ROLE OF NON-BANKING FINANCIAL INTERMEDIARIES IN ACCESS TO FINANCE IN SOUTH ASIA

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Introduction

South Asia comprises India, Pakistan, Nepal, Bangladesh, Bhutan, Maldives, Afghanistan and Sri Lanka. Together the collective GDP of the SAARC region stands at $3103 billion with 1.6 billion population. The MSME sector of the region is significantly disadvantaged in terms of access to finance which has resulted in inadequate employment, wealth creation and seriously affected the growth of the middle class in these countries. Financial intermediaries in the region play an important role in providing access to finance to the MSMEs to ensure that they grow and thrive, do not expose to high cost informal lending and grow into upper medium sized companies in the future. In this regard the growth of non-banking financial institutions (NBFI) is significant in that NBFIs can reach out to market segments which both commercial and development banks cannot cater to.

Purpose

i. To critically evaluate the role of non-banking financial intermediaries in providing access to finance in India and Sri Lanka with useful comparisons.
ii. To provide an analysis of the performance and challenges faced by the Indian and Sri Lankan markets.

NBFIs

i. Definition

Non- banking financial institutions are those that provide various banking services without a banking licence[1].

[1] https://www.investopedia.com/terms/n/nbfcs.asp

ii. Rationale and implications of NBFIs

NBFIs originated to assist those who need finance but cannot obtain finance from the formal banking sector. The access to finance is not only an issue for the economy and the financial system in Sri Lanka and India but a vital part in the political fabric of both countries due to the significant numbers of people who are affected due to lack of access to finance.

iii. Background

Access to finance has been a significant issue in both Sri Lanka and India for decades. In both India and Sri Lanka, a significant population have no access to finance in Sri Lanka. These groups include people without adequate collateral and documentation, self-employed and financially illiterate or semi-literate. Both countries have informal financing methods used by people which increase their financing cost. In addition, this type of financing does not meet their financing requirements fully. In Sri Lanka the informal savings groups using peer to peer (P2P) community financing called the seettu method is still an ongoing successful financing method outside of banks.[2] These methods of financing create social wealth which are beyond financial wealth recognizing existing local structures, social networks and community identities.

iv. Legal form and type of NBFIs

There are many types of NBFIs, finance companies, micro finance companies (MFI), consumer finance companies, cooperative credit unions and leasing companies. They are incorporated under the companies' act in their respective local jurisdictions and are subject to regulation sometimes by the same regulator of banks and sometimes left unregulated.

v. NBFI sector in Sri Lanka and India[3]

Country	**Sri Lanka**		**India**		
Type of NBFI	**Legal Act**	**Regulator**	**Type of NBFI**	**Legal Act**	**Regulator**
Micro Finance Company	Micro-finance Act, Companies Act	None	NBFC - Micro Finance Institution	Companies Act 1956 or Companies Act 2013 and RBI Amendment Act 1963	RBI
Licensed finance company	Finance Business Act (FBA) No 42 of 2011. Registration with CBSL is mandatory.	Non-banking division of CBSL under empowerment from the FBA	NBFC – Infrastructure Debt Funds	Companies Act 1956 or Companies Act 2013 and RBI Amendment Act 1963	RBI

[2] Seettu is a form of forced saving by a group of people usually about 10-30 people. The contributions are monthly and the number of people in the group determine the period of the seettu. There are two modes of the seettu, the auction system and the everybody gets the same amount at different times method.

[3] RBI and CBSL

Country	Sri Lanka		India		
Type of NBFI	**Legal Act**	**Regulator**	**Type of NBFI**	**Legal Act**	**Regulator**
Specialized leasing company	Finance Business Act (FBA) No 42 of 2011. Registration with CBSL is mandatory.	Non-banking division of CBSL under empowerment from the FBA	NBFC - Factors	Companies Act 1956 or Companies Act 2013 and RBI Amendment Act 1963	RBI
			Core Investment companies	Companies Act 1956 or Companies Act 2013 and RBI Amendment Act 1963	RBI
			NBFC – Asset finance companies	Companies Act 1956 or Companies Act 2013 and RBI Amendment Act 1963	RBI
			NBFC – Infrastructure finance companies	Companies Act 1956 or Companies Act 2013 and RBI Amendment Act 1963	RBI
			NBFC – Peer to peer companies	Companies Act 1956 or Companies Act 2013 and RBI Amendment Act 1963	RBI
			Asset reconstruction companies	Companies Act 1956 or Companies Act 2013 and RBI Amendment Act 1963	RBI

Regulation in the NBFI sector

The Central Banks in both Sri Lanka and India recognize the fact that NBFIs play a significant and useful role in providing access to finance to their populations. The provision of financial services to a larger segment who are not reached out to by the banks assists governments' targets to increase financial literacy and inclusion, promote savings habits and develop the rural and urban MSME segments[4 5].

Comparison of key regulations governing the NBFI sector in Sri Lanka and India

Regulation	Sri Lanka	India
Public quoted requirement	LFC	
Taking of public deposits	LFC	Housing finance companies authorized by National Housing Bank of India under delegated authority from RBI
Central bank re-purchasewindow access	None	None bur being discussed in the aftermath of the present crisis.
Capital adequacy Liquidity	Tier 1 and Total CAR limits Minimum ratios exist	Tier 1 and Total CAR limits Minimum ratios exist
Foreign borrowings	With CBSL permission	Permitted borrowings under external commercial borrowings and non-convertible debentures.
Debt issuances	Based on Securities and exchange commission and companies act regulation	Based on external commercial borrowing regulations.

Licensed finance companies - (LFC)

Current role of NBFIs

In both Sri Lanka and India banks consist of the main component of the financial system. The largest component of financial assets and liabilities are in the banking system. The NBFI system assumes higher risk than the banking sector. They collectively mitigate the risk profile of the banks. NBFI's client profile is micro, small and medium enterprises which require more stringent credit underwriting skills, recovery efforts and intensive non-performing loan management. NBFIs less formal approach to client acquisition and processes which are geared for less financially literate make them attractive to segments who find it difficult to open a bank account or secure a credit facility from them. NBFIs can typically be described as reaching the client before the bank. They offer higher rates for clients' savings and enable funds to those who may not be credit worthy without collateral or guarantors at the bank.

[4] Aadhaar Unique Identification Authority in India (UIDAI), 2009 – A scheme launched by the government of India to ensure a unique identification is given to each citizen based on biometrics and provide access to banking services, government and non-government programs and mobile phones.

[5] Priority Sector Lending Initiative, – A scheme which requires banks in India to ensure 40% of their net lending in the previous year to identified sectors in the economy.

In Sri Lanka the industry employs 32,000 people. The average credit facility offered is Rs250,000. The industry is funded mainly through public deposits (45%-56%), bank borrowings (32%-35%) and shareholder's capital infusion (8%-12%). It consists of 35 listed and 17 unlisted finance and leasing companies. While 85% of the industry is dominated by the top 20 players, the balance 15% is shared by the remaining 32 players. Rs 6.6 billion was paid by the industry for the betterment of the country in the last financial year in the form of direct taxes. This shows that the Non-Banking Financial Industry is contributing considerably to the national wealth beside its own growth. Alongside the above contribution to the nation, the industry has made an enormous impact in the living standards of the people and per capita income of the country.

The industry's branch network which consists of around 1,320 branches gives an indication of the reach of the industry to the public. It indicates every batch of 15,850 people of the population are provided with a Non-Banking Financial Industry branch. This shows the extent to which the industry can influence the people of this country.

However, in India by 2010 the country has had 12,630 non-banking financial institutes out of which 308 could accept public deposits. These figures would have been increased by now drastically from 2010 to 2018.

With their product diversification and risk-taking ability, they allow new entrants of the business community to experiment in various territories. The Non-Banking Financial Industry ground-level understanding of their customers' profile and their credit needs give them an edge over their counterparts in the banking industry. Their ability to innovate and customize products as per their clients' needs is another uniqueness that they possess. This makes them a perfect channel for delivering of credit.

Performance of NBFIs - quantitative[6]

Table 03: Key performance indicators of the NBFI sector FY2013 through FY2017

Indicator(all values in SLR millions)	Sri Lanka	India
Total assets	1,354,991	50,161,000
Gross loan assets	966,469	37,857,300
Borrowings	309,331	30,388,000
Deposits	686,720	780,300
Gross NPLs to gross loans	6.3%	6.1%
Total CAR	13.13%	22.8%
RoA	3.00%	1.6%
RoE	14.73%	7%
Cost to income ratio	66.64%	78.90%

FY Sri Lanka and India for NBFIs - April to March

[6] https://www.cbsl.gov.lk/en/statistics/statistical-tables/financial-sector and https://m.rbi.org.in/Scripts/PublicationsView.aspx?id=18063

The NBFI sector comprises 12.5% and 16% of total financial assets in the financial system in Sri Lanka and India. The Indian NBFC sector is better capitalized which may explain the significantly lower RoE in the sector in the country. The cost to income ratio is very high due to the inclusion of many micro finance companies. The micro finance companies need to employ a larger number of personnel and travel which increases operating expenses. A distinctive feature of the funding mix in India vis-à-vis Sri Lanka is the high concentration of borrowings. Sri Lankan NBFIs rely more on deposits than borrowings. The net interest margins in the industry too are higher and coupled with lower cost to income ratios have yielded much higher RoAs. The non-performing loan ratios are similar although the absolute non-performing loans in India are much higher.

The challenges facing the NBFI sector in both countries are state policies, capital, asset quality and liquidity. In Sri Lanka after the adverse weather conditions experienced in both 2017 and 2018 the government had announced possible moratoriums on loan programs less than Rs 100,000 to the micro finance sector. In India, post demonetization when there was a cash crunch and payment delays caused a temporary crisis in credit markets the central government announced a moratorium. Usually these programs are under funded by the governments and have an unfavourable impact on borrowers whose payments are regular. This impacts the asset quality of the NBFIs. It should be noted that most NBFIs except when they do asset financing such as auto financing or equipment financing are relatively asset light companies vis-à-vis banks. The capital buffers which are required to absorb potential credit losses are too thin. Sri Lanka looks quite thinly capitalized in terms of the total CAR which under Basle III total CAR (with effect from 2019) at xx%. India however appears to be well capitalized. However, the Indian NBFC sector is faced with a different crisis having extended credit to infrastructure and project finance.

Performance of NBFIs – qualitative

Both Sri Lankan and Indian NBFIs are faced with inadequate risk mitigation avenues. They should be encouraged in their business as they take some risks off the banking system and help diffuse borrower default risk apart from increasing access to credit. Their credit box expansion is based on mostly experience and track record rather than scientifically evaluated robust data covering a long period of time in a centralized location. Future trends with predictive analytics would help to identify potential credit risks before they materialize to diversify risk and take proactive recovery action.

Both countries have significant retail lending opportunities which are not catered to by the banking sectors. NBFIs perform well in this segment with innovative lending products. NBFIs are very imaginative in cash collection and disbursement using electronic information uploads and credit scoring mechanisms which reduce formality to a minimum.

In India NBFIs have made great strides into the housing market. In March 2018 based on

an ICRA research report on housing finance companies (HFC) in India it was noted that the market share of HFCS in the new housing loan origination segment increased to more than 30%.

Key success factors by NBFIs in both markets-

- Deep knowledge of customer –With their experience in unorganized and underserved segments in the market NBFIs have a good understanding of the customers ensuring last mile delivery of products and services.
- Customized lending – Unlike banks NBFIs are more flexible in customizing. The ease is also because of mostly mono line products where pricing would be one of the main variants along with repayment terms considering inherent risk characteristics and deep knowledge of client segments.
- Wider and effective reach – based on their business models NBFIs have wide reach leveraging on today's digitally connected world. Most NBFIs are successful in delivering an omni channel seamless experience to the borrowers. Most NBFIs can have multiple customer touch points on a 24/7 basis.
- Technology –NBFIs who are successful today are those who can leverage on a sustainable competitive advantage which is the ability to use technology to cut lead times in reaching the client, delivering services and collecting money to reach the bank in time.
- Alliances with multiple payment partners – Successful NBFIs stick to what they are good at doing and do not wish to lose focus. They form useful alliances with partners who have already invested in distribution to leverage off the network offer their products.
- Robust risk management – NBFIs are in a high-risk business lending to the lower tiers in the market. Agile risk management with the four eyed principle would prevent tipping the profitability scales into the realm of opaque losses.

Challenges facing NBFIs in Sri Lanka and India

(i) Potential deteriorating asset quality – NBFIs' exposure to middle to lower tier markets exposes them to vulnerabilities such as economic downturns more than the banks. Higher capital buffers with cyclical provisions are mandatory in the business. During an economic downturn slower growth would increase asset quality issues due to lack of growth unlike in the banking sector where a downturn has a lag effect on the portfolio.

(ii) Longer recovery cycles – Most NBFIs are used to collecting in a 182-day cycle which leads to credit indiscipline on the part of borrowers. Due to the target segments longer, recovery cycles are part of the business, but this could feed on itself during a downturn.

(iii) Liquidity under pressure – Most NBFIs rely on banks and debt capital markets or equity infusion to fund their lending operations. Therefore, bank liquidity is very crucial to growth of NBFIs. In recent times, NBFIs have used debt capital markets to raise funds in times of high market liquidity. The characteristics of the debt instruments pose significant asset and liability and pricing issues for NBFIs in that long-term debt assists maturity mismatches while increases pricing narrowing net interest margins. Most NBFIs run significant negative liquidity mismatches

in their books with high risk of running out of liquidity when bank markets dry up.

(iv) Weak capital – Capital is usually under pressure due to constant provisions for nonperforming loan ad losses which impacts internal capital generation and capital formation rates in the industry. Equity investors of NBFIs looking for upside and dividends would not meet their targets. Thus, attraction of investors would be difficult. Hence most NBFIs resort to issuing subordinated debt which have upper Basle III limitations.

(v) Continuous challenges in retaining trained staff – NBFI staff have special recovery and product development competencies which require a high-level of training. One of the key costs in NBFIs is staff costs. This is an unavoidable cost in NBFIs with their business model of last mile delivery.

Conclusions and recommendations

(i) Need for enabling regulation to NBFIs on asset quality and liquidity– Regulators in both Sri Lanka and India would need to consider the systemic importance of NBFIs to the economy. The current light touch regulation when NBFIs are taking significant risks with some of them taking public deposits leaves room for entrepreneurs who enter during an economic upturn and leave in a downturn with defaults, depositor money being lost and job losses. There is a strong case for NBFIs to be regulated like small finance banks in India and small banks in Sri Lanka. This is especially important in non-performing loan classifications. All banks have the 90-day rule while NBFIs are given 180 days promoting delayed recoveries. In this context prudent asset and liability management will address liquidity concerns by moderating growth when mismatches are significant until a stable base is built.

(ii) Incentivize innovation and increased access to finance – NBFIs need to be lauded for their innovation and last mile delivery of financial products. As a by product of their business model apart from access to finance financial literacy of target segments are significantly improved. New branch approvals should be based on presence in rural areas and the number of individuals reached.

(iii) Securitization – In India the securitization of portfolios of NBFIs is quite common even without clear securitization legal structures in place. In Sri Lanka it is not common. However, banks could use NBFI portfolios to reach regulatory minimum exposures to directed lending via pass through certificates and similar investment instruments.

(iv) Capital adequacy norms to reflect inherent risks in the business – The capital adequacy norms of the NBFI sector are less than those of banks although the credit risks are higher. It is understood that NBFIs do not run the gamut of risks banks do. However frequent alignments are necessary for correct loss absorption levels.

(v) Consolidation – NBFIs similar to banks require economies of scale and scope to reach efficiencies of scale to continue to grow and reach capital efficiencies, capacity to access liquidity

from debt markets and support inorganic growth.

(vi) Cohesive enterprise strategy–NBFIs need to develop sustainable advantages for the growth. Right customer segment, right product mix, optimum channel mix and optimum geographical footprint would define them. The following recommendations are proposed;

- Robust IT and digital capabilities– Maximize underwriting efficiencies using the digital revolution. The underwriting model is based on service delivery, risk management and cost efficiencies. Automation of rote based credit scoring will determine future underwriting models. This is possible for NBFI with their deeper knowledge of market segments.
- Partnership with fintech players
- Pro-active risk management- Advance analytics powered collection decisions are possible with technology.
- Agile organization design
- Effective governance mechanism – A strong governance culture is a significant survival tool for NBFIs in challenging situations.