CHAPTER I

INTRODUCTION

1.1 Introduction

Financial institutions play an important role in the financial system. A financial institution that does not perform banking activities is termed as Non Banking Financial Institution (NBFI). If this financial institution is in the form of a company, then they are categorised as Non Banking Finance Companies (NBFCs). Banks and NBFCs differ fundamentally on the ground of acceptance of demand deposits and issuance of cheques.

On the basis of the changes in the resources, fundamental characteristics of banks are; Liquidity Transformation, Maturity Transformation and Leverage. One of the major objectives of banks is to pool liquid liabilities and convert it into illiquid assets. The average maturity of the liability of banks is short term in nature. Banks transform these short term liabilities into medium and long term assets. Banks are governed by the Banking Regulation Act, 1949.

The Non Banking Finance Companies primarily engage in the maturity transformation of liability, even without having the right to accept demand deposits and issuance of banking instruments. Even though the NBFCs are not discharging practical banking activities, they have a significant role in the determination of leverage. In certain cases, these entities remain outside the purview of the regulatory authority and they are termed as *'shadow banks'*. Shadow banking refers to a system wherein financial entities undertake credit intermediation activities akin to banks, while remaining outside the traditional regulatory regime, which are otherwise applicable to banks (RBI, 2013)[1]. In India, Non Deposit taking NBFCs having huge asset size (with Rs 500 crore or more) are termed as shadow banks.

The global economies since crisis period 2007-08 can be attributed to the inefficient and improper financial intermediation done by shadow banks. The predicaments affiliated to the functioning of shadow banks have undergone earnest reviews in western countries. The issues were more alarming in developed financial markets like that of US, where they have diversified categories of financial intermediaries. Moreover, emerging market economies are trying to tap the potential of such diversified financial intermediaries like NBFCs to ensure the economic growth.

In India, certain NBFCs with huge asset base have been brought under the category of shadow banks. Acharya, Khandwala, & Oncu, (2013) studied the determinants of the growth of those non-deposit taking non-bank financial corporations which are regarded by the RBI as being systemically important[2]. They documented an apparent bank-NBFC linkage in India. Up to the period of crisis, monetary authority in India was vigilantly monitoring the functioning of deposit mobilising NBFCs only. Till 2008, the activities of non-deposit taking

[1] Report on Trend and Progress of Banking in India 2012-2013, RBI

[2] NBFCs whose asset size is of Rs 500 crore or more as per last audited balance sheet are considered as systemically important NBFCs. The rationale for such classification, by RBI, is that the activities of such NBFCs will have a bearing on the financial stability of the overall economy.

NBFCs have not come predominantly under the jurisdiction of monetary authority in India. Having realised the role of shadow banks in the genesis of crisis in developed economies, the monetary authority started to formulate proper regime for administering the functions of non-deposit taking NBFCs.

The collapse of large sized NBFCs has led to the failure of other regulated as well as non regulated firms. As an aftermath, Reserve Bank of India took an open move to minister the functioning of large sized non deposit taking NBFCs. It is in this backdrop, key regulations for Systemically Important Non Deposit taking NBFCs (ND-SI), came in to the picture.

Non Banking Finance Companies (NBFCs) perform developmental role in Indian financial system. The commercial banks in India have not attained that much degree of development to undertake the unique role of NBFCs too. The significance of these financial intermediaries is more visible when we look into the development of financial sector after financial liberalisation.

Non banks play an important role in Indian financial market. But the prevalence of non banks triggered some problems during the crisis period of economy. The problems during the crisis period may be aggravated by the functioning of shadow banks. Hence, it is inevitable to evaluate the prevailing regulatory frame work of NBFCs in India. In this decade of post economic crisis, and in the milieu of development of a regulatory frame work by monetary authority, this seminal research work intends to analyze the shadow banking practices of NBFCs in India. Here, the analysis of fundamental characteristics like leverage and maturity transformation of these entities are attempted.

From the view of constructive financial intermediation, the economy expects a great deal from active intermediaries. Unbanked sectors may assure the growth of informal and semi formal financial intermediaries. Here arises the prospect for alternative financial intermediaries. *Shadow banking* will be a threat in a developed economy as it may lead to dominance of NBFCs in the process of *maturity transformation*- an important element in meaningful intermediation. NBFCs in Kerala meet all types of financial requirements. While analysing the sources of funds of these NBFCs, it has been realised that, major NBFCs rely upon commercial banks and non convertible debentures for meeting their working capital requirements. Both sources can be adjudicated as safe and sometimes cheap. Undeniably, the low volume of deposits affects the functioning of commercial banks in Kerala. Simultaneously, NBFCs perform better.

1.2 Statement of the Problem

Financial intermediation practices in developed economies show that, a good financial system must survive with variant financial intermediaries. Thus, we cannot deny the role of non banks in Indian financial market. Financial development in India, especially the post financial liberalisation era, highlights the effective role of large sized NBFCs. But the shadow nature of these intermediaries may bring serious problems during the crisis period. Hence, it is necessary to understand the style and state of growth of these financial intermediaries. The financial system of Kerala is a specialised one with well developed banking and non-banking financial intermediation. In Kerala, eight major NBFCs-ND-SI are operating. Thus, it is obligatory to study the performance of such NBFCs in the state. Since these NBFCs have no direct access to public deposits, they have to depend on commercial banks for their smooth functioning. Thus the changes taking place in the banking systems may have a bearing on the performance of NBFCs-ND-SI. Further, the maturity transformation practice, which is a major component of shadow banking, is to be urgently studied. Although the problematic nature of leverage and interconnectedness of Non Banking Financial Institutions is documented well in previous literature, the explorations are limited or rather exhausted to some developed economies. The empirical studies which focus on the performance of NBFCs in Kerala were, largely, focussed on the direct beneficiaries' point of view. The research gap is visible in the area of the exploration of the performance of NBFCs, specifically relating to leverage and interconnectedness. The researcher is keenly interested to study the performance of NBFCs with respect to the performance of other financial intermediaries, interconnectedness and leverage.

1.3 Significance of the Study

After the economic crisis, a paradigm shift happened in the policy regime regulating the functioning of NBFCs. This research work has an intention to rigorously detect the alterations in the regulatory framework of NBFCs, predominantly after the global economic crisis. Growth of this sector of non banking finance is routed from a great deal of macroeconomic factors. The Monetary authority in India should have vigilance in consecutively checking the effect or role of other financial intermediaries on the growth of the non-banking sector. The vital financial intermediaries, both in the formal and informal sector, may have bearing on the functioning of these mediators. This research work studies the growth of NBFCs-ND-SI in India. Authorities shall develop policies for regulating the connected financial intermediaries on the basis of empirical knowledge about the relationship. Further, by analysing the shadow banking nature of NBFCs-ND-SI in Kerala, both the firms and authorities shall formulate effective policies for developments and changes in regulating environment.

1.4 Objectives of the Study

1. To study the growth of NBFCs-ND-SI in India
2. To evaluate the financial performance of NBFCs-ND-SI in Kerala
3. To examine the contributions made by banking sector towards the NBFCs with respect to deposit and credit.
4. To evaluate the maturity transformation practices of NBFCs-ND-SI in Kerala

1.5 Scope of the Study

This study deals with the performance evaluation of NBFCs especially the financial performance of NBFCs-ND-SI in Kerala. The policy framework, which regulates the NBFC regime in India, has been examined. It focuses specifically on the growth of shadow banks in India. The contribution of main stream banking sector to the progress of these NBFCs has also been examined. The aspect of maturity transformation of NBFCs has also been subjected for evaluation.

1.6 Hypotheses of the Study

Growth in the functioning of other financial intermediaries- banks and co operatives- affects the growth of NBFCs-ND-SI in India. Bank borrowings and net worth contribute towards the asset growth of NBFCs-ND-SI. Financial sustainability of NBFCs-ND-SI in Kerala is explainable by the volume of bank credit to weaker sections in the state and capital contribution of such NBFCs. Rural bank deposit, semi urban bank deposit and rural bank credit affect the total income of NBFCs-ND-SI in Kerala. Concentration of bank credit on urban districts has also a bearing on the total income of NBFCs-ND-SI.

These hypotheses can also be restated as follows;

- Growth in the functioning of other financial intermediaries- banks and co operatives- affects the growth of NBFCs-ND-SI in India.

- Bank borrowings and net worth contribute towards the asset growth of NBFCs-ND-SI.
- Financial sustainability of NBFCs-ND-SI in Kerala is explainable by the volume of bank credit to weaker sections in the state and capital contribution of such NBFCs.
- Rural bank deposit, semi urban bank deposit and rural bank credit affect the total income of NBFCs-ND-SI in Kerala.
- Concentration of bank credit on urban districts has a bearing on the total income of NBFCs-ND-SI.

1.7 Methodology

1.7.1 *Frame*

This study is based on descriptive research design. This study is primarily about the shadow banking practices of NBFCs in Kerala. It focuses chiefly on the exploration of the idea of *contemporary meaning and practices of shadow banking*. Vast literature discusses the practice of shadow banking in different economies. It also strives to know the level of understanding the concept of shadow banking as a distinguished one. The study encompasses a crosschecking of views of different authors and entities on the notion called shadow banking. Further, an attempt has also been made to appraise the concept. The study incorporates an examination of *shadow banking practices in India*. The study devolves with *financial performance* of NBFCs-ND-SI in Kerala. A part of the study has been made up with evaluation of *maturity* *transformation practices* of NBFCs-ND-SI in Kerala. A chapter concentrates on the *policy framework* of NBFCs in India. Possible efforts were taken to limit the discussion without violating the frame.

1.7.2 *Data*

The study is explanatory in nature. Both primary and secondary data were used for this research work. Data were gathered from the branch managers of selected NBFCs in Kerala. This data constitute the base of the evaluations made in this research work.

Perspectives of different economists have turned out to be the source of understanding the concept of shadow banking. Accordingly, different models on shadow banking have been examined. Using secondary data sought from the annual reports of two major NBFCs in Kerala (sample), the work focuses on the financial performance and maturity transformation of NBFCs-ND-SI.

1.7.3 *Sampling*

There are eight Systemically Important Non-Deposit taking NBFCs in Kerala. It constitutes 3.68 percentage of the total number of the NBFCs-ND-SI in India. The eight NBFCs (as on 31st October 2017) are as follows; Manappuram Finance Limited, Kerala Transport Development Finance Corporation Limited, Muthoot Fincorp Limited (Formerly known as Muthoot Debt Management Services Ltd), Muthoottu Mini Financiers Limited, Muthoot Finance Limited, Kosamattam Finance Limited, Kerala State Industrial Development Corporation Ltd and Fedbank Financial Services Limited.

Here, in this framework, only listed companies have been included in the sample. Government owned NBFCs may not, generally, pose a systemic risk. While starting this research work at the end of 2014, there were three such government owned NBFCs. The rest, five NBFCs were Manappuram Finance Limited, Muthoot Fincorp Limited, Muthoottu Mini Financiers Limited, Muthoot Finance Limited, and Kosamattam Finance Limited. According to their annual reports, total share holders funds of these NBFCs constituted Rs 933834.39 million (As at March 2016). Muthoot Finance Limited have 54 percentage of total share capital of the five NBFCs. Manappuram Finance Limited have 26 percentage of total share capital of the five NBFCs.

Conventionally, there is a notion that these NBFCs have to advance using their owned funds. Diversified and augmented financial needs of the community may not be fully satisfied with the functioning of commercial banks alone. Moreover, diversification and augmentation in the financial services, especially after the reforms, demanded the strengthening of these types of NBFCs. It is this factor which stimulated the intermediaries to depend on banks, and thus they come under the shadow of respective banks. Monetary authority, accordingly stipulates the Capital to Risk Weighted Assets (CRAR) for these types of NBFCs and it will quantitatively determine the total asset quantity. The CRAR for these NBFCs pegs around 15%. On the basis of the volume of share holders funds, the NBFCs can be arranged in descending order as; 1.

Muthoot Finance Limited, 2. Manappuram Finance Limited, 3. Muthoot Fincorp Limited, 4. Muthoottu Mini Financiers Limited and 5. Kosamattam Finance Limited.

In 2016, Muthoot Finance Limited have 49 percentage of total assets of the five NBFCs. Manappuram Finance Limited have 22 percentage of total assets of the five NBFCs.

Muthoot Finance Limited and Manappuram Finance Limited are the major financiers in this sector. Total assets of these two NBFCs constitute Rs 438594.359 million (As at March 2017). Considering the volume of share capital and total assets, two NBFCs were selected as sample- Manappuram Finance Limited and Muthoot Finance Limited.

1.7.4 *Data Sources*

Financial data of all NBFCs-ND-SI in India, Reports of RBI, Annual Reports of selected NBFCs-ND-SI in Kerala, Economic Review of Kerala (State Planning Board) for various years, publications of ASSOCHAM and Financial Stability Board.

1.7.5 *Tools*

Apart from the percentages and trends, elementary financial ratios have been computed and the correlation between various variables has been analyzed. Ordinary Least Square Regression (OLS) is used for comprehending the relationship among the variables. Before conducting OLS, all underlying assumptions (like normality of residuals, heteroscedasticity, colinearity, auto correlation, etc) have been verified and found correct.

1.8 Period

The research work mainly gives attention to the post crisis period. After the economic crisis (2007-08), RBI has taken sombre regulatory measures. Since the period of post crisis, RBI is cautious about publishing the financial data of NBFCs-ND-SI in India. The period 2008 to 2016 was selected for studying the growth of NBFCs-ND-SI. For studying the nature of shadow banking and financial performance of NBFCs-ND-SI in Kerala, the period stretching from 2008 to 2017 has been considered. In order to analyze the relationship between banking and NBFCs-ND-SI in Kerala, quarterly data for the period ranging from 2011 to 2017 has been taken in to account. In 2007, Muthoot Finance included in the category of NBFC-ND-SI as per the norms of RBI. Similarly, Manappuram Finance Ltd gained its status changed from Category A- Deposit taking NBFC to Category B- Non Deposit taking NBFC with effect from March 22, 2011. As the yearly data would be insufficient to statistical analysis, quarterly data has been considered for this purpose (23 observations). For sifting the maturity transformation practices, annual financial data of these two NBFCs for a period of 2012-2017 have been considered (6 observations). Again, to account the magnitude of liabilities and advances, half yearly data for the period 2012-2017 (11 observations) has been taken.

1.9 Different Types/ Categories of NBFCs Registered with RBI

NBFCs are categorized a) in terms of the type of liabilities into Deposit and Non-Deposit accepting NBFCs, b) non deposit taking NBFCs by their size into systemically important and other non-deposit holding companies (NBFC-NDSI and NBFC-ND) and c) by the kind of activity they conduct. Within this broad categorization the different types of NBFCs are as follows:

I. Asset Finance Company (AFC): An AFC is a 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. Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising thereupon is not less than 60% of its total assets and total income respectively.

II. Investment Company (IC): IC means any company, which is a financial institution, carrying on the acquisition of securities as its principal business.

III. Loan Company (LC): LC means any company which is a financial institution carrying on as its principal business the providing of finance either by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

IV. Infrastructure Finance Company (IFC): IFC is a non-banking finance company a) which deploys at least 75 per cent of its total assets in infrastructure loans, b) has a minimum Net Owned Funds of Rs 300 crore, c) has a minimum credit rating of ‘A ‘or equivalent and (d) a CRAR of 15%.

V. Systemically Important Core Investment Company (CIC-ND-SI): CIC-ND-SI is an NBFC carrying on the business of acquisition of shares and securities and which satisfies the following conditions:-

(a) It holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;

(b) 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 constitute not less than 60% of its Total Assets;

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

(d) It does not carry on any other financial activity referred to in Section 45I (c) and 45I(f) of the RBI Act, 1934 except investment in bank deposits, money market instruments, government securities, loans and investments in debt issuances of group companies or guarantees issued on behalf of group companies.

(e) Its asset size is Rs 100 crore or above and

(f) It accepts public funds

VI. Infrastructure Debt Fund Non- Banking Financial Company (IDF-NBFC): IDF-NBFC is a company registered as NBFC to facilitate the flow of long term debt into infrastructure projects. IDF-NBFC raise resources through issue of Rupee or Dollar denominated bonds of minimum 5 year maturity. Only Infrastructure Finance Companies (IFC) can sponsor IDF-NBFCs.

VII. Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI): NBFC-MFI is a non-deposit taking NBFC having not less than 85% of its assets in the nature of qualifying assets and which satisfies the following criteria:

a. loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs 1,00,000 or urban and semi-urban household income not exceeding Rs 1,60,000;

b. Loan amount does not exceed Rs 50,000 in the first cycle and Rs 1,00,000 in subsequent cycles;

c. Total indebtedness of the borrower does not exceed Rs 1,00,000;

d. Tenure of the loan not to be less than 24 months for loan amount in excess of Rs 15,000 with prepayment without penalty;

e. Loan to be extended without collateral;

f. Aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs;

g. Loan is repayable on weekly, fortnightly or monthly installments at the choice of the borrower

VIII. Non-Banking Financial Company – Factors (NBFC-Factors): NBFC-Factor is a non-deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring business should constitute at least 50 percent of its total assets and its income derived from factoring business should not be less than 50 percent of its gross income.

IX. Mortgage Guarantee Companies (MGC) - MGC are financial institutions for which at least 90% of the business turnover is mortgage guarantee business or at least 90% of the gross income is from mortgage guarantee business and net owned fund is Rs 100 crore.

X. NBFC- Non-Operative Financial Holding Company (NOFHC) is financial institution through which promoter / promoter groups will be permitted to set up a new bank .It's a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators, to the extent permissible under the applicable regulatory prescriptions.

1.10 Operational Definitions

Following operational definitions are used in this study.

1.10.1 Non-Banking Financial Company (NBFC)

A Non-Banking Financial Company is a company registered under the Companies Act, 1956. NBFCs normally engage 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. NBFCs do 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. Residuary Non-banking Company is a company engaged in principal business of receiving deposits under any scheme or arrangement in one lump sum or in instalments by way of contributions or in any other manner (RBI, January 10, 2017)

1.10.2 Shadow Banks

Financial intermediaries that fall outside the purview of regulators and which perform activities similar to banks- leverage and maturity transformation- are termed as shadow banks. In India, NBFCs-ND-SI are performing like shadow banks.

1.10.3 Maturity Transformation

A process through which short term/long term liabilities are converted into long term/short term assets. Generally, banks transform the maturity of liability.

1.11 Limitations of the Study

This research work concentrates on the performance of NBFCs after the economic crisis. Thus, the period of the study is from 2008 only. Secondary data of only two NBFCs-ND-SI is analysed for evaluating the performance of NBFCs in Kerala. These NBFCs have huge asset size. The beneficiaries of selected financial service providers show an abnormal spread in distribution. This limits the collection of primary data from beneficiaries. To overcome the necessity of primary data, the researcher contacted branch managers of NBFCs in Kerala and widely discussed to understand the nature of functioning.

The research problem is centred on shadow banking nature of NBFCs. Due to the non availability of financial data of other NBFCs, data of two major NBFCs-ND-SI is related with the deposit, credit and number of branches of whole banks in Kerala.

1.12 The Scheme of the Report

Second chapter of this report delves in to a survey of related literature. It contains studies associated with the performance of financial intermediaries like banks, shadow banks etc. The third chapter delineates the policy framework regulating NBFC regime in India. .The fourth chapter narrates the shadow banking practices in India. It attaches the functioning of shadow banks to that of other financial intermediaries in India. In the fifth chapter the financial performance of NBFCs-ND-SI in Kerala is analysed. In the sixth chapter, it has been elaborately elucidated the maturity transformation practices of NBFCs-ND-SI in Kerala. Contribution of the banking sector in Kerala to the total income of Kerala based NBFCs-ND-SI has been described in the seventh chapter. Eventually, in the eighth chapter, major findings, suggestions and conclusion have been recounted.

References

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