2016
OCT -NOV

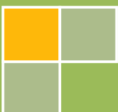
Aarhat Multidisciplinary International Education Research Journal (AMIERJ)

(Bi-Monthly)
Peer-Reviewed Journal
Impact factor: 2.125

VOL – V Issues: V

Chief-Editor:

Ubale Amol Baban



Aarhat Multidisciplinary International Education Research Journal (AMIERJ)
(Bi-Monthly) Peer-Reviewed Journal Vol No V Issues V
OCT-NOV 2016 ISSN 2278-5655

IMPACT OF NBFCs ON INDIA'S ECONOMIC GROWTH

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Abstract

Indian economy today is observing a phase of phenomenal growth. The country has seen year on year growth rate of about 8-9 per cent in the last 3-4 years. Financing requirement are also rising commensurately and will continue to increase in order to support and sustain the tremendous economic growth. As will all know, NBFCs have been playing a complementary role to the other financial institutions including banks in meeting the funding needs of the economy. They help fill the gaps in the availability of financial services that otherwise occur fin bank-dominated financial systems. Equally importantly, NBFCs provide competition for bank in the financial services domain. In fact, diversification of financial markets is an important component of financial sector reforms. As mentioned in the C.M. Vasudev committee Report on NBFCs, meeting the financing needs of all sectors of the financial system needs products and institutions which are in a position to absorb these risks. It is an established fact that the development of financial intermediaries contributes strongly to economic growth; and that contribution is increased where intermediation is provided through a balanced combination of NBFCs and banks-in particular, there is a strong correlation between the depth and activeness of non-banks and stock markets on the one hand, and economic development on the other. RBI reports on banking Trends have recognized the role played by the NBFCs.

***Keywords**: NBFCs, Liability, Capital, Recovery, Taxation, NPA, Loans*

Introduction

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 importance 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 committee 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 Fitch Report1 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.

Challenges Faced by NBFCs

Dependence on Banks for Resources, and Impact on profitability

A shallow bond market has forced NBFCs to rely on banks for their funding needs to a large extent. A CRISIL analysis shows that over one third of total liabilities of NBFSs were loans provided by banks. This ratio will be even higher for smaller NBFCs. Its is ironical to an extent because, on one hand, the NBFCs heavily rely on banks for the funds; while on the other hand, they compete with deposits formed a substantial portion (27 per cent) of NBFCs' liabilities. However, some unfortunate events like series of defaults and misdemeanors by a few NBFCs have led RBI to prescribe fairly restrictive guidelines on acceptance of public-deposits by NBFCs.

The resource crunch on one hand and entry of banks in retail lending segment in a big way has had a deep impact on the profitability of NBFCs. Growing competition from the banking sector has impacted the core profitability of non-banking finance companies(NBFCs). A number of NBFCs operate in businesses where banks have a presence; of late, banks have

acquired dominant position in these businesses, resulting in a contraction in business opportunities as well as interest spreads for most NBFCs.

No Access to Refinance

NBFCs face a high cost of funds compared to the banks partly because of the fact that NBFCs do not have any access to refinance like banks and housing finance companies (HFCs) have. Banks have access to refinance limits form several state-run agencies like RBI, EXIM Bank, NABARD and SIDBI. Similarly, HFCs regularly obtain refinance form National Housing Bank (NHB), who is also the regulator for HFCs. The refinance facilities help the banks and HFCs iron out any mismatch between assets and liabilities. NBFCS on the other hand, have to depend on their competitions, banks, or the capital markets for raising resources at all points of time. This situation is fraught with risks for the health of NBFC sector and can prove detrimental to the sustainability of their growth as in the case of any distress, flow of funds for them from above sources could dry up without much notice.

No Access to SARFAESI for Recovery From Bad Loans

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAEST) empowered Banks / Financial Institutions to recover their non-performing assests without the intervention of the Court. A CRISIL analysis on asset quality of banking system indicates that the gross and net NPAs have continuously declined over the last seven years in percentage as well as absolute terms. Gross NPAs have declined to 2.5 per cent as at March 21, 2007 compared to GNPA of 8.8 per cent and slippages of 3.4 per cent as at March 31, 2003. Banks have actively utilized SARFAESI since its enactment in 2002-03 for improving their recoveries; recoveries through this route has increased form 1.7 per cent of gross NPAs in 2003-01 to 6.6 per cent of gross NPAs in 2005-06.

On the other hand, NBFCs have traditionally been able to achieve superior results than banks in maintaining a better asset quality despite not having any access to effective recovery tools like SARFAESI; this has been primarily driven by better credit appraisal and underwriting standards. NBFCs primarily provide credit to economically weaker sections of the society, which

will be the first to be affected in case of any economic downturn, there is a compelling case for extending the benefits of potent recovery tools like SARFAESI uniformly to NBFCs as well.

No Insurance for public Deposits Held by NBFCs

Deposits kept in banks are insured by a state-run agency, Deposit Insurance and Credit Guarantee Corporation (DICGC). DICGC insures the depositor up to a maximum of Rs 1,00,000 and in will be liable to pay if either the bank is liquidated or it is reconstructed or amalgamated/merged with another bank. Deposit-taking NBFCs(NBFCs-D) do not enjoy any such advantage. Non-banking finance institutions in the US are treated at par withthe banks on this aspect as deposits of both are insured by insurance agencies. Given the fact that NBFCs in India are lending to sectors which are important for overall economic growth, there is a strong case for comparable institutional support being extended to the NBCs as well in order to perfect their competitiveness and to provide support and sustenance in times of distress.

Limited Capital Enhancing Options

RBI has provided banks with various capital-enhancing options in recent past. In February 2006, banks were allowed to issue several forms of hybrid capital-both as Tier-I and Tier-II capital. More recently, banks have been allowed to issue preference shares to further augment their capital base. As entities which are competing with banks for originating the same assets, NBFCs have not been provided level- playing field for raising capital. The only ways in which NBFCs can raise capital is through equity capital or Tier II bonds.

The global players having NBFC subsidiaries in India have regularly pumped in capital as RoE offered by these subsidiaries are comparable to that of any of their other businesses worldwide. Also, some of the larger NBFCS which do not enjoy parent support have regularly tapped global capital markets though ADR and GDR issues or have roped in private equity / venture capital partners. It needs to be noted that all the above capital raising options have high cost attached to them and put immense pressure on NBFCs to take risks and deliver supernormal returns to the shareholders. On the other hand, the banks have been provided capital enhancing options which are comparatively less costlier and lets the banks focus on the core business activities rather than taking excessive risks.

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Registration of NBFCs under State Money Lender Laws By Some of the State Governments is Retrograde

Despite being subject to the comprehensive and a constantly evolving, regulatory and supervisory scheme of Reserve Bank of India, in some of these states, NBFCs are now being asked to register under their Money lenders act apart from registration with RBI. This is acting as a hindrance in efficient functioning of the NBFC' s and is resulting in our member NBFCs suffering from complexities, and contradictions, of multiple regulations and having to comply with differing legislations of each of these states Legislations for controlling the activities of money lending by private moneylenders were enacted by States of India as part of their legislative domain with a view to preventing their exploitative money lending practices and to thus protect farmers and other vulnerable sections of society, particularly in rural areas. To equate the role of NBFCs with private moneylenders is not appropriate in view of significant role played by NBFCs in financial inclusion and economic development.

Incompatible and Differential Treatment on Matters Relating to Taxation

Sec.36(1) (viia)/43D Of the Income Tax Act, 1961-Benefits allowed to the banks and housing finance companies, but NBFC-AFCs left out

Under the existing provisions u/s 36 (1) (viia) of the income –Tax Act, a provision for bad anddoubtful debts made by banks and financial institutions is allowed as a deduction to the extent of 7.5% from the gross total income.

Alternatively, such banks and FIs have been given an option to claim a deduction in respect of any provision made for assets classified by the RBI as doubtful assets or loss assets to the extent of 10% (increased from 5%) of such assets. NBFC-AFCs are also compulsorily required to make provisions for Non-Performing Assets (NPA's). However, Provisions made by NBFC-AFCs in line with such prudential norms fixed by RBI are disallowed by tax authorities when assessing their income tax liabilities. These provisions made against NPAs are an NBFC-AFC as mandated by the regulator.

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Therefore, these provisions should be allowed to be deducted while arriving at the taxable profits of NBFC-AFCs. Any recovery made against these allowed provisions would automatically get taxed later on.

Banks/ HFCs/FIs enjoy tax benefit on income deferred as per RBI directives on NPA. NBFC-AFCs are also required to follow these prudential norms as per RBI directives, but they are the only segment of the financial sector denied this tax benefit.

It is suggested that being subject to all the prudential norms on provisioning and income recognition, under RBI regulations, it is only fair and equitable that the benefits already available to Banks & FIs and HFCs under Sec.36(1) (viia) and Sec. 43D of the IT Act be extended to AFCs also.

Exemption to NBFC-AFCs from TDS Requirements U/s 194A

The I.T. Act-Benefit allowed to banks, but NBFC-AFCs left out. As per Section 194A of theIncome Tax Act 1961, tax has to be deducted out of the interest payments made by specified borrowers to the lender at the rates in force. The rates vary depending on the constitution of the payee (lender). For the category of domestic companies in which NBFC-AFCs fall, the rate of TDS is presently 22.44% including surcharge of 10% and education cess of 2%.

Banking companies, Cooperative societies engaged in banking business, public financial institutions, LIC, UTI, Insurance companies and some other notified institutions are exempted from the purview of this section, implying that if the payment of interest is made to these entities, the borrower is not required to deduct TDS out of the interest payment. This is not available to NBFC-AFCs even though they are in similar lending activities. Consequently, their margins and cash flow are severely affected.

Therefore, exemption should be granted from TDS on interest payment to AFCs u/s 194A (3) (iii) of the I.T. Act.

TDS on Financial lease rental payment under Section 194-I of Income Tax Act-Gross lease rental subjected to TDS and not the interest portion alone Section 194-I of the Income Tax Act deals with TDS on rent payments.

The present TDS rate is 22.11% (20% TDS + 10% surcharge + 2% education cess). In this section, the definition of 'rent' has been enlarged to include lease, sub-lease, tenancy or any other agreement or arrangement for use of machinery, plant, equipment etc. besides land and buildings.s

NBFC-AFCs operate on very thin margins. On that, if a 20% TDS is applied on gross lease rentals, this will result in negative cash flows. It must be pointed out that unlike renting; leasing is a mode of financing and major portion of lease rentals includes repayment of principal just like a loan repayment.

If TDS is deducted on entire lease rental, it means not only will the TDS be deducted on the interest, but also on the principal amount.

This can spell disaster for the NBFC-AFC sector in India leading to its extinction.

The Future: Challengers and Opportunities

Looking ahead, the objectives of financial and balanced economic growth pose significant challenges for the financial sector given the size and uniqueness of the Indian economy. The relative underdevelopment to rural and semi-urban segment; low investment in agriculture; the need to develop self-employment opportunities; the need to create equal opportunities and economic empowerment for women and backward groups are amongst the many challengers that require quick and innovative solutions. Availability of funding, demographic knowledge and strong local relationships, identifying needs and developing relevant financial products, cost-effective credit delivery mechanisms, ensuring productive use of and adequate returns on credit deployed, and providing knowledge and technology tools are some of the building blocks for successful financial inclusion. This will require the combined resources and strengths of players within the financial sector acting in tandem; while banks will continue to take the leadership role, the importance of NBFCs and micro-financing institutions cannot be understated. Proximity to customers, knowledge of customer needs, efficient credit delivery methods, setting up cost-effective distribution networks, and the innovativeness that characterize NBFCS are critical components needed within the financial system. As a huge emerging economy, India offers unprecedented challengers as well as exciting opportunities for

players in the financial sector. Addressing customer needs and providing credit and financial services to large segment of the un-banked and under-served population will require unique and innovative solutions, which NBFCs are well placed to provide. There is a space in the market ant there is a market in such space. The act of discovery does not lie in looking for new lands alone, but also looking with new eyes.

Ancient Indian wisdom says, 'when you shut one eye, you don't hear everything'

Some of the specific Opportunities that will form an Increasingly Large part of NBFC Activities in Future will be:

Acting as a Distribution Backbone for Insurance Companies

With low insurance penetration in India, customized products are needed for low-income groups in the semi-urban and rural market who typically, are NBFC customers. As with banks, NBFCs are likely to evolve synergistic models with insurance companies, whereby they not only provide distribution services, but also offer customer base and provide feedback on product performance and customer needs.

Distribution of Mutual Fund Products

Given the rapid growth in the mutual fund industry, MF products will percolate into the semi-urban markets initially and seep into rural markets at a later point in time to tap investible surpluses. These markets are challenging and will require innovation in product offerings; NBFCs are well placed to work as partners with mutual funds in developing these markets.

Providing Collection Services for Portfolios Originated by Banks and Other NBFCs

Typically, NBFCs have robust collection mechanisms while banks generally depend on third party service providers for support in collection. As both set of players are regulated by the RBI, it is healthy for the financial sector (given the problems in enforcing operating guidelines for multifarious agencies operating in this area) that NBFCs and banks develop a collaborative relationship in collection. To the extent limited or partial recourse guarantees are collaborative relationship in collections. To the extent limited or partial recourse guarantees are provided by the collecting party, this also helps the originating party in rating its assets and in securitization.

Buyout and Servicing of Retail NPA's

This is at a nascent stage in India. The asset buyout and restructuring business is focused almost entirely on corporate asset; however, the rapid growth in retail asset portfolios creates a similar need for entities that will acquire and generate a yield form stressed asset portfolios. As low-cost operators, NBFCs are better suited to play this role, which is critical in maintaining the health of the retail financial sector. This activity plays a vital role in freeing up capital for lending institutions, which can be used productively. However, as a pre-requisite, the current restrictions placed on NBFCs in accessing the legal and judicial framework for recoveries need to be removed. Providing a single-window for meeting the borrowing and investment needs of individuals and SME enterprises. With 50% of the population not having bank accounts and lacking access to organized credit, the ability of NBFCs to address the needs of low-income groups and small businesses supplements the role of banks. By expending their own product offerings as well as acting as distributors for larger financial institutions, NBFCs have been able to serve customer needs while generating a fee-based income stream for themselves, which also helps in de-risking their operating models. Typically the relationship between the NBFCs' and banks would be that of 'Retailer: Wholesaler', where the retailer would provide last mile delivery in a more effective manner than banks, particularly in semi-urban and rural markets.

Leasing

Flawed policies relating to taxation on leasing transactions has driven the leasing industry into a comatose situation. An emerging economy needs a vibrant leasing sector, as this stimulates the growth of SME enterprises. Typically, smaller enterprises that lack capital use operating leases as a tool to overcome the investment barrier to growth. NBFCs have a large role in this segment, as they better understand the needs of smaller enterprises. Need to remove roadblocks However, for NBFCs to contribute effectively in future, the regulatory framework need to address the roadblocks to growth of the NBFC sector. These are highlighted below:

Absence of any refinancing agency for the sector, combined with restrictive caps on banks' lending to the NBFC sector

Limited access to ECB funding, which would help address funding cost and tenure issues Restrictions on issuing hybrid financial instruments for meeting regulatory capital needs No access to SARFAESI and Debt Recovery Tribunals for recovery of bad loans Multiplicity of taxes combined with differential and discriminatory tax treatment of the sector Need for a supportive Legal Infrastructure Supporting laws such as those governing accounting rules, property rights and contract enforcement will be of prime importance to the future growth of NBFCs. A study done by the World Bank (Levine, Loayza and Beck-1999:28) on the relationship between legal infrastructure and financial development finds that: "Countries with:

- Laws that give a high priority to secured creditiors,
- Legal system that rigorously enforce contracts, and
- Accounting standards that produce comprehensive and comparable corporate financial statements tend to have better-developed financial intermediaries."

Fast track recovery mechanism, like repossession of assets in case of default will hold the key. With huge backlog of pending cases before various across the country leading to long delays, a system of repossession using "private" means within the country's legal framework will ensure a healthy recovery trend.

Conclusion

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 has been modifying its regulatory and supervising policies from time to time 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 Report1 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. The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) empowered Banks / Financial Institutions to recover their non-performing assets without the intervention of the Court. A CRISIL analysis on asset quality of banking system indicates that the gross and net NPAs have continuously declined over the last seven years in percentage as well as absolute terms. Gross NPAs have declined to 2.5 per cent as at March 31, 2003. Banks have actively utilized SARFAESI since its enactment in 2002-03 for improving their recoveries; recoveries through this route has increased form 1.7 per cent of gross NPAs in 2003-04 to 6.6 per cent of gross NPAs in 2005-06.

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