CHAPTER- 1

INTRODUCTION

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Chapter – 1 Introduction

The word 'Performance' is obtained from the word 'parfourmen', which means 'to do', 'to carry out' or 'to render'. It refers to do something for execution and accomplishment. In wider sense, performance refers to the fulfilment of a targeted task measured with predetermined standards of accuracy, functionality, cost structure, and timeframe.

The word, "Assessment' basically refers to an act of comparing the actual performance against a predetermined standard for arriving at a conclusion regarding the efficacy of an assigned function.

Thus, performance assessment is the application of a suitable technique to measure the actual accomplishment against any preset standard, based on specific knowledge and skills and depending upon the pattern and nature of a particular task for which an organization exists. These tasks basically enhance learning of the organisation.

The process of financial performance assessment involved the determination of the operating and financial characteristics of an organisation from its financial statements, which are the end results of accounting. The goal of such analysis is to analyse the performance in detail to determine the overall efficiency of the management of the organisation, and the same is usually reflected through its published financial results. This analysis attempts to measure the firm's liquidity, profitability and various other aspects highlighting the financial health and mode of operation of an institution. The necessity of a sound and rational way of functioning of an organisation cannot be undermined, so far as the long run sustainability is concerned. Not only has the existence, its strategic positioning in a competitive situation also required a thorough analysis of performance at each and every level of its functioning. Through an

efficient analysis of the financial performance, the organization can identify various opportunities to improve its performance as a whole. In this context, various researches have been undertaken by many researchers to analyse the financial performance of Non-Banking Financing Companies to understand how management of finance shows a vital role in the accomplishment of objective of this service sector.

Basic techniques of financial assessment are as follows:

- Percentage analysis which includes both Vertical analysis and Horizontal analysis. Vertical analysis is a single statement prepared to show the relationship through the percentage analysis of each component with the total value. Under vertical analysis the statement of financial position indicating each component of assets and liabilities and returns is shown as a percentage of the total assets, total liabilities and net worth, respectively. On the other hand, the horizontal analysis is the analysis of increases or decreases in percentage with respect to related items in the comparative financial statements. The value of each component on the basis of the latest statement is compared in detail with the related components of earlier period's statements.
- Ratio analysis which includes the Profitability, Liquidity, Management efficiency, Solvency, and Investment in terms of ratios.
- Cash Flow Analysis which involves the analyses of inflows and outflows in respect of cash flow from operating activities, investing activities, and financing activities. The results of cash flow statement is analysed with ratio, as stated earlier, to assess the financial relationship between various components of cash flows and other financial statements.

1.1 NON-BANKING FINANCIAL COMPANIES: AN OVERVIEW

Financial Institutions can be classified as banking and non-banking financial institutions. Banking institutions are formulator as well as supplier of credit, while non-banking financial institutions are only supplier of credit.

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 / Companies Act 2013 involved in dealing with loans and advances, acquisition of securities issued by the Government or local authority, hire-purchase, leasing, insurance services, and chit fund business. But the activity of NBFCs does not include agricultural activity, industrial activity, trading of any goods and transfer of immovable property. In other words, a NBFC is an institution having its main business of accepting deposits under any scheme of arrangement as per the formulated rules in lump sum or in installments and using the same for financing the specific schemes which are also directed by formulated rules by the appropriate authority.

The functions of NBFCs are categorically restricted as per the guidelines of the Reserve Bank of India. These functions include those of hire-purchase financing companies, equipment leasing companies, and loan or mutual benefit financial companies but do not include an insurance company, a stock exchange, a stock broking company and a merchant banking company.

Section 45-I (b) of third chapter of Reserve Bank of India Act 1934, defines a Non-Banking Financial Company as:

(a) a financial institution, which is a company,

(b) a financial institution company, having its principal business of accepting deposits under any scheme of arrangement or advancing and financing in any manner,

(c) any other institution that may function as banks with the previous approval of Central Government and notification in this regard in the official gazette.

NBFCs are performing functions similar in nature to that of banks; however, there are certain differences between these two that are as follows:

1. a NBFC cannot accept demand deposits;
2. a NBFC is not a part of the payment and settlement system;
3. as such a NBFC cannot issue any payment order, like a Banker's Cheque issued by a Commercial bank; and
4. unlike banks Deposit Insurance offered by Credit Guarantee Corporation is not applicable for the depositors of a NBFC.

1.2 ROLE OF NBFCs

The activities of NBFCs are in many cases similar to those of the commercial banks and other financial institutions which are involved in the financing business. Basically NBFCs act as an intermediary between the final depositors and the final borrowers. The rationale of the existence of NBFCs is derived from the concept of saving of surplus and earnings from the same and deficit if any can be financed by sacrifice of some additional payments in respect to the unorganised sector. To balance between these two in an organised manner is the main objective of the NBFCs. In other words, surplus units (savers) can lend to the deficit units (borrowers) through a regulative mechanism. This, however, is normally not convenient for the depositors and borrowers without the involvement of an intermediary for the efficient way of flow of funds between the units. With the intervention of a financial institution, there is a decrease in the degree of risks involved and there is also an effective utilization of the available funds in the economy. Financial intermediaries can provide additional reasonable services because of their economies of scale, professional expertise, and ability to extend the risk over a large number of beneficiaries. Thus, their operational outcomes give to the investor with combined benefits of higher return, effective

liquidity, and lower risk. On the other hand the borrowers can avail wider choice on financing schemes in respect of the intermediation of financial institutions. The commercial banks generally provide grants for industrial, commercial and agricultural purposes; on the other hand, NBFCs generally grant loans for transport, acquisition of durable consumer goods, trading, purchase of houses, repair of houses, and purchase of household consumption goods. As compared to the commercial banks, the activities of NBFCs are not extensively managed by monetary authorities, so the credit extended by these institutions may not necessarily be in accordance with the unorganised sectors' needs and priorities. The major function of these financial intermediaries is to shift the savings of surplus units to deficit units in micro perspective and unreached areas of commercial banks. Hence, these institutions can play a vital role in the economy of the country for financing in a small scale. Basically the activities of these institutions can help in monetizing the financing stream of economy and transferring unproductive financial assets into productive assets.

The NBFCs can contribute through their financing schemes in the country's urban economic development. In fact, the activity of these financial institutions involves diversity so they can establish themselves to be a part of development of a country by suitable regulatory measures. The expert committees of RBI recognized the need of NBFCs in the following areas:

- Development and control of transport and infrastructure sectors,
- Substantial employment generation,
- Sustainable increase in wealth creation,
- Economic development in the county in a broad perspective,
- Distinctive supplement to the conventional bank credit in rural segments,

- Major driving force in semi-urban, rural areas, and new entrant buyers and users,
- Need based finance in the economically weaker sections of the country, and
- Significant contribution to the state specific sustainable development in the country.

1.3 TYPES OF NBFCs

NBFCs can be classified into different categories depending on the type of activities they undertake:

1. *Hire Purchase Company (HPC):* Hire purchase transactions or financing in such activity is the principal business of these NBFCs.
2. *Investment Company (IC):* Acquisition of new securities and subsequent trading of securities is the principal business of these NBFCs. These activities include primary dealers (PD) who deal in underwriting of non-Government securities and market making of Government securities.
3. *Loan Company (LC):* Providing finance by way of loans or advances or otherwise for any specific activity other than its own is the principal business of these NBFCs. But these activities exclude the financing through equipment leasing, hire purchase, and housing finance.
4. *Nidhi Company (NC)/Mutual Benefit Financial Company (MBFC):* This includes any company registered u/s 620A of the Companies Act; 1956 and notified by the Central Government as a Nidhi Company. The primary activities of these companies are borrowing from members and lending to members only by way of a generated fund commonly known as Nidhi Permanent Fund (NPF), Benefit Funds (BF) and Mutual Benefit Funds (MBF).

5. *Equipment Leasing Company (ELC):* These NBFCs are involved in the primary activities of equipment leasing or financing such activity.
6. *Chit Fund Company(CFC)/Miscellaneous Non-Banking Company (MNBC):* These NBFCs are engaged in the main business of managing, conducting or supervising as a promoter, foreman or agent of any transaction or arrangement by which the company is involved into an agreement with a particular number of subscriber that each one of them shall be entitled to subscribe a certain sum in installments during a specific period and that each one of such subscriber shall in turn, as determined by approved tender or in such manner as may be provided for in the understanding, be entitled to the prize amount.
7. *Residuary Non-Banking Company (RNBC):* These companies are engaged in the activities to receive deposit under any preset scheme of arrangement, by whatever name called, in one installment or multiple installments by way of contributions or subscriptions or by sale of units or certificates or other financial instruments, or in any other manner. These companies do not have any activities which are nearly associated with any activities of the NBFC categories as stated above.

However, with effect from December 6, 2006 the NBFCs registered with RBI have been reclassified as:

Asset Finance Company (AFC),

Investment Company (IC), and

Loan Company (LC).

Asset Finance Company (AFC): An AFC is a company which is a financial institution having its main business of financing physical moveable assets for supporting productive and economic activity, such as tractors, automobiles, agricultural

equipments, generator sets, lathe machines, earth moving and material management equipments, moving on own power, and wide-ranging functions of industrial machines.

Investment Company (IC): IC means any company which is a financial institution and is having its principal business of acquisition of new and existing securities and financing out of the generated fund associated with the same, if any.

Loan Company (LC): LC means any company which is a financial institution having its principal business of providing finance by way of making loans and advances or any other activity but does not include the activities of AFCs.

1.4 REGULATORY AUTHORITIES OF NBFCs

Sl No	Types of NBFCs	Name of the Regulatory Authority
1	Equipment Leasing Companies(EL)	Reserve Bank of India
2.	Hire Purchase Finance Companies (HP)	Reserve Bank of India
3.	Loan Companies	Reserve Bank of India
4.	Investment Companies	Reserve Bank of India
5.	Residuary Non-Banking Companies (RNBCs)	Reserve Bank of India
6.	Miscellaneous Non-Banking Companies (Chit Funds)	Reserve Bank of India and Registrars of Chits of the concerned states.
7.	Mutual Benefit Finance Companies (Nidhis)	Department of Company Affairs of the Government of India.

1.5 RBI REGULATIONS OVER NBFCs:

NBFCs ensure broad-based growth by financial inclusion and provide necessary finance in infrastructure, asset financing, factoring, etc. Thus, they perform well in bringing all sectors of the people under the domain of financial institutions. However, there are some specific reasons for adopting regulatory measures on NBFCS. The reasons of RBI regulations over NBFCs are as follows:

1. To ensure transparency in the financial transactions made by NBFCs,

2. To ensure growth of financial health components and earnings components of NBFCs,
3. To ensure that NBFCs should function under the supervision of regulatory authority and a definite policy framework, and
4. To ensure proper channelization of funds into the desired directions.

Following are the areas of RBI regulations over NBFCs:

- Registration
- Net Owned Fund (NOF) and Leverages
- Accounting Year
- KYC
- Issuing Guidelines
- Capital Adequacy
- Acceptance of Deposits
- Monetary and Credit Policy
- Maintenance of Liquid Assets
- Period of Deposits
- Interest Rate
- Prudential Norms
- Asset-Liability Management
- Responsibility of Board of Directors
- Maintenance of Reserve Fund
- Reporting and Disclosure Guidelines
- Submission of Returns
- Protection of Depositors Interest.

In the light of the RBI regulations, the performance of the NBFCs needs to be examined. It is worth examining how far improvements in the performance of the NBFCs have been achieved under the RBI regulatory framework.

1.6 STATEMET OF THE PROBLEM

Consequent upon an unsatisfactory performance of several banks between the period 1950s to 1960s in India, a large number of common depositors had lost their hard earned money. To manage the situation, the RBI established the Deposit Insurance Corporation (DIC) to provide a structural guarantee of investments to the depositors. In India, the traditional banking sector has experienced, as highly regulated by the acts, simplified procedures of sanctioning the loans, shorter sanctioning period in providing the credit needs and low processing cost resulting in the NBFCs getting marginal advantage over banks in providing finance in the traditionally regulated manner.

Since 1980s, NBFCs have been witnessing significant growth over the years. In 1990s the markets of NBFCs had seen a potential growth in respect to CAGR (Capital Asset Gearing Ratio) in comparison to banks and a good number of NBFCs cropped up. But in the year 1996, due to the failure of big NBFCs, the RBI tightened the regulatory structure and supervision of the NBFCs, with implementation of comprehensive registration requirements, improved reporting requirements, and transparent supervision procedure. The RBI also decided during that time to give more registration of NBFCs to raise deposits from the public. Later, when the NBFCs have shown better performance in compliances of regulatory norms and systemic risk related issues then the RBI permitted the new registration of NBFCs within the scope of the regulatory environment.

India has a bank-dominated financial system but still there is a significant presence of NBFCs. Basically NBFCs are acting as financial intermediaries that are involved in the activity of bringing the different level of savings and the different areas of investing community taken together. In this role they are supposed to be playing a complementary role to banks rather than acting as competitors of the banks. It is a common known fact in India that majority of the population of our country do not have access to conventional financial products and services as provided by the banking system, and that there exists a lower level of financial inclusion by the banks. The country, therefore, needs some institutions beyond the banks to provide finance through reaching out the non-banked areas where banks' presence is very much needed.

So, it can be said that the NBFCs have enjoyed an advantage over the conventional banking system in the semi urban and rural financial markets in India. The primary activities of NBFCs include providing finance to the non-salaried individuals, retail and small traders, infrastructure assets, equipments, vehicles, transporters, stock brokers, etc. Finally, these activities have developed financial services in India in a greater way as a complementary contribution to commercial banks in providing the finances in the same area of financial services.

The research on the NBFCs is carried out in different parts of the world to review and assess the functions, policies, regulations, compliances, customer satisfaction, scheme of financing, risk management, and asset liability management of these companies based on primary data as well as secondary data.

The RBI has classified the NBFCs into 7 categories since 1980; but from the year 2006, the NBFCs registered with RBI have been reclassified into three groups namely, Asset Finance Companies, Investment Companies, and Loan Companies. Out

of these three categories of NBFCs, Asset Finance Companies and Investment Companies have significant role in terms of the coverage of the basic activities of NBFCs.

In this backdrop, the present study makes an attempt to evaluate the financial performance of the two categories of NBFCs - Asset Finance Companies and Investment Companies, through an analysis of their assets and liabilities structures and the growth of each of these two categories, group wise and company wise. In addition, the study evaluates the NBFCs' performance using the indicators like Return on Assets (ROA), Return on Capital Employed (ROCE), Return on Equity (ROE), Debt-Equity Ratio (DER), Net Profit Ratio (NPR), and Current Ratio (CR).

1.7 IMPORTANCE OF THE STUDY

In the last 10 to 15 years, there have been many developments in Non-Banking Financial Sector. In the course of these developments, the RBI has recognised the necessity to recommend certain measures to have control over the financing activities in this sector which result in the growth of this sector. In respect of development in the service sector in the rural and semi urban India, the NBFCs have been playing a vital role by providing credit and making full use of this extensive networks across the country. The inclusion of chapter III B in the RBI Act, 1934 enables the RBI to regulate and supervise the activities of NBFCs statutorily from February 1964 and to recommend a series of measures in this regard from time to time. Again, in 1966 some new directives were also issued to enhance the regulatory powers of the RBI with respect to NBFCs.

In this backdrop, the present study is of extreme importance to assess the overall performance of NBFCs. This is because such an assessment will bring out the current position of the NBFCs taken collectively and individually inter alia, the overall

performance of this sector as a whole. The policy implications of the findings of this study are expected to help the regulators/policy makers to frame appropriate policies for NBFCs so as to ensure economic and social development of the urban, semi-urban and rural areas in India.

1.8 SCOPE OF THE STUDY

Since 1980s, RBI has classified NBFCs into 7 categories. However, from 2006, the NBFCs registered with RBI have been reclassified into three groups, namely, Assets Finance Companies, Investment Companies, and Loan Companies. Unfortunately, adequate data is not available relating to the list of functioning of Loan Companies and even if they are available, the same is not reliable. This is why Loan Companies have been kept outside the purview of our study. Thus, the scope of the present study finally encompasses two categories of NBFCs, namely, Asset Finance Companies and Investment Companies.

1.9 RESEARCH OBJECTIVES

The primary objective of this study is to assess the performance of the Non-Banking Financial Companies (NBFCs) in India. To attain this primary objective, the following secondary objectives are sought to be achieved:

1. To analyze the structure and growth of Liabilities of NBFCs, (Category-wise and Aggregative) in India.
2. To analyze the structure and growth of Assets of NBFCs (Category-wise and Aggregative) in India.
3. To make a critical assessment of the financial performance of NBFCs (Category-wise and Aggregative) in India.
4. To make a comparative analysis of the performance of each individual category of NBFCs.

1.10 HYPOTHESES OF THE STUDY

1st Hypothesis:

H_{O1}: There has been no significant growth in respect of various performance parameters during the period of study.

H_{A1}: H_{O1} is not true.

2nd Hypothesis:

H_{O2}: There is no significant difference in the average financial performance between the Investment Companies and Asset Finance Companies.

H_{A2}: H_{O2} is not true.

3rd Hypothesis:

H_{O3}: There have been no significant variations in the average performance with respect to performance indicators among the companies under each category of NBFCs.

H_{A3}: H_{O3} is not true.

1.11 CHAPTER PLAN

1. Introduction
2. Literature Review
3. Research Methodology
4. NBFCs in India: A Historical Analysis
5. Structure and Growth of Liabilities of the NBFCs (Aggregative and Category-wise)
6. Structure and Growth of Assets of the NBFCs (Aggregative and Category-wise)
7. Financial Performance of each Category of NBFCs: A Comparative Analysis
8. Summary, Conclusion, and Suggestions.

1.12 REFERENCES

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