pressure, non-banking financial institutions, especially FinTech firms that are not subject to the same financial pressures, are offering competing services to bank clients, establishing specific funds or investing in new challengers.

2 Digitalisation and technological advances

Technological advancement is changing financial institutions and the ways people interact. It has created opportunities for new challengers to disrupt traditional business models and penetrate new markets. The ubiquity of technology across the globe, such as the World Wide Web, mobile phones and Apps, has created FinTech companies who offer lower cost services for traditional services, such as e-payments and online trading.

Technology is changing the way that customers interact with financial institutions. Although investment in IT infrastructure has increased massively over the last few years, many traditional banks remain behind the curve. Social media companies such as Facebook, Twitter and Google have a huge user base and are moving into the financial sector, bringing new sources of capital and investment.

3 Changes in investment and capital sources and returns

Regulatory capital requirements are causing a drag on returns and taking significant management time. Banks are complying with stress tests, responding to regulatory investigations or managing increasingly punitive regulatory fines. Some non-bank financial institutions are more profitable than banks and are as large and significant in terms of global stability. Entrants with lighter regulatory burdens are moving into areas (insurance, lending, ownership of hard assets) traditionally undertaken by banks, in a search for yield, and are creating or exploiting opportunities. Non-bank financial institutions are investing in new challengers to banks. New FinTech firms, providing financial solutions, are investing heavily and online only banking ventures, or other platforms, are attracting investment and gaining traction.

4 Demographic and behavioural changes

There is a new generation of young people (millennials) with different expectations and ways of interacting with financial institutions: through online and social media based platforms. They are using social media to connect, communicate or complain and do not have traditional customer loyalties. Mature customers and retirees are demanding improved returns from investments and moving against intermediaries due to a perception of a lack of transparency.

There is government and regulatory pressure upon pension funds and asset managers to reduce management fees yet maximise returns for the 'grey market'. High net worth and ultra high net worth individuals and families are growing outside of the UK/US/Europe, in new regions, such as LatAm, the Middle East and parts of Asia. This is in concert with improved education, skills and a rising middle class in these areas creating a new 'mass affluent' class, potential client base and work force.

5 Global talent and skills race

Regulatory pressures, risk management and technological advances are creating a new and challenging environment which risks driving out some of today's leaders. Financial institutions will need new leaders who can identify, understand and manage new and emerging risks. New leaders will be sought by traditional banks, NBFIs, FinTech firms and regulators. Competition will become fierce as the talent pool decreases but demand increases for those who can keep pace with the changing financial landscape.

Emerging markets such as LatAm and Asia will offer new consumers and a highly skilled labour force, creating new outsourcing hubs in regions outside the UK/ US and Europe. Technology will diminish the geographical divide but only new leaders will bridge the cultural differences. There will be a renewed focus on risk management but, as regulators improve their understanding of risk and compliance, there will be a skills gap as firms try to recruit new staff, up-skill existing teams and rely on specialist risk advisors.

6 Business operating model pressures

Traditional business operating structures are under pressure from regulators demanding transparency over fees and greater competition for consumers. There is pressure on the efficacy/profitability of the universal bank model and a return to the wholesale/retail banking division, driving down returns and potentially stifling innovation. The financial sector is becoming increasingly segmented.

Regulatory pressures and the cost of capital is pushing financial institutions to focus on core consumers, creating opportunities for specialist service providers, such as infrastructure or SME focused funds or through online platforms. There is a rise of specialist retail and wholesale competitors, or successful regional banks in the US or Multilatinas. These pressures are also driving disintermediation as intermediaries are displaced and/or specialist providers cater to specific sectors and take market share from traditional FIs. New challengers are obtaining market share through innovative uses of technology, such as P2P lending, crowd funding and mobile payment.

Conclusion:

The non-banking financial companies (NBFC's) have emerged as substantial contributors to the Indian economic growth by having access to certain deposit segments and catering to the specialized credit requirements of certain classes of borrowers. Recent developments in non banking financial companies will improve the activities of NBFC's in India.

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