Solvency, Productivity and Profitability Of Non-Banking Financial Companies in TamilNadu

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Abstract

In recent times, non-banking financial companies (NBFCs) have emerged as substantial contributors to the Indian economic growth by supplementing the efforts of bank and other development financial institutions. NBFCs play a key role in the direction of savings and investments. On the basis of their legal status and their principal activities, the NBFCs have been classified as Loan Company, Hire purchase finance company, Equipment leasing company, Investment Company and Residuary non banking company. The scope of the NBFCs is fast growing with the multiplication of financial services. Some of the NBFCs are also engaging in underwriting through subsidiary units, and by offering allied financial services including stock broking, investment banking, asset management and portfolio management.

Key Words: Non-Banking Financial Companies, Financial Performance, Customer Loyalty, Solvency Position, Financial & Operational Performances, Productivity & Profitability Evaluation, Tamil Nadu

1 Introduction

Economic reforms in India were initiated in 1991. It has two main objectives 1. Stabilization and 2. Structural adjustment. Stabilization is necessary to correct the macro-economic imbalances, which periodically destabilize the Indian economy, such as inflation, unsustainable fiscal deficit, acute foreign exchange shortage and balance of payment problem. Structural adjustment is necessary to observe international standards. The Structural Adjustment Programme (SAP) comprises basically of reforms in fiscal, trade and exchange rate policies. The policy shifts, corresponding to these reforms, are clearly manifest in the on-going process towards privatization, liberalization and globalization. The kind of reforms that India has introduced in 1991 is not uncommon. During the beginning of
1990, Indian economy was going through a period of increased financialization. The share of assets of the financial institutions to the GDP increased considerably. The nineties have seen a drastic reduction in global barriers to competition in the financial services industry. Deregulation around the world has permitted consolidation across more distant and different types of financial institutions. The growth in cross border activities of Non-Banking Financial Companies has spurred greater demands for institutions that can provide financial services across borders. Liberalization has brought about a transformation in every sector of the economy, so is the case with NBFCs.

Non banking financial company is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares, stock, bonds, debentures or securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business, but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construct of immovable property. A non banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement or any other manner, or lending in any manner is also a non-banking financial company.¹

2 Significance of Non-Banking Financial Companies (NBFCs)

**Procedural Convenience:** Government’s attitude with regard to providing finance to industries has changed since 1991 and as a policy matter, the government imposed restrictions on banks to provide term loan as well as cash credit facilities to the industries. Not only that, in getting finance from banks, industries have to follow rigid legal formalities which not only create major problems in starting the projects but also the possibility of cost over runs. NBFCs providing lease finance which is free from cumbersome procedures, compliance of covenants and regulations as compared to procuring finance from financial institutions. Leasing finance is the quickest finance available for meeting the costs of capital expenditure of business enterprises. It allows a client to acquire assets at a fast pace. Thus, in case of NBFCs, the process of providing finance to the industries is not lengthy and as a result their businesses improve steadily.

**Effect on borrowing capacity:** The term borrowing capacity signifies the scope which the company enjoys to increase its borrowed capital without damaging the credit rating and market price of its shares. It is needless to mention that, if a firm increases debt without increasing the equity, the borrowing capacity of the firm is reduced. Leasing is not borrowing and as such the borrowing capacity of the firms remains intact and preserved for future borrowing. Lease is an equivalent to borrowing and it commits a firm to a schedule of fixed payments. Equipment leasing under the garb of NBFCs does not appear as debt on a firm’s balance sheet and this does not adversely affect the firm’s debt-equity ratio. Thus, it helps in increasing the borrowing capacity of the firm in the sense that it is off-balance sheet item of finance. On the other hand, companies which have exhausted their borrowing capacity can pursue their growth of operations by means of lease finance to acquire additional equipment for increasing their production capacities.

**Shifting obsolescence risk:** It is undeniably true that if any industry does not use modern technology, it cannot compete with other industries using the same. However, it should be kept in mind that any plant or equipment carries the risk of obsolescence. This particular fact raises a great question mark to the entrepreneurs who have been suffering from financial crisis. This risk is 100 per cent shared by the lessor under the lease agreement. So, an entrepreneur opts for leasing, because, under this agreement the risk of obsolescence shifts from the user to the owner.
Piecemeal financing device: Lease financing is a less costly and more convenient piecemeal financing device, particularly in those circumstances, when a firm is expanding by adding relatively smaller amounts of fixed assets at regular intervals. In such a scenario, the firm will have to locate a series of funds to finance its growth. However, with the passage of time, the cost of financing will increase, thereby posing unnecessary hardship on the financial position of the firm for raising funds from other sources. Hence, NBFCs, by means of offering the leasing facility, helps the firm to avoid high cost of piecemeal financing.

Cash not tied up in fixed assets: NBFCs provide equipment to the entrepreneurs under the lease agreements and the firm uses the assets without incurring huge capital expenditure. Hence, the surplus cash can be utilized by the firm in building of additional manufacturing capacity or financing the working capital. If the return on working capital is higher than the cost of leasing then the acquirer may opt for leasing the equipment instead of buying it.

Boon for small firms: Small firms which have no access to raise funds from capital markets can acquire assets by means of leasing arrangements from NBFCs. Thus, NBFCs serve the small firms in arranging funds for launching of new business or for expanding the existing one. Therefore, NBFCs help to create better employment opportunities for the society.

Image of the country: Among the many factors responsible for underdevelopment, lack of capital formation is considered to be a factor of prime importance. In case of India, lease financing is beneficial for importing ships, aircrafts, etc. instead of borrowing. This will create a better image of the nation than being a borrower with no pressing service charges for unpaid loans. Thus, large-sized NBFCs can help big companies and also the government to acquire capital assets under the lease agreements. Overall NBFCs contribute to our national economic growth.

Loan financing to small operators: Small road transport operators generally acquire their vehicles by taking finance from NBFCs. Loan financing from NBFCs is easy than the bank financing. The auto finance sector has traditionally been dominated by the NBFCs.

Wide area network: With the increasing services sector activity in India, NBFCs have been playing a critical role in providing the credit. NBFCs have extensive networks and many have appointed a large number of agents who collect money from small depositors through door to door service. Thus, NBFCs provide a good investment opportunity for the small investors.

Attractive rates of return: The NBFCs flourished well for the reasons that they offered attractive rates of return to the depositors. On many occasions, they have offered attractive gifts to their depositors through their brokers and agents. They even offer at least four per cent more interest to their depositors than the public sector banks on 1-3 year maturity deposits. This helps them in establishing a better position to collect deposits from the small investors.

3 Financial performance

Finance is one of the foundations of all kinds of economic activities. No business activity can ever be pursued without financial support. This point of view is well brought out by A. L. Kingshott who states: “Finance is the common denominator for a vast range of corporate objectives and the major part of any corporate plan must be expressed in financial terms”.

Financial viability is perhaps the central theme of any business proposition. A firm’s success, and in fact, its very survival depends upon how efficiently it is able to generate funds, as and when needed.
Broadly speaking, finance serves two important functions. First, it is a means of assembling the funds necessary to initiate a new activity. Second, it provides the basis for continued operation—finishing additional capital, covering the costs of operation and synchronizing various factors of an on-going business. Underlying these two functions is the formulation of policy, which provides a sense of direction and actual plan of operation.

Financial management applies to an organization, irrespective of its size, nature of ownership and control—whether it is a manufacturing or service organization, which has financial implication. That is why Raymond Chambers says, “The term financial management may be applied to any kind of undertaking or organization regardless of its aims or constitution”8. Therefore, proper financial management in NBFCs will help not only to provide greater return on investment but also to provide better services at reasonable charges to the society, to pay higher salaries to their employees and operate business efficiently.

3 Financial analysis

Performance of NBFCs can be evaluated by analyzing the financial statements of NBFCs. Financial statements are prepared primarily for decision-making. They play a dominant role in setting the framework of managerial decisions. But the information provided in the financial statements is not an end in itself as no meaningful conclusions can be drawn from these statements alone. However, the information provided in the financial statements is of immense use in making decisions through analysis and interpretation of various items of the financial statements.

The financial analysis, also known as analysis and interpretation of financial statements, refers to the process of determining financial strengths and weakness of the firm by establishing strategic relationship between the items of the balance sheet, profit and loss account and other data related to operational results. Analyzing financial statements, according to Metcalf and Titard, “is a process of evaluating the relationship between component parts of a financial statement to obtain a better understanding of a firm’s position and performance”. In the words of Mayers, “financial analysis is largely a study of relationship among the various financial factors as shown in a series of statements”.

The purpose of financial analysis is to diagnose the information contained in financial statements so as to judge the profitability and financial soundness of the firm. Just like a doctor examines a patient by recording the body temperature, blood pressure, etc. before making his conclusion regarding the illness and before giving his treatment, a financial analyst analyses the financial statements with various tools of analysis before commenting upon the financial health or weakness of an enterprise. The analysis and interpretation of financial statements is essential to bring out the mystery behind the figures appearing in financial statements.

4 Statement of the problem

The growth of NBFCs has helped the industrial development to a greater extent. They complement the role of commercial banks, filling gaps in their range of services, but they also compete with commercial banks and force them to be more efficient and responsive to the needs of their customers. Most NBFCs are also actively involved in the securities markets and in the mobilization and allocation of long-term financial resources. A number of innovative financial products and services such as credit cards, consumer finance, scripless trading of shares, mutual
funds, credit rating, venture capital, factoring, leasing, merchant / investment banking, etc. have been introduced that have got integrated with the Indian financial system. Thus, the scope of financial services is expanding and the industry is heading for competition.

NBFCs make attractive advertisements and project glamorous schemes to woo more depositors as well as borrowers. They also do good business and earn profits. But NBFCs could not enjoy the customer loyalty and confidence due to frequent incidences of failure of NBFCs in the financial market.

Of late, the public has lost their confidence in these companies as most of these companies were run by fly-by-night operators or could not survive due to defective management policies.

The reasons of failure are many, such as inadequate control and monitoring by the regulating authorities like central bank, management friendly auditors, non-professional management and in case of serious entrepreneurs the reasons vary from lack of corporate governance system, ineffective risk management strategies to inadequate investment opportunities.

Further the failures of NBFCs are due to financial indiscipline and mismanagement of the funds mobilized and funds deployed in lending or investment. Lack of experience and expertise in managing the assets and liabilities is one of the vital reasons for failure of NBFCs. Such failures of NBFCs made RBI to appoint several working groups to study the functions of NBFCs. Certain committees were also formulated to recommend regulatory measures to streamline NBFCs and their financial service activities. At present NBFCs are brought under RBI control and even the prudential norms applicable to banks are also extended to NBFCs with certain modifications.

NBFCs are facing stiff competition from the bank both public and private sector banks. Public sector banks enjoy low deposit cost due to vast distribution network and have occupied a majority share in housing finance where as private banks, particularly new generation banks are actively engaged in retail assets financing. This increased competition certainly affects the business risk profile of NBFCs.

Perception problem has also been dogging the NBFCs particularly after C.R. Bhansali scams rocked the financial sector. The perception problem has been well reflected in the sharp decline of public deposit held with NBFCs by about 28 percentage during the period. The decline, through was partially attributed to the prudential norms suggested by the RBI, reflects the reluctance of the people towards NBFCs.

The poor assets quality of NBFCs is another challenge before them. Poor recovery of loans and subsequent write-off mean that balance sheet of various financing companies reflect a higher percentage of over-dues in comparisons of total assets. This has affected their solvency and profitability which led to their debt instrument being downgraded by the rating agency.

In the light of the above stated facts, the researcher has identified the following as the common problems faced by NBFCs.

1. Stiff competition among NBFCs as well as with banking sector;
2. Small balance sheet size resulting in high cost of funds and low asset profile;
3. Prudential norms, especially, non performing assets;
4. Inadequate expertise in asset and liability management;
5. Lack of experience in lending and recoveries; and
6. The interest rates charged by NBFCs for financial assistance are higher than those charged by commercial banks and other organized financial institutions.
The problems are common to all NBFCs. Still, there are some NBFCs which are thriving well and keep on progressing. They develop their performance making appreciable improvements in all parameters of business, such as, deposit mobilization, credit deployment, income generation, control of expenses, low level of NPA, capital adequacy ratio, comfortable liquidity, etc. There are also some NBFCs which are straggling a lot to make progress.

Hence it is attempted in this study to analyze the solvency, productivity and profitability performance of sample NBFCs in detail, applying systematic analytical approach and find out the valid causes in order to bring out possible remedial measures, so that NBFCs can prepare themselves to solve the problems and to make continuous progress.

5 Scope of the study

There were 12,409 NBFCs in India during 2011. Of which, 526 NBFCs have their registered offices in Tamilnadu. The companies having registered offices in Tamilnadu are considered for the present study. Two companies from ‘accepting deposits category’ and two companies from ‘not accepting deposits category’ have been chosen for the present study. There are several measures to evaluate the financial and operational performances of the business enterprises. In this study it is restricted to the analysis of solvency, productivity and profitability of the selected NBFCs.

6 Objectives of the study

The study covers a period of ten years from 2002-03 to 2011-12 has the following objectives:
1. To document the growth and development of NBFCs;
2. To analyze the solvency position of the selected NBFCs;
3. To appraise the productivity of the selected NBFCs; and
4. To evaluate the profitability of the selected NBFCs;

7 Methodology

Survey method has been followed for this study. Primary and secondary information have been collected through various sources. The primary data has been gathered through personal interviews with the officials of selected NBFCs. Data collected from secondary sources includes annual reports of selected NBFCs, RBI reports and leading journals in the field of commerce and management and related websites.

In the course of the analysis in this study, the use of various accounting and statistical techniques has been made. Ratio analysis, mean, standard deviation, coefficient variation, ANOVA, multiple regression and t-test have been applied.

8 Sampling

Stratified random sampling method has been followed for this study. The registered NBFCs with RBI stratified into ‘NBFCs which accept deposits’ and ‘NBFCs which do not accept deposits’. Two companies from ‘accepting deposits category’ and two companies from ‘not accepting deposits category’ were selected for this study using the above sampling method. Thus four companies are considered, they are Sundaram Finance Limited (SFL), Sriram City Union Finance Limited (SRFL), Cholamandalam Investment and Finance Company Limited (CFL) and Darani Finance Limited.
(DFL). First two companies have been registered with RBI under accepting deposits category and other two companies have been registered with RBI under not accepting deposits category.

7 Chapterisation
The present study is organized into seven chapters as per the details given below: The first chapter deals with the introduction, design and execution of the study. The second chapter reviews the previous studies. The third chapter deals with the Indian perspective of non banking financial companies. The fourth chapter is devoted to the analysis of solvency position of the selected NBFCs. The fifth chapter appraises the productivity of the selected NBFCs. The sixth chapter evaluates the profitability of the selected NBFCs. The last chapter summarizes the findings and suggestions of the study.

8 Findings
The following are the major findings of the analysis:

8.1 Analysis of Solvency
The average of current ratio of the select NBFCs during the study period is more than the accepted optimum level of 2.00. They have comfortable liquidity ratio.

Analysis of cash flow statement shows that except DFL, the other NBFCs under study have been doing the business with good cash generation through their various functional activities. The business of DFL is almost limited to its owned funds, as cash inflow is nil in its financing activities.

Except DFL, the other three NBFCs have high level of debt-equity ratio. On an average these three NBFCs have raised around 5 to 6 times of their respective equity during the decade of study.

Barring DFL, the proprietor’s funds of the other three NBFCs are around 13 to 14 per cent of their respective total assets. DFL does its business mainly with its own funds, where as the other three NBFCs do business mainly with their respective borrowed funds.

8.2 Measurement of Productivity
Analysis of productivity shows that sharp fall and steep increase in the advances as well as in the ratio of advances per branch are seen in all the four NBFCs during the decade.

In SFL deposit position has improved in 10 years, while the SRFL has shown weakening of its deposits position.

The productivity ratio of establishment expenses per branch has increased in all the four sample NBFCs. Profit per branch is comfortable for the NBFCs under study. However, DFL could not exhibit positive ratio throughout the decade.

Income per branch has been comfortable for all the four NBFCs. Advances per employee of the four sample NBFCs have shown fluctuations throughout the decade. The varied ratios exhibit the absence of correlation between the increase in the advances and in the number of employees.

Select NBFCs do not concentrate more on deposit mobilization. Even the deposit taking NBFCs have reduced their deposit levels and this is evident from the reduction in the ratio of per employee deposits during the decade.
Per employee establishment expenses of the NBFCs shows significant variations throughout the decade. The establishment expenses have increased in the last few years of the decade for all the NBFCs.

Both the income and the number of employees have shown increase in all the NBFCs throughout the decade of study. But, their annual increase is not regular and they do not exhibit any proportionate increase throughout the decade. Therefore the ratios of per employee income of the NBFCs show fluctuations throughout.

8.3 Evaluation of Profitability

The net profit margin of the sample NBFCs have been highly positive and are around their respective mean ratios during the last two years of the decade, though these ratios varied marginally and widely during the other years of the decade.

The operating profit ratios of the NBFCs show fluctuations during the years of the decade. However, the ratios are comfortably around their respective mean ratios in the last two years of the decade.

Both volume of financial expenses and total income have grown in all the NBFCs during the decade. However, the growth of financial expenses is marginally higher in all NBFCs.

The administrative and other expenses ratios of the NBFCs have shown variations throughout the decade of study.

The ratios of return on assets are almost constant for the two deposit taking NBFCs, while the ratios are fluctuating for the other two non-deposit taking NBFCs.

The ratios of net profit to capital employed for the sample NBFCs are around their respective mean ratio in the last years and they exhibit variations in other years of the decade.

The ratios of Return on Equity show variations due to disproportionate increase in net profit and equity.

In case of deposit taking NBFCs, the EPS has shown good improvement during the decade of study. On the other hand, the non-deposit taking NBFCs have their EPS fluctuating throughout the decade having less relevance to their respective mean ratio.

Analysis of multiple regression model reveals that in the case of SFL, the independent variables current ratio, debt equity ratio and profit per branch have a positive effect on net profit margin but the profit per employee has negative effect. In the case of SRFL, the debt equity ratio, profit per branch and profit per employee have positive effect whereas, current ratio has negative effect. In the case of CFL, the profit per employee has positive effect whereas, current ratio, debt equity ratio and profit per branch have negative effect. In the case of DFL, profit per employee has positive effect whereas; current ratio, debt equity ratio and profit per branch have negative effect.

8.4 Suggestions

On the basis of the above observations the following measures are suggested to improve the performance of the selected NBFCs.

8.5 Analysis of Solvency

- Current ratio and quick ratio of the NBFCs must be reviewed periodically to maintain them at an optimum level of 2:1 and 1:1 respectively.
The NBFCs must ensure periodical follow up of their cash flow statements to ensure healthy cash generation and to avoid alarming hike in the cash balances.

The NBFCs must practise an effective debt management as their debt-equity ratios are high. This is essential for the NBFCs to have quality assets (performing assets).

Asset-Liability Management must be practised by the NBFCs, as they create assets mainly from borrowed funds. Effective ALM only will save the NBFCs from any possible financial disaster.

### 8.6 Measurement of Productivity

- The branch expansion must be done by the NBFCs after studying the viability. Gradual growth of the ratios of advances per branch is essential for the NBFCs.
- When compared to other sources of funds, deposits are low cost of funds for the NBFCs. Therefore NBFCs must take the advantage of deposit growth to sustain their productivity.
- The increase in the establishment expenses must be justified with reference to the growth in the business. Justified increase may be allowed to modernize the branches to cope with the changing technology.
- NBFCs must concentrate on profit making business in order to survive in the competitive market.
- The NBFCs need to have an annual credit plan and manpower plan. Also the NBFCs must review the performance result periodically using the productivity ratios in order to ensure continuous improvement in their productivity.
- The per employee establishment expenses must be contained to an optimum level to ensure adequate productivity. Improved quality output reduces wasteful expenses and so quality performance of the employees has to be ensured.

### 8.9 Evaluation of Profitability

- Constant, gradual and continuous increase in net profit must be ensured by the NBFCs through proper profit planning.
- The NBFCs must take periodical review of their operating results using the latest tools of information technology to ensure progressive operating profit ratio.
- Financial expenses and the administrative and other expenses have to be incurred judiciously and with reference to the total income. Therefore, the NBFCs must have annual budget for the expenses. Further the NBFCs must have an effective audit both for income and expenditure.
- NBFCs must enhance the volume of quality (performing) assets to avoid burden of NPAs. The ratio of return on assets must be utilized as an effective tool to monitor the quality of assets in all the NBFCs.
- NBFCs must have adequate expertise in evolving strategies to employ its capital to improve its business. Further, the NBFCs should strengthen their capital through the improved returns from the business.
- The NBFCs have to concentrate in improving their net profit with reference to their equity. Improved ROE helps the NBFCs to establish their image and goodwill in the financial market.

### 10 Conclusion

The integrated growth of NBFCs is based on their operational efficiency. The operational efficiency is gauged by the various functional results of the NBFCs over a period of time. The overall functional results could be comprehensively studied using the vital triangular parameters, namely,
solvency, productivity and profitability. A comfortable and stable solvency position provides a confident business atmosphere to improve productivity and, of course, improved productivity ensures profitability. It is a cyclic performance results as profitability adds strength to the solvent position of the NBFCs. The chosen NBFCs have displayed their management efficiency with regard to their productivity as their per employee as well as per branch business has grown during the decade. Similarly, their solvency position, though oscillated during the mid years of the decade, has shown comfortable results in the last few years of the decade of study. The profitability of the NBFCs also has shown fluctuating results, as against expected continuous consistent growth, during the decade. However, the performance of the NBFCs during the last couple of years of the decade has gives encouraging results. The various statistical tools employed in the analysis of the data have helped to verify the certainty of his findings during the course of study. Perusal and implementations of the suggestions are expected to help the sample NBFCs and NBFCs in general to establish their brand image in the arena of competitive financial institutions.

11 References