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COMPARATIVE DEPOSIT PROFILE AND COMPARATIVE RISK ANALYSIS OF HFCs, BANKS & NBFCs

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For
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FOREWORD

This report was prepared as a supplement to *The Potential Role of Deposit Insurance in the Development of the Housing Finance Sector : A Report to the National Housing Bank* (1996) by Dr. Douglas B. Diamond, which was also funded by Indo-US Housing Finance Expansion Program.

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PART-A
OVERVIEW

Part-A : Overview

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I. Background

As part of the Indo-US Housing Finance Expansion Program, Abt Associates Inc. is conducting a study on "Structuring and Pricing Deposit Insurance for Housing Finance Companies". The objective is to analyse alternative means of providing deposit insurance to housing finance companies. It is felt that a viable system of deposit insurance could increase the resources available for the housing finance sector.

This report provides the research backdrop for the study.

II. Objective of the study

The study presents a comparative analysis of Housing Finance Companies (HFCs), Banks and Non Banking Financial Companies (NBFCs) with the objective of assessing the following:

- Relative position of these intermediaries with respect to resource mobilisation capabilities. This would be an input in establishing the need, if any for deposit insurance for HFCs.

- The risk profile of housing finance companies compared to other financial intermediaries. This analysis would form the basis for determining the premia for deposit insurance for HFCs.

Any assessment of the need for deposit insurance for HFCs and pricing for the same would be based *interalia* on an understanding of the above issues.

III. Approach and methodology

The study is a combination of CRISIL's own understanding of the financial sector, literature research and specific data obtained from NBFCs and HFCs for the purpose of the study. Keeping the objectives in mind, the CRISIL team has approached the study in two modules as given below:

- **Module 1** - Comparative deposit profile
- **Module 2** - Comparative risk profile

The conclusion in these modules is based on our analysis in the deposit profile of HFCs, NBFCs and Banks (Volume II) and risk profile of HFCs, NBFCs and Banks(Volume III).

The scope of the analysis including sources of information for the two modules are given below:

Module 1: Comparison of deposit profiles

This part of the study consists of an analysis of the deposit profile of HFCs, NBFCs and banks and aims at drawing conclusions as to how HFCs are positioned vis-à-vis the others. Although the all-India financial institutions (FIs) also accept deposits from the public, it is only in the recent past that they have begun doing so. Hence, they have been excluded from the scope of the analysis.

The main parameters for comparison are deposit mix (client profile and region wise), tenure, cost, sustainability and outlook for such funds. It may be mentioned that the scope of analysis with regard to NBFCs extends only to Loan companies, Investment companies, Hire Purchase Finance companies and Equipment Leasing companies. Mutual Benefit Finance companies and Miscellaneous Non-Banking companies have not been included in the scope of analysis since adequate data on them is not available while Housing Finance Companies have been analysed as a separate category.

Sources of information

Housing finance companies

Data available in the Report on Trend and Progress in Housing in India, dated June 1993, published by the NHB has been used in the study. As recent data was not available, CRISIL estimates had to be used. CRISIL estimates are based on the annual reports of the recognised housing finance companies and other published material on the industry.

Non banking financial companies

Reliable data on the industry is difficult to come by. The two main sources of information for the study are draft report of RBI expert group for NBFCs and data of a representative sample of 40 NBFCs representing over 50 % of the public deposits mobilised by NBFCs in 1993-94. These include loan companies, investment companies, hire purchase finance companies and equipment leasing companies.

Banks

Published data has been used for the study from the following sources:

- Economic Survey 1995-96
- Report on Currency and Finance 1993-94, RBI
- RBI Bulletin
- Annual reports of Banks
- CRISIL Database

Module 2: Comparison of risk profiles

This section of the study contains a comparison of the risk profile of HFCs with other NBFCs and banks. This analysis would help in making a judgement on the relative risks of the housing finance sector vis-à-vis banks and other NBFCs which could be an important input in determining the comparative deposit insurance premia for the HFC sector. The main parameters for comparison under business risk and financial risk are:

2.1 Business risk

Range of activities
- *Analysis of the business mix*

Growth potential
- *Outlook for growth*
- *Main drivers of growth*
- *Demand-supply gap*

Size
- *Industry size*
- *Size of players in each sector*

Geographic diversification

- *Extent of spread of operations*

Systems/procedures and computerisation

- *Standard operating procedures*
- *Automation*
- *Management information systems*
- *Systems for tracking risks*

Productivity

- *Business and profitability per employee*
- *Service levels*

Resources/funding

- *Outlook and sustainablility for main funding sources*
- *Diversity of funding sources*
- *Cost of funding*

Government support and regulatory framework

- *Impact of regulatory framework on the risk profile of each sector*

Asset quality

- *Major lending segments*
- *Loan approval and review process*
- *Collection efficiency and level of non performing assets*
- *Provisioning for loan losses*
- *Investment policies including depreciation on investments*

Degree of competition

- *Competitive dynamics of each sector.*

2.2 Financial risk

Capital adequacy

- *Current status with regard to achievement of prudential capital adequacy norms and outlook*

Accounting policies and transparency of accounts

- *Income recognition policies*
- *Method of providing depreciation on leased assets*
- *Valuation of investments*
- *Asset classification and provisioning*
- *Transparency /level of disclosures*

Profitability
- *Sources of income*
- *Yields from different businesses*
- *Expense levels*
- *Ability to sustain earnings*
- *Off balance sheet items*

Asset liability matching
- *Interest rate risk*
- *Maturity risk*

Liquidity
- *Financial flexibility*

2.3 Sources of information

Housing finance companies

The analysis is based on a sample of 13 "recognised HFCs" which are eligible for refinance from the NHB. Since the top five HFCs themselves account for 80% of the market, this coverage can be considered to be adequate.

Non banking financial companies

The analysis is based on CRISIL's understanding of the sector. Special focus has been on the data relating to 150 NBFCs. These include loan companies, investment companies, hire purchase finance companies and equipment leasing companies. This sample represents a good mix of small medium and large players. With a few exceptions the top 50 NBFCs are included in the 150 companies.

Banks

In the case of banks, the analysis primarily relates to public and private sector banks. Foreign banks' dependence on local deposits for funding is relatively low; they have therefore not been covered in the analysis.

Section IV

Structure of the Report

IV. Structure of the report

The report is organised into 3 volumes. The contents of each volume are:

Volume I

Objective of the Study
Approach and Methodology
Structure of the Report

Module 1: Comparative deposit profile of HFCs, NBFCs and banks
Module 2: Comparison of risk profile of HFCs, NBFCs and Banks

Volume II

Deposit profile of Housing Finance Companies
Deposit profile of Non Banking Financial Companies
Deposit profile of Banks

Volume III

Risk profile of Housing Finance Companies
Risk profile of Non Banking Financial Companies
Risk profile of Banks

Section V

Module 1: Comparative deposit profile

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V. Comparative deposit profile (Module 1)

1. Introduction

This section contains a comparison of the deposit profile of HFCs with banks and NBFCs on certain quantitative and qualitative parameters. A snapshot profile of deposits of the 3 sectors is presented in Exhibit 1.

Exhibit I : Comparative deposit profile of HFCs, NBFCs and Banks

	HFCs	Banks	NBFCs
Deposits outstanding (Rs. crore) (as at March 31, 1995)	~ 3200	386,859	~ 5000
Growth rate over the previous year (%)	37%	16%	45%
Deposits as % of funds deployed (as at March end 1995)	36%	75%	25%
Average tenure (years)	2- 3 years	2-3 years	<2 years
Average cost (%) (1994-95)	14% - 15%*	7%- 8%	14%-15%*
Source of deposits	Retail - 40% Wholesale - 60%	Retail- 74% Wholesale - 26%	Retail
Size of retail deposits (Rs.)	10,000-25,000	1,000-50,000@	2,500-10,000
Region-wise profile	Largely in metros	Metro 40% Urban (Non-Metro) 24% Semi-Urban 20% Rural 16%	Largely in metros and some smaller towns

* excluding brokerage and incentives in kind.
@ term deposits

Note :
HFCs: Wholesale deposits include deposits from corporates, trusts, local authorities and other bodies.
NBFCs : Deposits refer to retail deposits of loan, investment, equipment leasing and hire purchase companies. ***Banks :*** Wholesale deposits include deposits from corporates and other bodies and certificates of deposit.

A detailed analysis of the deposit profile of HFCs, banks and NBFCs is presented in Volume II of this report. Based on this analysis, the relative position of HFCs, banks and NBFCs on deposit profile determinants is discussed below:

2. Regulatory aspects

While the deposit activities of NBFCs and Banks are regulated by the RBI, the HFCs are regulated by the National Housing Bank (NHB), a wholly owned subsidiary of RBI. The significant differences between the regulatory framework for deposits between these sectors are:

Deposit Insurance: Deposits upto Rs. 1 lakh for all banks are covered under the deposit insurance program. Deposits of NBFCs and HFCs are not covered by deposit insurance.

Tenure: HFCs can accept deposits upto 7 years while NBFCs can accept deposits upto 5 years. The longer tenure permitted for HFCs takes into account the long term nature of their lending operations. While HFCs and NBFCs cannot accept deposits of less than one year, banks can accept deposits of shorter tenures.

Interest rates: HFCs and NBFCs cannot pay interest rates exceeding 15% p.a. irrespective of the tenure of the deposits. Banks cannot pay rates exceeding 12% p.a. for deposits upto 2 years; for longer deposits they are permitted to fix their own rates.

Ceiling on amount of deposits raised. While NBFCs and HFCs have ceilings on borrowings related to their networth, banks do not have such ceilings.

Statutory liquidity requirements(SLR): HFCs have to statutorily maintain 10% of their deposits in approved securities. NBFCs have to maintain 15% of their deposits in such securities. The mandated limits for banks are far higher. Banks have to maintain roughly 40% of their deposits under the SLR and Cash Reserve Ratio (CRR) regulations.

3. Aggregate deposits and extent of reliance on deposits

Deposits of banks exceed the combined deposits of HFCs and NBFCs by over 40 times. Public sector banks account for 86% of the deposit base of the banking system. NBFCs and HFCs have a negligible presence in the rural areas.

Traditionally, banks have been the primary channel for mobilising household savings through deposit schemes. NBFCs and HFCs have mushroomed only in the last decade. Banks therefore had a monopoly over deposits until the 1980s. Banks have a distinct edge over other financial intermediaries because of their large branch network, widespread geographical presence and perception of safety arising out of government ownership and deposit insurance.

Deposits form the single largest source of funds for banks and constitute 75% of the their funds deployed. In comparison, deposits constitute only a third of the funds deployed by HFCs; in the case of NBFCs the extent of reliance on deposits is even lower. HFCs have other sources of finance in the form of NHB loans and directed credit from other sectors. It is only in recent times with constraints on these sources, that HFCs have targeted public deposits. NBFCs, on the other hand, have traditionally accessed bank funds and the inter-corporate deposit market for resources. Of late NBFCs have experienced constraints on bank finance with banks perceiving them as competition. In search for alternate resources, NBFCs have initiated a major drive to mobilise deposits by offering incentives and their reliance on deposits is expected to increase. However, their drive for deposits would be tempered by the increasing regulation by RBI and its insistence on registration by NBFCs for mobilising deposits.

4. Growth of deposits

NBFCs and HFCs have shown an impressive growth in deposits of over 35% (see Exhibit I) mainly due to their proliferation in the recent past. The growth of deposits for banks has been less spectacular at 16%. However as the absolute deposit base of the banks itself is very large, the prevalent growth rates are not unfavourable. Banks face increasing competition from NBFCs and HFCs as the latter can offer higher rates. With the drying up of traditional sources of funds, HFCs have been aggressively tapping public deposits. However, banks face more serious competition from the NBFCs which offer special incentives to attract deposits. Banks are not permitted to offer brokerage for deposits.

While the deposit growth rates of NBFCs and HFCs will continue to be higher, banks are not expected to face serious threats in the medium term. An important advantage that banks have is that they are the only intermediary permitted to accept demand and savings deposits.

5. Source of deposits

The deposit mix of banks and NBFCs is dominated by retail deposits. HFCs have a greater reliance on wholesale deposits. It is estimated that about 60% of HFCs' deposits are from wholesale sources. HFCs access deposits from trusts, co-operative societies, State Boards and local authorities. HDFC has a significant portion of deposits from these sources. Given the sluggishness in deposit growth rates in the recent past, banks have increasingly resorted to high cost Certificates of Deposit.

Retail deposits are more stable than wholesale deposits. Banks and NBFCs are relatively better positioned than HFCs in this regard. Small ticket deposits (from Rs. 1000/- to Rs. 50,000/-)account for around 50% of the total deposits and lend a great deal of stability to the deposit base of public sector banks.

6. Region-wise profile

The deposit base of banks is well diversified geographically with the banks' network extending to the far flung areas of the country. The West is the largest contributor to deposits followed by South and North India. This is because the West is more industrialised than other parts of the country. Similar statistics are not available for NBFCs and HFCs. However as per CRISIL estimates, south based NBFCs lead in deposit mobilisation followed by the West, North and East in that order. HFCs are of recent origin and only HDFC, LIC Housing and Canfin Homes have an all India presence. The other players are restricted to certain geographic areas and their deposit base is also limited to their areas of operation.

Banks have a deposit base in the rural and semi urban areas which account for 36% of their deposits. NBFCs are metro based; however they have a presence in the smaller towns also. Some of the south based NBFCs have branches in the rural areas as well. HFCs are based in the urban areas (metropolitan cities, some smaller cities and larger towns); however, the Gujarat Rural Housing Corporation operates in the rural areas of Gujarat.

Rural deposits are channelised into banks and post offices. These deposits can be expected to be fairly stable as access to alternative investment channels is relatively lower.

7. Average tenure of deposits

The average tenure of NBFCs is the lowest at less than 2 years. This is because, for deposits less than 2 years, the rates offered by NBFCs at 15% is higher than 12% offered by the banks. Also in 1993, when the minimum tenure of deposits for NBFCs was reduced from 2 years to 1 year, there was a shift in the deposit profile to one year term. It appears that investors are more comfortable with investing in short term deposits given the uncertainties in interest rates. (Only banks are allowed to offer deposits less than one year, however the interest rates are modest at 10% and investors park their funds in such short term deposits more for liquidity reasons.)

The deposits of HFCs have a longer maturity of 2-3 years. This is probably because HFCs have a sizeable amount of trust deposits which are of a longer tenure.

8. Average cost of deposits

HFCs and NBFCs pay interest rates over 14% p.a. for deposits raised. Currently the rates are 15% p.a. The effective cost of NBFC deposits is the highest when brokerage and incentives are considered. Although RBI has pegged brokerage rates at 2% NBFCs circumvent this limit by offering upfront and rear end incentives which are accounted as marketing expenses in the books. Industry estimates are that many NBFCs pay brokerage rates as high as 7%. In comparison, HFCs pay modest brokerage for their deposits, with the exception of the private sector HFCs which pay higher rates. Since many of the HFCs have strong parentage (being owned by banks) or a strong status such as HDFC, the public perceives them as relatively safer and does not mind accepting lower returns.

Banks have the lowest cost of deposits at 7% to 8% p.a. because of a significant portion of demand and savings deposits in their profile. About 40% of the deposits of the public sector banks consist of demand and savings deposits. While demand deposits are interest free, savings deposits are paid less than 5% which reduces the average cost of deposits considerably. Term deposits of upto 2 years are capped at 12% and for longer tenures, rates are determined by banks and are in the range of 13% to 14.5% p.a.

9. Depositor profile

The profile of the bank depositor is slightly different from that of the NBFC/ HFC depositor. Investors tend to save in banks largely for liquidity reasons. Available statistics show that the growth in deposits of banks is more in the savings deposits than in the term deposits. Further, the main banks are owned by the government and offer deposit insurance which renders them safe in the eyes of the investor. The depositor investing in NBFC deposits and HFCs is looking more for returns and is prepared to accept higher risks. It may be mentioned here that in South India, the large and well established NBFCs are perceived to be as safe as banks given their track record.

10. Sustainability and outlook

Banks are expected to continue as the foremost depository institutions in the country given their unique position in the economy. However, increasing competition from NBFCs and to a lesser extent from HFCs as well as other investment opportunities would affect their growth rates. The recent sluggishness in bank deposit growth is attributed in part to the diversion of deposits to NBFCs which offer higher interest rates on deposits upto 2 years - their rates inclusive of brokerage average 17% compared to 12% offered by banks.

The ability of NBFCs to raise deposits depends on the interest rates they can continue to offer. With increasing cost of deposits these companies have to make higher returns. This might cause these companies to take higher risks which could impair their profitability and in turn their capacity to service these deposits.

HFCs would be constrained in raising deposit by the fact that they have the smallest network compared to the other players and cannot afford to pay high interest rates like NBFCs since their flexibility to pass on higher funding costs is limited.

VI. Risk profile comparison (Module 2)

This section contains a comparison of the risk profile of HFCs with NBFCs and banks. The comparison is based on the critical parameters that determine the business risk and financial risk of these financial sector players.

1. Parameters for comparison

The following parameters are important in determining the business risk profile.

- Range of activities
- Growth potential
- Size
- Geographic diversification
- Systems / procedures and computerisation
- Employee productivity
- Resources
- Government support and regulatory framework
- Asset quality
- Degree of competition

The financial risk profile is determined by:

- Capital adequacy
- Accounting policies and transparency of accounts
- Profitability
- Asset liability matching
- Liquidity

A detailed analysis of the risk profile of HFCs, banks and NBFCs is presented in Volume III of this report. Based on this analysis, the relative position of HFCs, banks and NBFCs on risk profile determinants is discussed below:

2. Business Risk

Prima facie, a wider range of activities affords better opportunities for risk diversification. As Table 1 indicates, the diversity of business is highest in the case of banks. While working capital finance and treasury operations (money market operations arising out of SLR / CRR requirements) form the major business activities of banks, there is a now a greater focus on increasing the scale of non fund based activities in the business mix. Banks are also offering an increasing number of retail banking products like consumer loans, loans against shares, etc. Banks have mandated lending to the housing sector; however, such lending forms a small portion of its total business.

At the other end of the spectrum, HFCs' activities are confined to housing loans and investment activities (lending in the inter-corporate market and capital market investments) with limited leasing done for tax shelter purposes.

While the range of activities of NBFCs is fairly large, most NBFCs tend to focus on asset financing, which is supplemented by one or two activities like bills discounting and merchant banking on a small scale.

Table 1 : Range of Activities

	HFCs	Banks	NBFCs
Fund based activities			
Working capital finance (cash credit)		√	
Term loans (project finance)		√	
Money market (govt. securities)		√	
ICD lending	√		√
Consumer loans (asset financing)		√	√
Leasing	√	√	√
Housing finance	√	√	
Foreign exchange loans		√	
Capital market investments	√	√	√
Loan against shares		√	√
Promoter funding		√	√
Primary market funding			√
Bill discounting		√	√
Fee based activities			
Letters of credit		√	
Guarantees		√	
Credit cards		√	
Merchant banking		√	√
Collection charges		√	
Remittances		√	
Foreign exchange transactions		√	
Advisory services		√	√
Loan/lease syndication		√	√

The growth potential for all three sectors can be considered to be favourable due to the following reasons:

- With the Indian economy growing at a rate of around 6%, funding requirements for all sectors would be high.
- Substantial funding requirements for essential infrastructure projects.
- A growing middle class offers good opportunities for consumer finance.
- Large demand-supply gap in housing.

The issue of size becomes important from a risk perspective because a larger size offers greater opportunities to diversify sources of income, asset concentrations and deposit base. At an industry level, the banking system is the largest in terms of funds deployed (Rs. 5,00,000 crore). The funds deployed in 150 NBFCs studied by CRISIL are around Rs. 20,000 crore. The funds deployed in the 13 sample HFCs (does not include HUDCO) studied by CRISIL are around Rs. 9,000 crore.

The average bank size is much larger than the HFCs and NBFCs. On an average, the recognised HFCs have a larger balance sheet size than the NBFCs.

Following the nationalisation of banks, the government used the banking system as the primary vehicle of economic development. Thus the banking network has extended to the far flung areas of the country. NBFCs have a wider reach and geographic spread than HFCs, which operate mainly in the large urban centres.

Systems and automation refer to standard operating procedures, management information systems, automation of operations and systems for tracking risks. Banks and HFCs generally have well laid out operating systems and procedures. However, despite recent efforts at computerisation, the levels of automation in Indian public sector banks is very low. The new private sector banks are better placed in this regard. Automation of HFCs' operation include areas like loan account information, repayment position, etc. In the case of NBFCs, the better companies have high levels of automation including all operations like deposits, lending, tracking of maturity on the asset and liability side, etc. With increasing deregulation of interest rates and other controls on banking activities, there is an urgent need for banks to upgrade their systems for tracking risks in areas like maturity and interest rate mismatches between assets and liabilities, exposures by industry, corporate groups etc.

Traditionally, for the banking system, the key productivity parameter has been business per employee, which is defined as the sum of deposits and advances divided by the number of employees. The massive expansion of the Indian branch network with large intake of staff, lack of customer orientation and strong unions has resulted in productivity levels being generally low. The parameter of business per employee as defined by (deposits + advances)/ number of employees is not adequate in measuring productivity in NBFCs and HFCs as it does not take into account other funding sources on the liabilities side and investments on the asset side which could be a large proportion of balance sheet size. NBFCs and HFCs are better placed on the productivity front with profits per employee being at much higher levels than for the banking industry. NBFCs and HFCs have also established a good reputation for customer service.

Funding is the most critical parameter for players in the financial sector, which has money as its main raw material. The most important strength of the Indian banking system has been its ability to achieve significant increases in deposit mobilisation on a sustained basis. Even though deposit growth rates are not likely to be as high as in the past due to competition from other sources, the resources outlook for banks is still the brightest. This is mainly due to their large branch network which other players will find uneconomic to replicate and high level of government support which makes banks the preferred depository for savings. The stability of the banks' deposit base is also very high and they have the lowest cost of funds.

While NBFCs have shown a good growth rate in deposits, these are at a higher cost compared to banks. An area of concern for the NBFC sector is the strained outlook for bank funding.

HFCs are in a difficult position on the resources front. NHB refinance is expected to decline in future as the number of HFCs increase. Moreover, banks and insurance companies are meeting their housing finance lending targets by increasing lending to their own subsidiaries. HFCs are constrained in offering the kind of incentives being offered by NBFCs in raising public deposits because of the low spreads in the business. HFCs promoted by banks, will be slightly more successful in raising public deposits. It is expected that insurance companies promoted HFCs will continue to receive funding from their parent in the medium term. In the long run, however, funding alternatives like mortgage backed securitisation would have to be tapped.

The inherent asset quality of HFCs is the best among the three sectors. This is because of factors like rising property prices and the customer profile comprising middle and upper income groups, which is considered a safe segment. Non performing assets (NPA) levels are lowest in the housing finance sector. In future, if the scenario of property prices moving in a single direction only i.e. upwards, changes, it is bound to affect the asset quality of HFCs. NBFCs have also managed to exercise good control over asset quality.

The asset quality of Indian banks does not compare favourably with international standards. The NPA levels of the industry are estimated at 20%. The poor asset quality is an overhang of the pre-reform era, which focused on target based lending with little consciousness on asset quality. The introduction of provisioning norms recently has been a redeeming feature and most banks have cleaned up their books. However, in the long run, a definitive solution to the problem implies a significant improvement in the quality of credit management in terms of appraisal and monitoring of loan assets. This would call for upgradation of analytical approaches by credit departments in public sector banks as well as streamlining of systems and procedures for credit delivery and monitoring.

The extent of government support is highest in the banking industry. This arises out of government ownership of the major banks and the high level of integration of the banking system with the Indian economy. The level of regulation of banks' operations is very high.

The NBFC sector has been most vulnerable to changes in government policies. This sector has been affected by developments like permitting banks to enter leasing, increasing deregulation of banks interest rates, changes in borrowing limits, RBI directives to banks to reduce funding to NBFCs, etc.

Housing is a priority area for the government; thus the HFC sector has some benefits like tax incentives. However, the housing finance sector is yet to see government support of the type given by the US authorities through organisations like Fannie Mae and Ginnie Mae which have given a boost to MBS and the housing finance sector.

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3. Financial Risk

All three sectors are required to achieve a capital adequacy norm of 8%. HFCs are well placed on the capital adequacy front. Given the low margins in the industry, the preference would be for equity funding as debt servicing would be a further strain on profitability. Moreover, HFCs have access to capital markets for raising equity.

NBFCs too, are comfortable as regards capital adequacy. The maximum permitted gearing level of 10 times, in itself ensures capital adequacy levels of 9%.

In the last three years, the government has recapitalised banks to the extent of Rs. 11,800 crore. In future, banks will have to reduce dependence on recapitalisation by the government. Thus, augmentation of capital base would have to come from internal generation and access to capital markets, which would be dependent on healthy bottom lines. Banks have been permitted access to the capital markets and some banks have already tapped this route.

As part of the process of financial sector reform, prudential accounting standards have been made mandatory for all three sectors. The level of transparency in the balance sheets however, still continues to be low.

With increasing competition both on the lending and resources side, margins of all three sectors are coming under pressure. Interest spreads for HFCs are low, leaving little cushion to absorb further funding cost increases and provisioning requirements. Moreover, there is limited flexibility for increasing the interest rates for individuals. Accordingly, HFCs protect earnings by lending to lucrative segments like builders and deploying funds in investment operations. However, as explained in Volume III of the report, there are limitations to both these activities.

NBFCs are better placed on the profitability front with a judicious balancing of fund based and fee based income and good controls over expense levels.

The ratio of post tax profits to funds deployed is lowest for the banking sector. Important strategies for improving profitability of banks would be increasing the proportion of non investment income, new product innovations and strict cost control measures.

The asset liability mismatch is the most severe in the case of HFCs since the average tenure of housing loans is much higher than their borrowings (except NHB refinance). HFCs try and manage the mismatch by reducing asset tenure through lending to builders/ corporates, investment activities, increasing dependence on equity funding and accessing NHB refinance which is tenure matched. As business volumes grow with long term lending to individuals, the problem of asset liability mismatch is likely to pose serious problems to the industry. NBFCs are relatively better placed in this regard as most asset financing is for three year tenures and investment portfolios are liquid.

As regards banks, given the almost perpetual nature of the cash credit system of lending and the long dated government securities forming a large portion of investment portfolio, the Indian banking system has a chronic asset liability mismatch. The changing regulatory framework which requires banks to mark investment portfolios to market values and the gradual phasing out of the cash credit system are positive developments, which would reduce the extent of mismatch.

Banks are very favourably placed on the liquidity front as they have high levels of internal liquidity, access to call money borrowings, refinance from the RBI and growing deposit base. NBFCs also have access to deposits, inter-corporate borrowings and steady cash flows arising out of repayment streams on assets financed. The turnaround time of HFCs' asset portfolio is high compared to the other sectors; thus its liquidity position is not as comfortable. However, all players need to significantly improve risk management techniques as financial markets become increasingly volatile.

4. Conclusion

Overall, the strong growth of the Indian economy has thrown up tremendous opportunities for all three sectors. Increasing liberalisation of financial markets together with increased competition pose challenges for these entities in terms of technology, product innovation, cost control and risk management techniques.

Banks enjoy a distinct advantage on the critical parameters of resources and government/regulatory support. The banking sector today appears to be more robust than at the start of the reform process due to adoption of prudential norms and cleaning up of books. However, challenges in terms of asset quality and capital adequacy still remain.

NBFCs are favourably placed as regards productivity, profitability and asset liability management. However, increasing competition and pressure on margins together with strained funding are critical issues for the NBFC sector.

While HFCs are on a strong footing as regards asset quality; asset liability mismatches and funding constrains are key issues, which would determine the future performance of the industry.

PART-B
DEPOSIT PROFILE

Part-B : Deposit Profiles

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I. Deposit profile of Housing Finance Companies

1. Introduction

Deposits form a significant source of funds for Housing Finance Companies (HFCs). With the reduction in directed credit for the housing finance sector, HFCs are increasingly looking to household savings for resource mobilisation. These companies face stiff competition from other financial intermediaries, notably the Non-Banking Financial Companies and the Banks.

This chapter analyses the extent of dependence of HFCs on deposits for funding, the deposit profile and the sustainability and outlook for deposit mobilisation. It may be mentioned that since HDFC alone accounts for 70% of the deposits of this sector, it significantly influences the deposit profile of the industry.

2. Sources of information

Data available in the Report on Trend and Progress in Housing in India, dated June 1993, published by the NHB has been used in the study. As recent data was not available, CRISIL estimates had to be used. CRISIL estimates are based on the available annual reports of recognised housing finance companies and other published material on the industry.

3. Regulatory framework for deposit mobilisation

NHB's regulations on deposits apply only to the public deposits. Intercorporate deposits and deposits received from trusts, Government, NHB etc. are exempted from these directions.

- The deposit activities of HFCs are regulated by the National Housing Bank (NHB). HFCs are required to file quarterly returns with the NHB on details of deposits. The interest rates and brokerage payable on deposits are regulated by the NHB and move in tandem with the rates fixed by the RBI for NBFCs.

- HFCs can accept deposits for a period of 1-7 years

- The extent to which HFCs can raise deposits is limited by the company's networth. Aggregate borrowing limits permitted for HFCs (inclusive of deposits) is as follows:

Networth	Aggregate borrowings * (including deposits)
Upto Rs. 10 crore	10 times
Rs. 10-20 crore	12.5 times
Above Rs. 20 crore	15 times

* Excludes NHB refinance

- HFCs cannot pay interest rates exceeding 15% p.a. Monthly compounding of interest is allowed. Maximum brokerage rates permitted are:

Tenure of deposits	Brokerage as % of deposits
upto 12 months	1%
12-24 months	1.5%
over 24 months	2%

- Like NBFCs and banks, HFCs can also grant loans against deposits.

- HFCs are required to maintain a minimum of 10% of the deposits outstanding in approved securities and deposits with NHB or scheduled banks. NBFCs and banks also have similar regulatory features and this is primarily imposed on companies to provide a measure of safety to the depositors.

  The NHB Act also provides for guaranteeing of financial obligations of HFCs. However, since NHB's directions (1989) and subsequent amendments thereto are applicable to public deposits alone, it would appear that were NHB to take on a deposit insurance role, this would be restricted to public deposits only.

4. Aggregate deposits and growth rates

Aggregate industry deposits for 1994 are currently being compiled by NHB. As per CRISIL estimates, aggregate deposits of HFCs as at March 31, 1995 were in the region of Rs. 4,000 crore. HFCs' deposits have grown at a compound annual growth rate of around 30% since 1992.

5. Reliance on deposits

The extent of reliance on deposits for various categories of HFCs viz. HFCs promoted by banks, HFCs promoted by insurance companies and other private sector HFCs is discussed below.

5.1 HFCs promoted by Insurance Companies

LIC Housing Finance and GIC Housing Finance do not have deposits in their funding mix. As on March 31, 1995, LIC Housing Finance had a negligible amount of deposits which were mobilised under the Home Loan Account Scheme. As these companies have access to resources from their promoter companies, they have not made attempts to raise deposits. However, such HFCs are expected to tap this resource in the future as they are uniquely positioned to mobilise deposits; their parent companies have a huge network of insurance agents and service millions of individuals and it would be easy for these housing finance companies to use this network for deposit mobilisation.

5.2 HFCs promoted by Banks

This group is the largest mobiliser of deposits. They have capitalised on the branch network and goodwill of their promoter banks to raise deposits. Deposits account for 50% of the funds deployed of this group.

5.3 Private sector HFCs

Deposits constitute around 30% of the funds deployed by this segment. Private sector HFCs barring HDFC are of very recent origin; thus their dependence on deposits as of March 31, 1995 is comparatively low. Eventually, however, these HFCs which are currently dependent heavily on promoter funding, will have to explore other sources including deposits to finance their operations.

For the sector (excluding HUDCO and HFCs promoted by insurance companies) as a whole, deposits constituted around one third of the funding mix in 1994 and 1995.

6. Source of deposits

HFCs mobilise deposits from both retail and wholesale sources. Wholesale sources include trusts, registered co-operative societies, state boards and other local authorities. As regards deposits from trusts, all HFCs recognised by NHB and the Central Board of Direct Taxes for the purpose of Sec. 36 (1) (8) of the Income Tax Act are eligible to apply to the State Endowment Commissioner for enlistment of their FDs as 'permissible investments'. Recognised HFCs generally do not face a problem in getting their FDs registered as approved securities for investment by registered co-operative societies, state boards and local authorities. While several HFCs have raised deposits from these wholesale sources, the extent of dependence on wholesale deposits varies across companies. HDFC is the largest mobiliser of wholesale deposits. The advantage of wholesale sources is the facility of obtaining large quantum of deposits at lower marketing costs.

HFCs promoted by banks have, like their parents, generally looked to the households for their funding needs and their dependence on retail deposits is higher. About 90% of their deposits are from retail sources.

7. Tenure of deposits

HFCs are allowed to raise deposits of tenure ranging from 1-7 years. According to NHB, in March 1993, 47% of the deposits outstanding with classified HFCs were for a period of 2-4 years. CRISIL estimates the average tenure of deposits of HFCs at less than 3 years. Renewal rates of deposits in the industry are not available. In any case, renewals would vary with the company depending on the service levels, the rating of the company and alternative modes of investment available to the investor at that point of time.

8. Cost of deposits

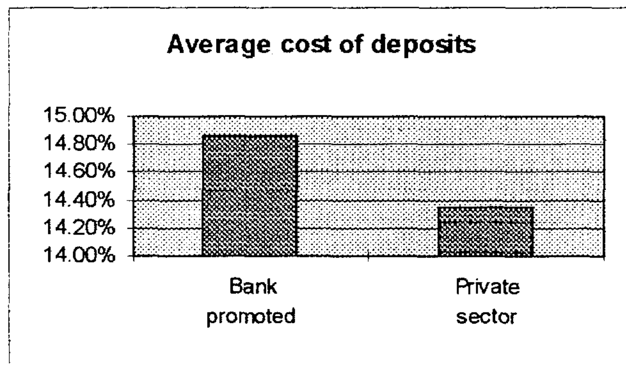
According to NHB, 68% of the deposits outstanding with classified HFCs in March 1993 were at interest rates of over 14% Average interest rates paid on deposits outstanding as at March 1995 for the sample companies analysed by CRISIL was 14.5%-15%. The cost would have further increased since then as the marginal cost of deposits has risen with the hike in interest rates to 15%

Despite the ceiling of 15% of deposit rates, many HFCs effectively pay 16.08% as interest is compounded monthly. After adding 2% brokerage the actual cost of funds raised is around 18% However, not all HFCs raise deposits at these costs. HDFC and HFCs promoted by banks raise deposits at less expensive rates because the public perceives them to be relatively safer. Private sector HFCs pay considerably more brokerage; estimated rates are in the region of 5% inclusive of incentive in kind.

The average cost of deposits of HFCs promoted by banks and other HFCs is depicted below in Exhibit 1.

Private sector HFCs appear to have a lower cost of deposits as their average is skewed by the presence of HDFC which because of its status is able to raise deposits at below market rates. While HDFC raises deposits at a cost of 14.55%, other private sector HFCs raise them at a significantly higher cost of 17 to 18%

Exhibit I (1994-95)



Source: Annual Reports

Average cost = Interest paid on deposits /average deposits raised.

9. Average size of deposits

The NHB report states that 53% of the deposits outstanding as at March 1993 with the classified HFCs was over Rs. 1,00,000/- This is possibly because of the presence of the wholesale deposits raised by the industry.

In the case of retail deposits, the average size of the deposit is estimated in the range of Rs.10,000-25,000. This points to a profile of a middle income group investor.

10. Region-wise profile

Only the top five HFCs - HDFC, Canfin Homes, LIC Housing, SBI Home and Dewan Housing have a significant branch network. Of these LIC Housing does not raise deposits. The other four HFCs are also largely metro based; their deposits therefore flow from these centres. The households in these centres also have access to NBFCs which offer higher rates. The depositor profile is similar to the customer profile for housing loans and comprise middle income groups.

Other HFCs in the industry are primarily based in certain areas of the country. For example Vysya Housing has an extensive branch network in Karnataka but does not have a significant presence in the North. AB Homes has a significant presence in Andhra Pradesh and Centbank Home Finance has a presence in Madhya Pradesh where it is based. As deposits to these companies flow from the areas in which they operate, their deposit base is also confined to these regions only.

The industry is yet to target the rural investors (the only exception being Gujarat Rural Housing Corporation which operates in the rural areas of Gujarat) or investors in the smaller towns effectively which banks and to a lesser extent, NBFCs have penetrated.

11. Sustainability and outlook

Housing Finance companies have traditionally depended on NHB refinance, promoters' funding and, in the case of HDFC, foreign loans and directed credit from institutions. It is only with constraints on these sources drying up that HFCs are looking at alternative sources of funding. HFCs have identified household savings as a major source of funding particularly because it is the same market that forms its clientele for housing loans.

However, HFCs face strong competition from banks and NBFCs in deposit mobilisation. Banks have the advantage of a vast network of branches, ability to provide current, savings and term deposits, and freedom to fix rates for deposits of over 2 years. Even though NBFCs are constrained by RBI to offer not more than 15% on deposits and cannot mobilise deposits of less than a year, they pay higher brokerage to canvass for deposits. Since the margins of NBFCs are higher, they can afford to raise deposits at a higher cost.

So far HDFC and certain other premier bank promoted HFCs such as Canfin Homes and SBI Home have managed to raise deposits at reasonable costs. However, the increasing deposit mobilisation cost for the financial sector in general has increased marginal deposit costs for HFCs also.

The industry has attempted to innovate by introducing the Home Loan Account Scheme similar to the contractual savings scheme in Germany where households save with the HFC and are entitled to loans based on their savings. Such deposits are raised at 10% and the HFC lends at 10.5% to 14.5% However, the scheme which was aimed at the lower income groups has not been very successful.

Section II

Deposit profile of Non Banking Financial Companies

II. Deposit Profile of NBFCs

1. Introduction

NBFCs, by and large, have a fairly diversified funding mix with a higher reliance on bank finance (availed in the form of cash credit) and fixed deposits (FDs). Other funding sources include equity, debentures and linked issues and inter corporate deposits (ICDs).

Due to conservative lending policies of financial institutions and banks to NBFCs, and difficult capital market conditions, these companies have started increasingly focusing on FDs for funding. The aggregate public deposits of NBFCs as on March 31, 1995 was around Rs. 5000 crore.

2. Sources of information

Reliable data on the industry is difficult to come by. The main sources of information for this study have been:

- Draft report of the expert group for designing a supervisory framework for NBFCs set up by RBI.
- Annual reports of NBFCs
- Personal interaction with representatives of NBFCs and RBI
- Newspaper reports
- Data on a representative sample of 40 NBFCs representing over 50% of the public deposits mobilised by NBFCs in 1993-94.

It may be noted that for the purpose of this study, NBFCs include loan companies, investment companies, hire purchase finance companies and equipment leasing companies, as defined by the RBI classification.

3. Regulations for acceptance of deposits

NBFCs are governed by the Acceptance of Deposit Rules, 1975, and the NBFC (Reserve Bank) Directions, 1977 (as amended upto December, 1995). The main features of the regulations are given below:

- NBFCs have to be registered with the RBI.
- Submission of an annual statement of deposits (form 58 A) to the RBI.
- Ceiling rate of 15% p.a. interest on deposits with maturities of 12 to 60 months.
- 15% of deposits to be invested in government/guaranteed securities.
- Brokerage permitted upto 1 % for deposits with tenure upto 1 year, upto 1.5 % for tenure between 1-2 years and upto 2% for tenures of more than 2 years.
- Aggregate deposits (read borrowings, including any money received from banking institutions specified in paragraph 3 (ii), any loan received from financial institutions specified in paragraph 3 (iii) and any money raised by issue of convertible debentures and bonds specified in paragraph 3 (ix) of the NBFC(RB) Directions, 1977) of equipment leasing and hire purchase company not to exceed ten times its net owned funds (NOF) provided that deposits received for periods not exceeding 12 months from any other company incorporated in India does not exceed two times the NOF of the leasing or hire purchase company.

4. Aggregate deposits and growth rates

Aggregate deposits of NBFCs have grown steadily but the volume of aggregate deposits mobilised by them is still small as compared to total bank deposits.

The aggregate public deposits of NBFCs (loan, investment, hire purchase and equipment leasing companies) in 1993-94, according to the draft report of the expert group for NBFCs set up by RBI, was Rs. 3,176 crore. CRISIL estimates industry deposit figures in March 1995 to be in the region of Rs. 5,000 crore.

A recent study conducted by ICICI of 150 NBFCs showed an increase of 44.9 % in their FDs during the year 1993-94 as compared to an increase of 24.4% in 1992-93. The NBFCs in the sample selected by CRISIL had a deposit growth rate of 63% in 1994-95.

5. Reliance on deposits

FDs constitute about 25% of the total funds deployed by NBFCs. South based companies have greater degree of reliance on FDs for funding. Banks view NBFCs as competition and have restricted disbursements to them. Also, the RBI has asserted the need to moderate overall limits of lending to NBFCs by banks and FIs. The interest rates from banks in the last one year had gone up as high as 23%. Currently, companies with AAA and AA+ rating can access bank funds only at around 20-21%.

6. Regional profile

NBFCs based in the south lead in deposit mobilisation followed by west, north and east in that order. This could be attributed to, amongst other reasons, difference in investor preferences, competition from residuary non-banking companies in certain regions, etc.

The NBFC branch network in South India extends beyond the metros to the smaller towns. NBFCs based in other regions have smaller branch networks and tend to concentrate on the bigger cities. However, of late, they have started opening deposit mobilisation centres in the smaller cities as the response of depositors from these places has been encouraging.

7. Source of deposits

Deposits mobilised by NBFCs are mainly retail deposits. These are sourced either through the companies' own branch network as is prevalent in the South or through brokers as is prevalent in North India.

Many NBFCs have started vigorously mobilising NRI deposits overseas. Some companies have set up special centres in the Gulf to mobilise these deposits. The compounded return on NBFCs' three year NRI deposit schemes has been around 17%. In the past, commercial banks offered a 10% return on NRE deposits. With the withdrawal of CRR requirements on NRE deposits and freeing of interest rates, banks have increased the interest rates on NRE deposits of over 2 years maturity to 15-17%, and some newly set up private sector banks are offering rates between 19% - 20%. NBFCs are likely to follow suit.

8. Tenure of deposits

NBFCs are allowed to raise deposits of tenures ranging from 12 to 60 months. The average tenure of deposits in the industry is around 2 years. Established companies have a renewal rate of over 70 % on their deposits.

Deposits of maturity of upto two years account for 60 percent of the deposit base of the NBFCs. This segment of NBFC deposits is expected to receive a boost since the new deposits rates for NBFCs compare favourably to that for the banks. The ceiling on bank deposit rates of upto two years has been pegged at 12 % thus maintaining a 3 % differential as suggested by the A.C.Shah Committee. However, while the banks can accept deposits for as low a period as 46 days, the NBFCs cannot maintain deposits for less than one year.

9. Cost of deposits

The average cost of deposits raised by NBFCs in 1994-95 was about 17% p.a. including the mandatory brokerage of around 2%. However, this does not include other issue expenses of around 1% and incentives in kind.

Brokers to some leading NBFCs are offering upfront incentives of upto 7 percent to the depositors. In addition, many lower rated companies offer incentives in kind.

RBI has prescribed limits for brokerages. However, the guidelines are silent on mailing or out of pocket expenses. The mandatory 2 % is accounted for by NBFCs as brokerage while the balance is clubbed under business promotion, entertainment, conveyance and postage.

With the RBI ceiling of 15% on the interest rates the yield works out to 16.08% on a monthly compounding basis, 15.86% on a quarterly compounding basis and 15.56% on half yearly compounding basis. Front-end or rear-end incentives enhance the yield to the investor.

10. Legal recourse in event of default

In the event of default on FDs the investor could approach either the Company Law Board (CLB) or the court which is a tedious and time consuming procedure. CLB is the nodal agency for redressing disputes arising out of non payment of deposits. The department of company affairs maintains that while the RBI Act can be amended to impart more teeth to the central bank to regulate the pure depositor functions of NBFCs, the proposed amendments could also designate CLB as the court of appeal for all deposits by NBFCs.

The money raised through FDs is unsecured debt and in the event of the company winding up, the claim of the FD holders is dealt with the last.

11. Marketing Strategies

We find a difference in marketing strategies adopted by companies in different regions based on the investor preferences.

In the southern region people prefer fixed and assured returns to equity investment. Strategies like offering one gram of gold with a deposit of Rs. 10,000 for a year are peculiar to this region.

Western region has the highest preference for equity investments. However, of late there has been a great change in the FD market with a general rise in the preference of investors for fixed returns. Service orientation forms the thrust of the marketing strategy for the companies in the west.

In the northern region, incentives and upfront commissions play an important role in FD mobilisation. Brokers play an important part in the investment decision about the choice of the company.

In the eastern region safety of the funds is the underlying core of the marketing strategy.

12. Sustainability and outlook

There has been a mushrooming growth of NBFCs in the last few years and NBFCs have been offering very high rates of interest (inclusive of incentives) in their bid to mobilise deposits. The logical concomitant of this development has been the increasing number of defaulters among the NBFCs. Consequently, RBI set up a panel under the chairmanship of Mr. P.N.Khanna to recommend a supervisory framework for NBFCs. The panel, in its draft report, has recommended that companies not registered with the RBI should not be allowed to collect deposits from the public. Under provisions of Section 45 S of the RBI Act, a proprietary firm cannot accept deposits from more than 25 depositors (excluding deposits from relatives as defined therein) and a partnership firm cannot accept deposits from more than 25 depositors per partner and not more than 250 depositors in all (excluding deposits from relatives of partners). This provision has also been flouted by many NBFCs. Enforcement of repayment of deposits is another area that the panel is looking at.

The A.C.Shah Committee recommended maintaining a 3 % differential between the NBFC deposit rates and bank deposit rates. In October, 1995 RBI hiked the ceiling on deposit rates of NBFCs as a logical extension of freeing of bank deposit rates for deposits of more than two years maturity in the busy season credit policy. Ceilings on deposit rates of NBFCs will not be removed until a substantial number of companies meet the registration and prudential norms requirements.

With NCDs coming into their own, NBFCs are bound to have an additional constraint in raising deposits. The previous distinctions between FDs and debentures is getting increasingly blurred as the disadvantages associated with debentures in terms of funds being locked up for longer periods and lack of a liquid secondary market disappear because of increasing use of various options facilitating the investor's exit before the end of maturity period.

While fixed deposits are bound by the RBI imposed interest rate ceilings, there is no such restriction in the case of debentures. Aided by the guidelines waiving credit rating for debenture issues of less than 18 months, NBFCs are likely to go in for debenture issues of shorter duration offering higher interest rates. Thus, the funding pattern might shift in favour of the latter from the FDs to some extent.

The increasing regulation of NBFCs and the prevalent competitive scenario is likely to result in a shake-out and under such circumstances NBFCs with a stable deposit base are likely to be the ones to survive. These established NBFCs will be the ones to provide competition in deposit mobilisation to banks and HFCs as they have an advantage in terms of better service levels. However, the aggregate deposits of NBFCs being a very small proportion of aggregate bank deposits, banks do not face competition to the same extent as HFCs.

III. Deposit Profile of Banks

1. Introduction

Deposits constitute the predominant source of funding for banks. Banks are the primary deposit mobilising institutions in India. The large branch network of banks and the image of safety which the banks carry in the retail depositors' minds are the factors which facilitate banks in maintaining their leadership position in mobilising deposits.

Banks have started exploring capital markets for additional funding. However, the funds raised from capital markets are mainly for capital adequacy purposes and deposits would continue to be their main funding source.

2. Sources of Information

The main sources of information for this study have been:

- Economic Survey 1995-96
- Report on Currency and Finance 1993-94, RBI
- IBA publications
- RBI Bulletin
- Annual reports of Banks
- Personal interaction with representatives of Banks
- Newspaper reports

3. Regulatory Framework for bank deposits

The main regulations applicable to deposit mobilisation by banks are :

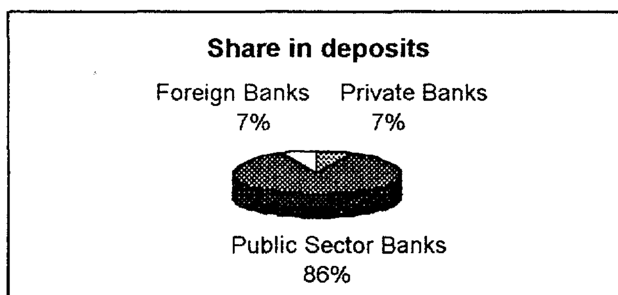
- Banks are regulated by RBI.
- Monthly returns on deposits to be submitted to RBI
- Interest rates on deposits over two years have been freed, however the deposits upto two years have a ceiling of 12% interest rate.
- Banks are not allowed to pay brokerage for raising deposits
- Minimum tenure of deposits is 46 days. (Maximum tenure is not specified by RBI)
- No ceilings on raising deposits
- CRR of 13% and SLR of 29%
- Deposit Insurance and Credit Guarantee Corporation (DICGC) provides insurance cover of Rs. 1,00,000 per depositor. The premium payable by banks is 0.05% of deposits.

4. Aggregate deposits

As per the RBI Monetary data the aggregate deposits in the banking sector as at March 29, 1996 were Rs. 432,345 crore. As at March 31, 1995 aggregate bank deposits outstanding were Rs. 386,859 crore.

The deposit base in the system is dominated by the public sector banks which had 86% of the total deposits raised by the sector as on March 31, 1995(Exhibit - 1).

Exhibit - 1



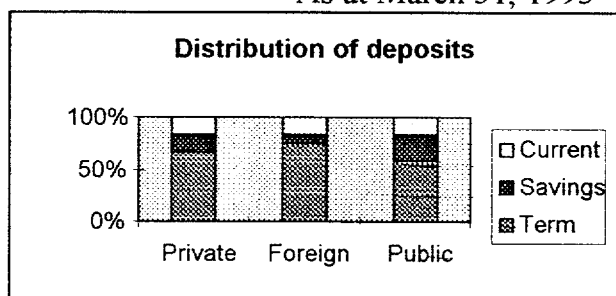
Source: IBA

The public sector banks have 93% of bank branches and their dominant share in deposits can be attributed to their widespread branch network.

Banks deposits are of three types : current, savings and term deposits. Current deposit accounts are largely maintained by the business and industrial clients and are interest free. Savings deposits carry an interest rate of 4.5% while term deposits are the fixed deposits ranging from 46 days to 10 years and bear interest rates from 10% upwards.

Exhibit -2

As at March 31, 1995



Source: IBA

Term deposits are the dominant form of deposits, though the proportion of term deposits in the total deposits varies for public sector and private sector banks. The absence of large branch network and corporate clients, which lead to savings and current account balances, has resulted in a higher proportion of term deposits for private sector banks. 67% of their deposits are term deposits. In contrast, only 59% of the deposits of the public sector banks are term deposits.

5. Growth of deposits

The deposit growth rate of banks was 16% in 1994-95. Although interest rates on term deposits is higher than on savings and current deposits, the growth rates are higher in the savings and current segment. (See Exhibit - 3)The slow growth of term deposits could be attributed to increasing depositor preference for financial instruments of NBFCs, HFCs and FIs which offer higher yields. On the other hand banks are the only financial intermediaries to operate the savings and current accounts which serve the liquidity requirements of depositors.

Exhibit - 3

Scheduled Commercial Banks		(Rs. crore)	
Deposits	**1995**	**1994**	**Growth**
Term	231,481	204,225	13.35%
Savings	87,677	71,313	22.95%
Current	65,878	56,100	17.43%
Total	**385,036**	**331,638**	**16.10%**

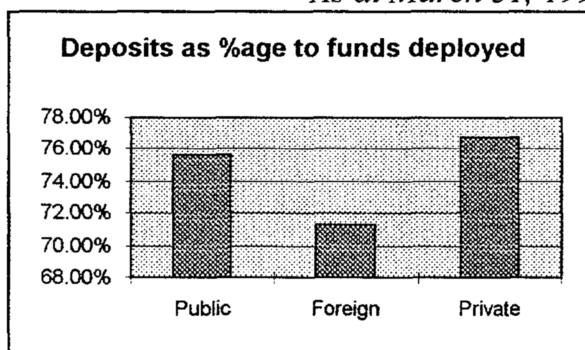
Source : IBA

6. Extent of reliance on deposits

Deposits form the main source of funds for the banking system. Within the banking system private banks have the highest dependence on deposits as indicated by the Exhibit - 4. This is on account of their lower capital base. The reliance of Foreign banks on deposits is lower on account of their higher capital base.

Exhibit - 4

As at March 31, 1995



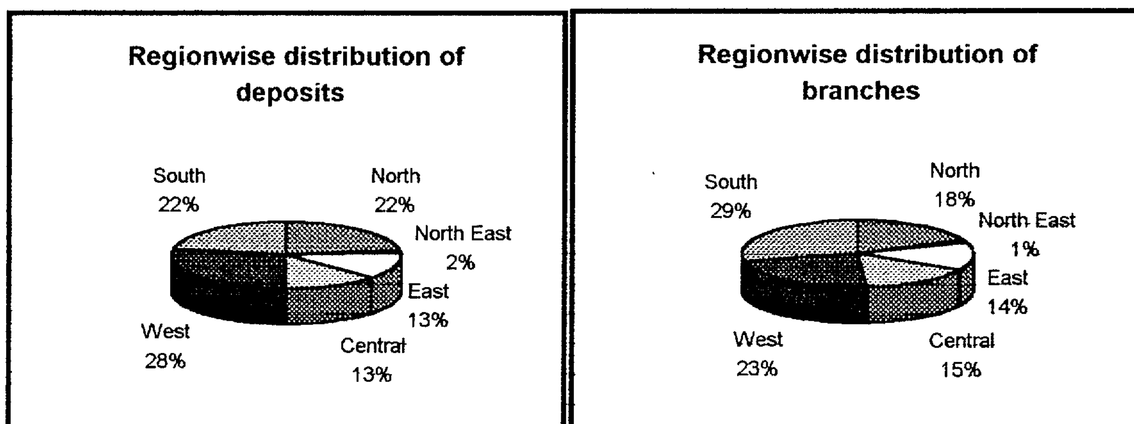
Source: IBA

7. Regional profile

The region wise distribution of deposits and branches of banks is presented in the Exhibit - 5.

Exhibit - 5

As on September 30, 1995



Source: RBI

Western India, the most industrialised region of the country constitutes the largest deposit base for banks. The South has the largest number of bank branches but does not form the largest deposit base. The southern region has a large number of NBFCs and a significant portion of savings of the public is invested in this sector. The North comes third in the share of bank reach and is on par with the south as the second largest deposit base. The northern region has a higher per-capita NDP (1992 CMIE statistics) and consequently income/savings available with the public is higher as compared to the South.

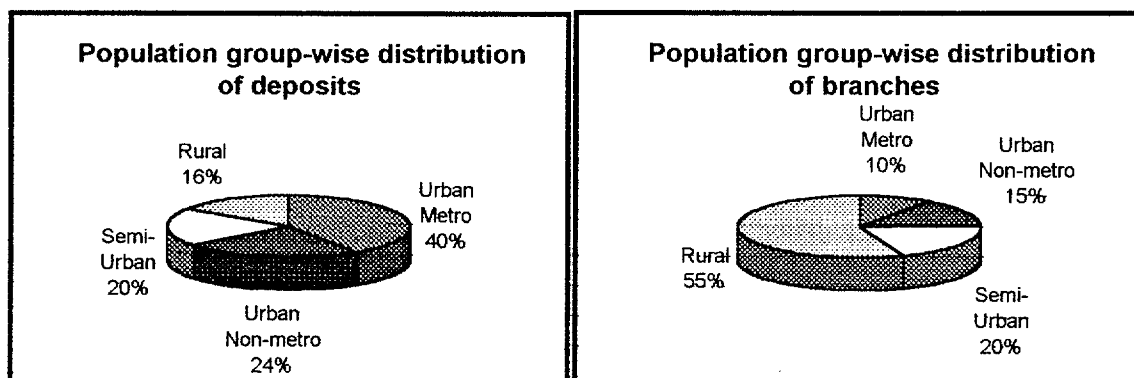
As per RBI Statistics, Maharashtra is by far the leader state in terms of deposits with Rs. 82,830 crore, followed by Delhi (Rs. 39,688 crore), Uttar Pradesh (37,921 crore), West Bengal (Rs. 29,005 crore) and Tamil Nadu (Rs. 27,069 crore). These five states constitute 55% of the deposits in the banking sector.

Urban v/s Rural

The distribution of deposits as per RBI classification of population groups: i.e. Rural, Semi-Urban, Urban - Metros & Non Metros is presented in Exhibit - 6.

Exhibit - 6

As at September 30, 1995



Source : RBI

Bank branches in rural areas comprising 55 % of the total branches, contributed only 16% of aggregate deposits of all scheduled commercial banks. On the other hand, branches in metropolitan cities consisting only 10% of the total branches contributed 40% of the deposits. Deposits in the urban areas tend to flow mainly from the metros- Bombay, Delhi, Calcutta and Madras followed by cities such as Bangalore, Hyderabad and Ahmedabad.

The rural population of India comprises 74% of the total population while their contribution to deposits is only 16% of the total deposits in the banking sector. The low contribution of rural areas in the deposits in the banking sector is due to lower monetisation of the rural economy.

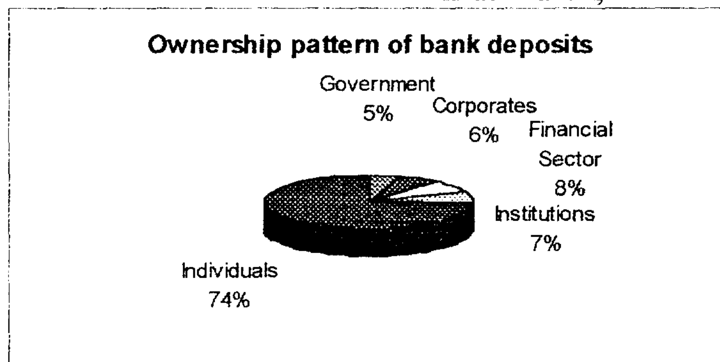
The deposits from rural and semi-urban areas are largely with the public sector banks as they have a rural network unlike the private sector banks which are concentrated in the urban areas. The savings of the public in the rural areas flow into limited channels; they do not have access to capital markets to the extent the urban public has. The two major channels of investment in these areas are the nationalised banks and the post offices which have savings schemes for the public.

8. Source of Deposits

The ownership pattern of bank deposits is given in Exhibit - 7.

Exhibit - 7

As at March, 1993



Source : RBI

Retail deposits constitute 74% of total deposits. The retail deposits are usually of smaller size (less than Rs. 50,000) as compared to corporate deposits. Smaller size deposits are inherently more stable than larger sized deposits; the deposit base of banks can be considered to be stable. It should be noted that some new private sector banks have a significant percentage of corporate (wholesale) deposits as they are yet to build a retail network, resulting in instability in their deposit base.

The deposits from NRIs form 16% of the retail deposits in the banking sector. The foreign banks who have a limited network in India target NRIs for foreign currency deposits.

9. Size of Deposits

The foreign banks and new private sector banks prefer to tap larger size deposits of as compared to the public sector banks and established private sector banks. The table below compares the minimum size of term deposits by banks in various categories.

April 1996

	Public	Private	Foreign	New private sector banks
Minimum size of term deposit	1,000	1,000 - 10,000	25,000-100,000	2,500-10,000

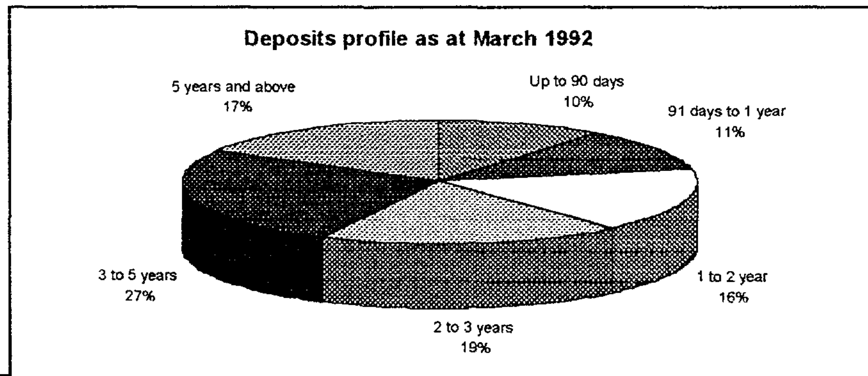
Source : Banks

The minimum size of deposit is the highest in the case of foreign bank followed by the new private sector banks which clearly indicates their preference for larger sized deposits to save on transaction costs. Most of the established private sector banks have minimum size of deposits of Rs. 1,000 as in case of public sector banks.

10. Tenure of deposits

The tenure profile of term deposits of banks is given in Exhibit - 8:

Exhibit - 8



Source : RBI

A large portion of the term deposits in March 1992 were over 2 years. The interest rates on deposits with larger maturities are higher, which is the primary reason for the deposit profile of the banks to be skewed towards the longer end. However since then the average maturity of deposits would have declined.

11. Cost of deposits

Cost of deposits of established banks is in the range of 7 to 8% given that a significant portion of the deposits are savings and current deposits which have low cost. The new banks and private sector banks have a higher cost of deposits on account of lower proportion of savings and current deposits.

Rates on term deposits were freed to some extent in the busy season credit policy of October 1995. As per the current RBI norms, banks are free to price deposits of tenures of over 2 years. Previously, the RBI capped the interest rates that banks could offer at 12% Within the prescribed ceiling rate on deposits, there had to be at least three maturity prescriptions with a minimum differential of 0.25% These stipulations were withdrawn in September 1995. After the rates were freed, interest rates have increased for deposits over 2 years.

12. Sustainability & outlook

The competitive advantage of banks in deposit mobilisation, arising out of their vast branch network in the urban and rural areas and perception of safety in depositors' minds due to government ownership and deposit insurance, is expected to be sustained.

Banks have been exploring capital markets as additional sources of funding. However, the funds raised from the capital markets in the form of equity and bonds are primarily for capital adequacy purposes and their dependence on the deposits as a primary resource would continue in future.

The competition for deposits is increasing in the financial sector. The competition to the banks is from new banks as well as NBFCs, HFCs & FIs. The alternate funding sources of the NBFCs, HFCs and FIs have been under constraint which has led them to increase their efforts in raising retail deposits.

The deregulation of interest rates on bank deposits over 2 years and increased competition has resulted in the increase in deposit rates of the banks. The competition to banks would be in respect of term deposits. Banks would continue to be comfortable with respect to savings and current deposits.

PART-C
RISK PROFILES

Part-C : Risk Profiles

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I. Risk profile of Housing Finance Companies

Introduction

The housing finance sector in India comprises of both the informal and formal sector.

Institutions in the formal sector include:

- Scheduled commercial banks
- Insurance companies and UTI
- Housing finance companies
- State level housing boards, co-operative housing finance societies, state co-operative banks, primary urban co-operative societies
- Agriculture and rural development banks

The informal sector includes personal savings, borrowings from moneylenders, friends and relatives and loans given by employers to employees. It is estimated that 65% of total housing needs are met by the informal sector.

The first specialised housing finance institution, HUDCO, was set up in 1970. However HUDCO is not a retail financier, its mandate was to lend to housing development bodies. HDFC, the first retail HFC started operations in 1977. The demonstrated success of HDFC, rising middle class, large demand supply gap and availability of refinance from NHB are the main reasons for mushrooming of HFCs since the latter half of the 1980s.

The market serviced by HFCs is still very small; disbursements of all HFCs put together would not exceed Rs. 2,500 crore per year. One reason for the relatively minor role of HFCs in housing finance is the relatively recent start of their operations. Even now the reach of these companies is limited to a narrow clientele in the urban areas.

In 1988 National Housing Bank, a regulatory body for the HFCs was set up as a wholly owned subsidiary of the Reserve Bank of India under an Act (the NHB Act) of Parliament. Until then, HFCs were classified as NBFCs and regulated by the RBI. With NHB's formation, the regulatory powers vested with the RBI with regard to HFCs were transferred to the NHB.

Business risk

The key parameters of business risks of HFCs are market position, operating efficiency, management evaluation, resources and asset quality.

1. Market position

The key determinants of the market position of a HFC are its business mix, branch network, geographic concentration, client profile, business volumes and quality of service.

1.1 Business mix

The main lending segments are individuals, corporates, public housing agencies and builders.

1.1.1 Individuals

Individuals represent the largest business segment for HFCs and comprise mainly middle and high income salaried groups. The market is more interest sensitive as compared to other segments like car and consumer durable financing. Attempts to tap the lower income group through schemes like the home loan account scheme have not met with much success. The rural markets are largely untapped by HFCs because of problems of income verifications for non salaried class workers besides perceived problems of clear title to the land. The inherent risk in lending to individuals is the lowest. Smaller loan sizes (average size : Rs. 1 lakh - Rs. 5 lakh) ensure diversification of risk. The predominance of the salaried middle class in the 'individuals' segment also renders this segment less risky. Moreover, in the event of a fall in interest rates, the prepayment risk is the lowest in this segment since the ability of individuals to access cheaper funds to repay higher cost loans is relatively limited.

1.1.2 Builders

Loans to builders are for project construction and are mainly short term loans (less than 3 years) at higher interest rates (over 20% p.a.). The builder segment is more risky than the "individuals" segment. Any delay in project completion may affect the ability and willingness of the builder to meet his debt servicing obligations. Traditionally, institutional finance to this segment has been limited as banks are extremely wary of lending to this segment. HFCs try and mitigate this risk by lending to reputed builders with a good track record of client servicing.

1.1.3 Corporates

Corporates borrow from HFCs under the 'rental housing scheme' whereby employees borrow to build homes and rent to employees. The risks in these loans would be determined by the creditworthiness of the corporates. The prepayment risk in the event of interest rates declining is high.

1.1.4 Public housing agencies

Public housing agencies are a risky segment. Such loans for land development and shelter projects have long tenures of about 13 years. Delays in project implementation often affect loan repayments. Although these loans are backed by government guarantees such guarantees are difficult to enforce.

The business mix of HFCs largely comprises loans to individuals. However there are HFCs like Centbank Housing and PNB Housing which lend largely to corporates and builders.

1.2 Branch network and geographic concentration

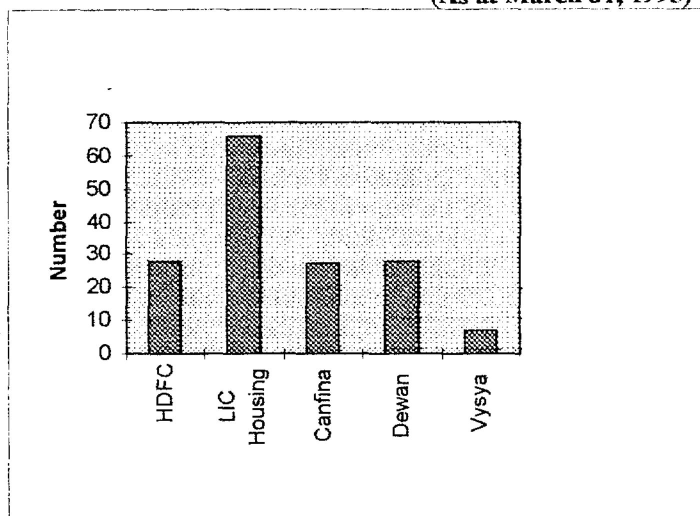
The branch network gives an indication of the relative size of the HFC. A larger network affords greater opportunity to reduce geographical portfolio concentration and to widen the deposit base. Locationally diversified loan portfolio also reduces vulnerability to adverse property price movements in a single region.

As regards geographic concentration, HFCs of insurance companies and banks generally have a relatively wider spread, while the others have a concentration in Western and Southern India where property prices are booming and the borrowers have a better track record of repayments. HDFC has an all India presence.

A comparison of the branch network of a few HFCs is given in Exhibit I

Exhibit I: Branch network of select HFCs

(As at March 31, 1995)



HDFC	- Housing Finance Development Corporation Ltd.
LIC Housing	- LIC Housing Finance Limited
Canfina	- Canfin Homes Limited
Dewan	- Dewan Housing Finance Corporation Ltd.
Vysya	- Vysya Bank Housing Finance Ltd.

LIC Housing has the largest network but is not the market leader. Vysya Housing being a relatively new entrant has a smaller network compared to other established players.

1.3 Client profile

The quality of clientele has a bearing on the asset quality of the HFC and is thus critical in assessing the risk profile of the HFC. The client profile in case of individuals could be shaped by the demographic criteria specified in the appraisal process of the HFC. In the builder and corporate segment, each of the borrowers will have to be analysed for their credit worthiness.

1.4 Business volumes

Margins in the industry are low. Generation of sufficiently large business volumes is thus a key success factor in the business.

The top 5 HFCs viz. HDFC, LIC Housing Finance, Canfin Homes, Dewan Housing and SBI Home Finance have a combined market share of over 80% in terms of cumulative disbursements. HDFC alone has a market share of 55 %. The cumulative disbursements of top 5 HFCs is given in Table 1.

Table 1: Cumulative disbursements of HFCs

(March 31, 1995)

Company	Amount (Rs. crore)
1. HDFC	5695
2. LIC Housing Finance	1688
3. Canfin Homes	545
4. Dewan Housing	368
5. SBI Home Finance	355

Note: HUDCO being a wholesale lender is not included.

1.5 Service levels

The quality of service is determined by the variety of the product range (different loan schemes to suit different types of customers), simplified transaction and operating procedures, customer orientation of front office staff etc. In a highly competitive industry service forms an important basis of competition.

The high standard of customer service set by HDFC has become a landmark for other players to follow.

2. Operating efficiency

The main indicators of operating efficiency are the quality of systems and procedures and the expense levels of the HFC.

2.1 Systems and procedures

Well laid out systems and procedures for loan appraisal, disbursement and credit monitoring enable proper control on portfolio quality and quick responses to customer requirements. Internal control systems such as exposure norms for advances need to be well formulated and adhered to. The operating efficiency is also greatly enhanced by computerised management information systems which capture information on loan performance of individual accounts including repayment pattern, delays in payment, prepayments etc. Adequate systems are required to track asset - liability matching in terms of maturity and interest rate matching.

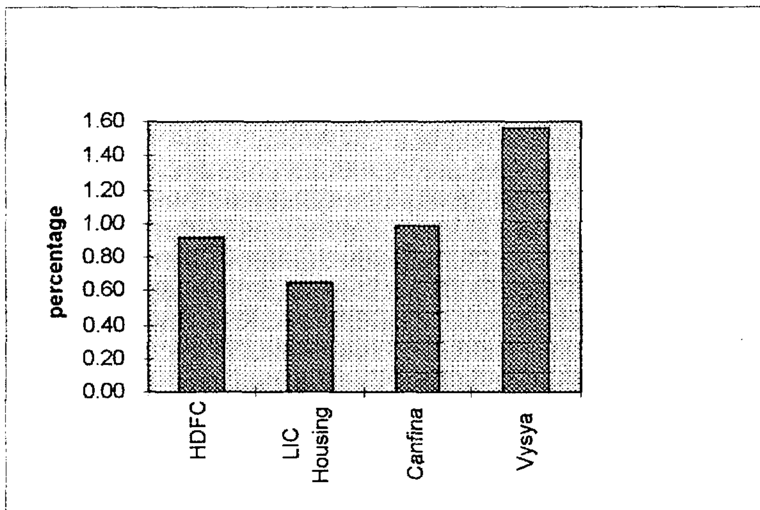
The larger HFCs have computerised operations. However, appraisal criteria and documentation are not standardised across the industry. The quality of information systems embedded needs to be considerably empowered, particularly if the industry to tap new funding sources like securitisation of loans.

2.2 Expense levels

Expense levels which include all expenses of the HFC including interest and depreciation are an important indicator of the operating efficiency. A larger number of loan accounts implies higher transaction costs resulting in higher expense levels. However, as volumes grow, the costs tend to be absorbed by the increased scale of operations.

Most HFC are well within the stipulated NHB norm of expense ratio of 1.5% Expense ratios (administrative expenses as a percentage to loans) for select HFCs are given in Exhibit II.

Exhibit II: Expense ratios (1994-95)



3. Management evaluation

The management's attitude to risk, its ability to manage growth and the level of decentralisation in the organisation affect the risk profile of the HFC. This is specially relevant for companies with high growth rates. When the growth rate in disbursements exceeds say 25%, the pointers are that the company is on a high growth phase and unless it has the systems to manage this growth, its performance will be affected. Being a relatively young industry, most of the HFCs are in the phase of development of systems and procedures and formulation of clear cut policies and strategies and hence the importance of assessing the same while evaluating the management.

4. Resources

The key determinants of this are diversity of funding sources, sustainability and outlook for main funding sources, track record and ability to replace funding sources, the cost of funding and ability to raise funds at short notice. Resource position of 13 sample HFCs (excluding HUDCO) is given in Table II

Table II: Resource position of 13 sample HFCs

Rs. cr	Total	% of total
Loans from NHB	1,115.63	13%
Banking sector	491.51	6%
Insurance sector	1,734.07	20%
Financial institutions	15.75	0%
Total directed credit	***3,356.96***	***38%***
Borrowings		
Bonds	760.91	9%
Fixed deposits	2,530.09	29%
Inter-corporate deposits	2.46	0%
Total market borrowings	***3,293.46***	***37%***
Total domestic source	**6,650.42**	**75%**
Foreign funds	**800.98**	**9%**
Promoters funds	**1,377.46**	**16%**
Total sources	**8,828.85**	**100%**

4.1 Diversity of funding sources

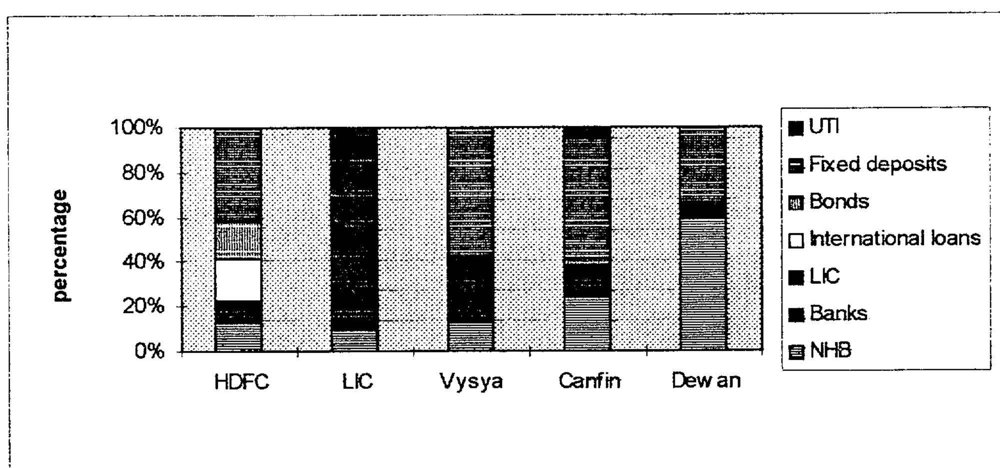
At an industry level, HFCs have available a reasonably well diversified funding base comprising

- Owned funds : (including equity and resources)
- Directed credit (including loans from banks, insurance companies, financial institutions)
- NHB refinance
- Debentures and bonds
- Public Deposits
- International loans

However the actual funding profile of a HFC is dependent on its ownership. HFCs promoted by insurance companies are almost inclusively dependent on loans from their parent company. The dependence on NHB refinance is the highest for the private HFCs followed by HFCs promoted by banks. HFCs promoted by banks have a fairly high proportion of public deposits in their funding mix reflecting synergy with the parent. HDFC has a well diversified funding base and has also accessed international loans in the past from USAID, IBRD, IFC(W) and CDC at subsidised interest rates.

The resource position of select HFCs as at March 31, 1995 is given in Exhibit III

Exhibit III- Funding profile of HFCs as at March 31, 1995



4.2 Sustainability and outlook for main funding sources

Diversion of the insurance sector funds to their own sponsored HFCs has adversely affected the availability of these funds to the other HFCs. As regards funds from banks, of the mandated lending of 1.5% of their incremental deposits to the housing sector, 30% is by way of indirect lending to the HFCs. (Of the balance, 20% is for direct lending and 50% to be deployed in government guarantee bonds / debentures of HUDCO / NHB.) Banks are increasingly fulfilling this by lending to their subsidiary HFCs. Refinance from NHB is under strain both on account of the increase in the number of recognised HFCs and NHB's own resource constraints. While dependence on public deposits is expected to increase, the increasingly competitive scenario for deposit mobilisation would impact both the availability and cost of deposits.

4.3 Ability to replace funding sources

A diversified funding base offers the advantage of shifting focus to alternative funding source in case traditional sources are under pressure. The aggressive deposit mobilisation by HDFC in the wake of drying up of loans from LIC and international agencies (which are increasingly routing funds through NHB) is a case in point.

4.4 Cost of funds

Higher funding costs put pressure on HFCs to lend at higher rates to maintain spreads. This could be possibly increase the risk profile of clients as well as impair competitiveness in an interest sensitive market. The cost of funds for the HFCs is expected to increase.

4.5 Ability to raise funds at short notice

Raising funds at short notice might be required for short term asset liability mismatch. In such a situation strong promoter backing like bank ownership is a definite advantage for (bank backed) HFCs.

5. Asset quality

Despite the absence of foreclosure laws in the country, the inherent asset quality of the HFCs' loan portfolio is good. Increasing property prices ensure that the borrower repays the loan as he would like to hold the asset. Moreover, since most houses are bought by the middle income groups for their own residential purposes, the tendency to default is low.

As regards the investment portfolio, HFCs invest their surplus funds in shares, debentures/bonds, units and inter-corporate loans. Yield on investments is fairly high across the industry. This, to some extent, compensates HFCs for the low interest spreads.

5.1 Risk of defaults

The key determinants of the asset quality of the loan portfolio are credit appraisal systems and the underwriting norms, portfolio concentration by location, borrower types/groups, and the monitoring and recovery mechanisms.

5.1.1 Credit appraisal systems

Well laid out systems and procedures for credit appraisal are essential for ensuring a quality loan portfolio. Some HFCs have a committee system for loan approvals.

5.1.2 Underwriting norms

Underwriting criteria in the industry are not standardised. HFCs try to mitigate risk by minimising loan to cost ratio and the instalment to income ratios. While the former increases the equity of the home owner, the latter ensures that the repayment capabilities are not overstepped. Although the Loan Cost Ratio (LCR) varies depending on the type of borrower, the average LCR for the industry is 60%. The average Instalment to Income Ratio (IIR) is about 33%.

5.1.3 Portfolio concentration

NHB guidelines specify that a HFC cannot lend more than 15% of its net owned funds to a single company and 25% to a single group. With a few exceptions, these norms are generally adhered to by the HFCs. The geographical concentration of the loan portfolios is determined by the locational presence of the branch network. HDFC and LIC Housing Finance have fairly widespread geographic distribution of loan portfolio.

5.1.4 Monitoring

Sound systems are required to monitor loan performance. Prompt follow up action needs to be taken for delinquent accounts. Most HFCs have dedicated collection teams and computerised credit management information systems.

5.1.5 Provisioning norms

From the financial year 1995-96, asset classification norms have been introduced for HFCs. These norms are similar to those introduced for banks and NBFCs.

Despite lack of standardisation in accounting policy so far, the level of non-performing assets in the industry is estimated to be less than 5%. LIC Housing however, is reported to have higher NPA levels. NPAs are particularly high for HFCs lending predominantly to public agencies who are notorious for late payments.

5.2 Investment portfolio

The proportion of investment income to total income varies across HFCs and at 28% is the highest for HDFC. Most other HFCs are yet to adequately develop their treasury operations. With the pressure on spreads, other companies are expected to step up their investment activities. A well laid out investment policy, adherence to operating procedures and exposure norms together with strong control systems are important in mitigating investment portfolio risks.

6. Regulatory aspects

Prior to the formation of NHB, HFCs were classified as NBFCs and regulated by the RBI. However, after NHB came into existence, the regulatory powers vested with the RBI with regard to HFCs were transferred to the NHB.

Unlike banks which require to be licensed by RBI, the housing finance sector has no entry barriers as no licensing requirement exists.

NHB guidelines specify eligibility criteria for categorisation as a "recognised HFC", which would entitle it to receive refinance assistance from NHB. These include paid up capital, listing, limits on borrowings, lending rates on refinanced loans, acceptance of deposits, sealing on expenses, and liquidity requirements. The salient features of the NHB guidelines are annexed.

All HFCs with a paid up capital of over Rs. 50 lakh are governed by NHB's general directions concerning deposits and borrowings and have to file annual reports with the NHB.

NHB actively supports the industry through a system of below market refinance. In the initial years NHB provided refinance for only loans upto Rs. 50000 and subject to certain size limits of the house financed (upto 40 sq.m. to prevent higher income households from accessing the refinance through taking a small loan) at a spread of over 1% NHB liberalised these terms in 1990 and permitted refinance for loans upto Rs. 200000. In 1992 the spread was raised to 2% for loans upto Rs. 50000 and 1.5% for the larger loans. In 1992-93, due to high interest rates and increased demands of project finance (financing of Land Development and Shelter Projects of Public agencies) on its resources, NHB had to scale down its assistance. NHB cut its refinance to 60% of outstanding loans and reduced the spread from 1.5% to 1.25% In 1995, NHB cut its refinance even further to 50%.

HFCs are required to file annual returns with NHB. Inspection of NHB is not routinely carried out by NHB, but on a case to case basis.

Financial risks

Important parameters in the financial risk of a HFC are capital adequacy, accounting quality, earnings profile and asset liability matching.

7. Capital adequacy

In terms of guidelines issued in June, 1995, HFCs have to achieve 8% capital adequacy by March 1996. In general, HFCs are comfortably placed with regard to achievement of capital adequacy norms. This is a young profit making industry which has access to capital markets for raising further funds.

8. Accounting quality

Accounting practices in the industry are not standardised. Although the industry practice is to calculate EMI at annual rests, there is no prescription from the NHB in this regard. The new guidelines regarding income recognition, asset classification and provisioning are expected to standardise the accounting quality across the industry.

9. Earnings

Generation of adequate volumes is important as margins in this business are 3% on an average. This leaves little cushion to absorb increased funding cost and provisioning/write off for non-performing assets. Strategies for earnings protection include lending to the more lucrative builders segment and deployment of funds in investment operation. HFCs also undertake actives like leasing to minimise tax outflow.

However, HFCs are not permitted to deploy more than 25% of their funds for non-housing purposes. There is a further restriction on income from non-housing activities to 50% of total income of a HFC. This implies that a HFC's flexibility to boost income from non-housing activities is limited.

Further, even lending to builders segment, would be categorised as lending for short term purposes. As per NHB guidelines, HFCs have to deploy 75% of their funds for long term lending for housing purposes. Thus lending for short term purposes would fall within the residual 25%.

The tax benefits available under Section 36(i)(viii) of the Income Tax Act are now restricted to income from housing finance activities only. This would impact the profitability of HFCs.

The financials of 13 sample HFCs along with key ratios are annexed.

10. Asset liability management

Asset liability management is a critical issue for HFCs. By their very nature, HFCs are susceptible to asset liability mismatches with liabilities on the balance sheet generally being of a shorter duration than assets.

Asset Liability Management has two components viz. interest risk and maturity risk.

10.1 Interest risk

Interest rate risk arises because lending is generally at fixed interest rates, whereas cost of borrowings would increase with interest rate hikes. Conversely, interest rate risk could also arise in a scenario of declining interest rates and large scale prepayment by borrowers. Although HFCs have a loan variability clause in the Loan agreement, this is not normally enforced. It is only in the case of loans to corporates/builders, that HFCs apply variable interest rates. SBI Home Finance is reported to have recently introduced a Variable Rate but its success is yet to be demonstrated. There are proposals to introduce variable rate mortgages; however, issues like index to which the rates have to be penned, etc. need to be sorted out.

10.2 Maturity risk

This risk arises because of the difference in tenure between a HFC's assets and liabilities. Loans to individuals normally have a tenure of 10-15 years. The weighted average term would be lower and would further decline in the event of prepayment. Moreover, a mix of long term and short term loan would further reduce the maturity on the asset side. Precise calculations of the asset liability gap for HFCs are not available. However, the maturity profile of liabilities is far lower.

Reduction in the mismatch could be brought about for long term funding. Currently, HFCs with good credit rating/promoter backing have a high renewal rate on their deposits. They can also raise equity at a premium which could reduce the mismatch. Another strategy has been to increase lending to builders as such loans have lower maturities. Further, since NHB refinance is tenure matched, the problem does not arise in case of NHB refinanced loans. A long term solution lies in securitisation of the loan portfolio. However, a whole range of issues like legal aspects, taxation aspects and adequacy of management information systems need to be sorted out before this option can be utilised. NHB has been working on a pilot project for mortgage backed securitisation; however, this is in a preliminary stage.

11. Liquidity risk

Liquidity risk is determined by the ease and flexibility of access to funding sources such as deposits, liquid investments, promoter funding and capital markets. The greater the access of the HFC to these resources, the more comfortable is its liquidity position.

APPENDIX I

List of Housing Finance Companies approved by the NHB for its refinance facility

(As on November 1, 1995)

HFCs	Principal area of operations/Based in	Year of commencement of operations
HFCs set up by Insurance companies		
1. LIC Housing Finance	Bombay	1989
2. GIC Housing Finance Ltd.	Bombay	1990-91
HFCs set up by banks		
1. AB Homes Finance Ltd.	Hyderabad	1991
2. BOB Housing Finance Ltd.	Jaipur	1990
3. Canfin Homes Limited	Bangalore	1987
4. Cent Bank Home Finance Ltd.	Bhopal	1991
5. Indian Bank Housing Ltd.	Madras	
6. PNB Housing Finance Ltd.	New Delhi	1988
7. SBI Home Finance Ltd.	Calcutta	1988
8. Vysya Bank Home Finance Ltd.	Bangalore	1991
Private Sector HFCs		
1. Dewan Housing Development Finance Ltd.	Bombay	1984
2. Fair growth Home Finance Ltd./ Vijaya Home Loans	Bangalore	1990-91
3. Gujarat Rural Housing Corporation Ltd.	Ahmedabad	1988
4. GLFL Housing Finance Ltd.	Ahmedabad	1992
5. HDFC	Bombay	1977
6. Hometrust Housing Finance Ltd.	Calcutta	1994
7. India Housing Finance and Development Ltd . *		
8. Live Well Housing Finance	Hyderabad	
9. Parashwanath Housing Finance Corporation Ltd.	Ahmedabad	1986
10. Peerless Abasan Finance Ltd.	Calcutta	
11 Saya Housing Finance Company	Ahmedabad	1985-86
HUDCO	Finances state level housing development bodies.	1970

* De-recognised by NHB

APPENDIX II

Financials for year ending March 31, 1995

Rs. crore	HDFC	LIC Housing	Canfin Homes	Dewan Housing	SBI Home	GIC Housing	PNB Housing	AB Homes	Vysya Housing	Centbank Home	GLFL Housing	Parshwanath Housing	Hometrust Housing	HUDCO *
No. of branches	28	66	27	28	17	14	10	11	7	9	4	3	4	22
Cumulative disbursements	5695	1688	545	368	355	138	131	54	43	42	11	7	3	7341
Paid up capital	101.25	74.87	20.48	27.80	15.00	17.64	10.00	9.00	3.00	10.00	3.00	2.00	10.00	298.00
Networth	874.86	255.69	46.58	50.20	25.33	55.93	24.28	10.87	4.87	11.95	3.74	3.07	10.09	633.53
Total borrowings	4436.33	1639.91	423.25	291.13	269.16	119.20	109.39	53.80	41.39	38.63	15.59	15.59	15.59	4461.23
Total Income	780.34	258.39	70.80	50.77	42.35	21.14	32.58	7.68	6.54	6.95	2.17	2.43	0.18	614.37
PBT	184.39	55.50	13.56	6.71	8.61	7.95	10.47	0.90	1.96	1.81	0.74	0.91	0.14	100.16
PAT	146.15	41.35	10.84	5.90	8.30	6.23	9.58	0.66	1.44	1.38	0.67	0.61	0.14	70.60
Interest earned on average loans	16.00%	15.34%	16.76%	16.72%	18.60%	16.33%	21.70%	17.05%	18.47%	17.22%	17.48%	16.48%	5.83%	11.47%
Income earned on investments	21.57%	19.13%	18.20%	23.62%	23.59%	25.87%	32.98%	6.12%	32.89%	14.26%		92.31%		17.68%
Interest paid on average borrowings	13.58%	12.69%	13.49%	14.41%	13.49%	11.53%	17.40%	13.49%	13.15%	13.26%	13.15%	10.77%		11.24%
Interest spread	2.42%	2.65%	3.27%	2.31%	5.11%	4.80%	4.30%	3.56%	5.32%	3.96%	4.33%	5.71%	5.83%	0.23%
Investment income/Total income	27.81%	9.39%	4.16%	0.58%	2.48%	2.24%	5.03%	0.31%	0.57%	0.18%	0.09%	0.02%		17.67%
PBT/Total Income	23.63%	21.48%	19.15%	13.22%	20.33%	37.61%	32.14%	11.72%	29.97%	26.04%	34.10%	37.45%	77.78%	16.30%
PAT/ Total Income	18.73%	16.00%	15.31%	11.62%	19.60%	29.47%	29.40%	8.59%	22.02%	19.86%	30.88%	25.10%	77.78%	11.49%
Operating margin/Avg. Assets	4.18%	3.68%	3.15%	12.91%	12.59%	12.33%	6.85%	1.58%	5.46%	4.05%	4.34%	5.72%	-2.46%	2.16%
Operating expenses/Avg Assets	0.64%	0.56%	0.79%	1.64%	1.54%	1.04%	0.67%	0.95%	1.17%	0.98%	2.82%	1.23%	4.22%	0.15%
PAT/Average assets	2.96%	2.38%	2.43%	1.84%	3.37%	4.48%	6.24%	1.15%	3.91%	3.07%	5.10%	3.76%	1.38%	1.32%
PAT/Avg. Networth	16.71%	16.17%	23.27%	11.75%	32.77%	11.14%	39.46%	6.07%	29.57%	11.55%	17.91%	19.87%	1.39%	11.14%
Debt/Equity (Times)	5.07	6.41	9.09	5.80	10.63	2.13	4.51	4.95	8.50	3.23	4.17	4.44		7.04

* HUDCO is not really comparable with other HFCs as it is not a retail financier; it is a government undertaking which finances state level agencies and plays a developmental role in the housing sector. It has a mandate to lend 55% of its funds towards housing projects for the lower income groups.

II. Risk profile of Non-Banking Financial Companies

Introduction

The non banking financial companies (NBFCs) have different characteristics as compared to other segments of the financial sector. The sector is much more dynamic with the possibility of high and fluctuating growth rates, changing business mix in response to market and regulatory changes, and the ability of the companies to rapidly change their financial profile by adding new businesses, dropping old ones and altering their funding profile. Entry barriers are far lower, which adds to the dynamism of the industry.

The last two years have seen a proliferation of NBFCs and today there are over 30,000 companies in India. NBFCs have expanded their activities to include a range of fund based and fee based services. Fund based services include leasing, hire purchase, bill discounting, promoter funding, inter corporate deposits and investments, while fee based services cover issue management, corporate advisory services, loan syndication and underwriting.

The extent of regulation over NBFCs has also increased. Registered under the Companies Act, they are also governed by the RBI guidelines regarding registration, income recognition, capital adequacy requirements etc. Further, those engaged in merchant banking activities are subject to scrutiny by SEBI.

All NBFCs with net owned funds of over Rs. 50 lakh have to register themselves with RBI. Of the 750 NBFCs registered with RBI, only 255 companies filed their returns with the RBI as on September 30, 1995. As explained earlier, this analysis is based on a sample of 150 NBFCs which well represents the profile of main deposit taking NBFCs.

Business risk

1. Market position

The key determinants of the market position of NBFCs are the business mix, size, branch network and geographical spread, track record and the quality of service offered by the company.

1.1 Business mix

The relative share of different fund based and fee based activities in the total income of the company is the single most important determinant of the business risk profile of the NBFC. The main risk in fund based business is the loss of capital. On the other hand, fee based businesses carry the risk of variability of income and profits. Fund and fee based activities tend to supplement each other and it is possible for a company to reduce its overall risk profile by diversifying its business mix.

The fundamental risks of fund and fee based activities are given in Table 1.

Table 1: Fundamental Risks of NBFCs

Fund Based Activities	Fee Based Activities
• Recovery risk • Interest rate risk • Environment risk • Funding of future operations	• Risk of variability of business • Devolvement risk • Environment risk • Risk of high professional turnover

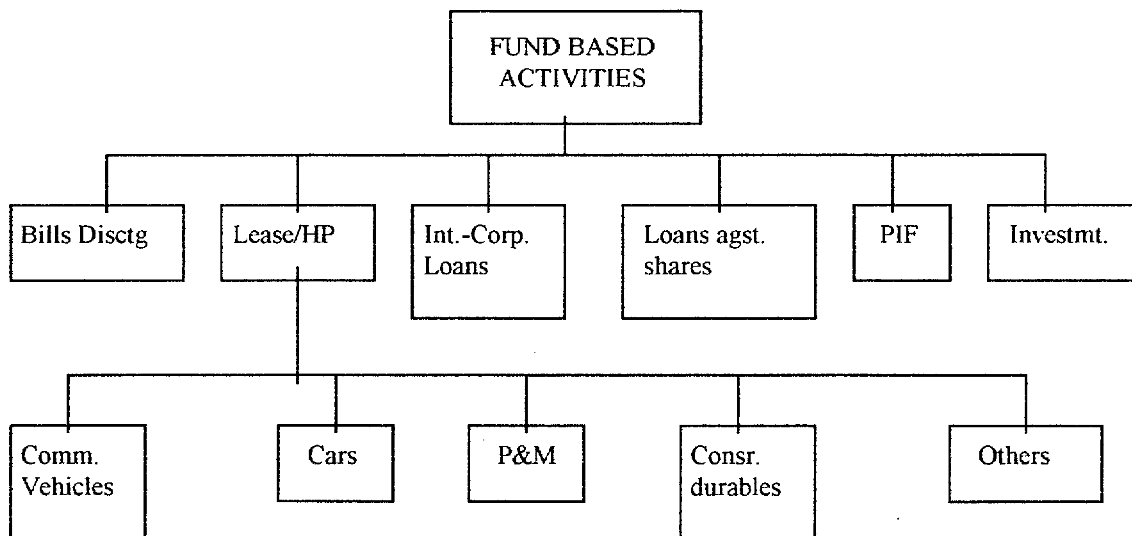
The risk profile of fund and fee based businesses are discussed in the following analytical frame work:

- fundamental risk (including variability of earnings and recovery risk)
- growth prospects
- degree of competition
- key success factors

Fund based activities

The various segments of the fund based activities are given in Exhibit 1.

Exhibit 1: Segments of Fund Based Activities



PIF - Primary issue financing
P&M - Plant and machinery

1.1.1 Asset financing through lease and hire purchase

Asset financing through lease and hire purchase constitutes the main business segment for majority of the NBFCs. Leasing in India is done primarily for tax shelter purposes (as being the lessor NBFCs get tax shield on depreciation). Leasing is undertaken primarily for plant and machinery items (particularly 100% depreciation items) and to a lesser extent for vehicles. Leasing is done in cases when the lessee prefers lower finance charges and can forego the depreciation benefit. Hire purchase is undertaken primarily for vehicle financing and to a lesser extent for consumer durables and plant and machinery. The client profile comprises both corporates and individuals.

The asset financing business is relatively less risky as compared to other fund based activities due to the availability of security in the form of the asset financed which results in a higher degree of certainty of cash flows. In case of default in repayments the asset can be repossessed and sold off.

Within asset financing, the degree of risk varies across different asset types and is determined by the following parameters :

- Resale value : high resale value of the asset leads to low risk of default.
- Ease of repossession : assets which are easy to repossess form less risky segments.
- Tenure : short tenure financing carries lower risk.
- Client profile : corporate customers would be low risk segments as compared to individual customers.

A comparison of various asset types on the above parameters is presented in the Table 2.

Table 2 : Comparison of various asset types

	Cars	**Commercial Vehicles (CVs)**	**Plant & Machinery (P&M)**	**Consumer durables**
resale value	High	High	Average/Low	Low
ease of repossession	High	High	Low	Average
tenure	3 - 5 years	around 5 years	around 5 years	around 3 years
customer profile	Corporates/ Individuals	Single vehicle/ fleet operators	Corporates	Individuals

Overall, out of the four asset types, cars and CVs are the least risky and consumer durables the most, mainly on account of high resale value and ease of repossession of the asset. Further, though contrary to normal risk-return pattern, the margins in plant and machinery segment are lower than in cars and CVs. Plant and machinery financing is normally done through the lease route for depreciation benefits and intense competition has led to low rates.

The degree of competition in the asset financing business is very high on account of mushrooming growth in the industry. Besides, the entry of banks has further increased competition. There has been a shift out of consumer durable financing to wards the safer car and commercial vehicle financing segments. As of now, plant and machinery financing is mainly undertaken for tax shelter purposes. However, we can expect to see the larger NBFCs with asset base of over Rs. 1,000 crore to make an entry into big ticket leasing as the investment in the infrastructure sector picks up.

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1.1.2 Bill discounting

The business risk of bill discounting operations would depend on credit quality of the customers and credit quality of corporate on whom the bill is drawn (bills drawn on highly rated corporates like Telco, Reliance, etc. by their suppliers would have low risk of default). Another factor is the type of bills; clean bills have high risk high return profile as compared to L/C based bills.

Similarly, a higher proportion of bills drawn by suppliers of group companies can be perceived to have higher/lower risk on the basis of the strength/weakness of the group companies. This analysis is critical for a sector where there has been a very high growth rate on account of the existence of fly by night operators with a hand in glove arrangement with their parent companies.

Tight money market conditions have lead to buoyant demand and high returns in bills discounting business. However, access to funds for rediscounting is strained. In the long term overall demand is expected to grow with economic and corporate growth. Fluctuations, however, can be expected depending on cost of alternative sources of funding for corporates. The competition in this business is very high and the spreads available are always under pressure.

Ability to generate volumes while maintaining credit quality, ability to rediscount/arrange short term funds at attractive rates and relationship with corporates for repeat business are some of the key success factors in this segment.

1.1.3 Share trading / portfolio management

Share trading business is inherently risky as the returns depend on the vagaries of stock markets. Down turns in the stock markets could lead to substantial erosion of the invested amounts.

The business risk of share trading business depends on the investment objectives of the company, and is determined by the following parameters :

- primary vs. secondary market : till recently primary market operations were perceived to be less risky. However, recent issues indicate that this may not always be true.
- nature of investments : speculative vs. long term investments
- liquidity of scrips : low capitalisation scrips would have higher risk.

In share market activities it is important to enforce stop loss limits and thus efficiency of entry and exit is critical. This necessitates good systems and procedures and investment in good companies through adequate research support. A clear strategy of scrip selection, holding period and target rate of return is required.

In the long term, as Indian stock markets mature, share trading activity would not see super normal returns. Like other mature markets, the major players would be mutual funds and institutional investors; as such NBFCs would be on a weaker footing as compared to the competition.

1.1.4 Miscellaneous loans

This line of business includes inter corporate deposits (ICDs), loans against shares, promoter funding etc. The risk of these activities can be judged only on a case to case basis depending on customer profile, nature of under lying security and linkage with other economic factors/activities. As regards customer profile, retail customers would form high risk segments as compared to promoters and large brokers. Ease of repossession and resale value of the underlying security is critical for assessing the risk of the business. Similarly, linkage with other economic factors/activities such as stock market movements would affect the recovery risk of the above activities.

These lending operations are usually short term in nature and the business opportunity varies based on other economic activities such as money market conditions, stock markets, etc. The sustainability of this line of business would always be under question. The competition would also be high on account of very low entry barriers.

Fee based activities

1.1.5 Merchant banking - issue management

Like any fee based business, issue management activities have no capital recovery risk but high risk in terms of sustainability of operations. The risk of fluctuation in business in future would depend on market conditions and the competitive scenario.

The demand for issue management services is growing with the growth in private sector funding though capital markets. Currently merchant banking activities are going through a lean phase due to depressed market conditions, however, the long term prospects are favourable.

The mushrooming growth of NBFCs and increasing number of merchant bankers have increased competitive pressures in the industry. In the long run merchant banks who can establish a reputation of reliability with the investors can be expected to fare significantly better than the others.

1.1.6 Merchant banking - underwriting

The underwriting of public issues is a fee based activity as long as the issue does not devolve. The primary risk in this line of business is risk of devolvement and the future market value of the devolved scrips. The devolvement may also disrupt the funding plans of the company and cause disruptions in normal lines of businesses.

The devolvement may be due to weakness of merchant bankers, inherent weakness of the issue, overpricing of issue or inadequate marketing support. In view of highly competitive scenario in issue management services the issues devolve mainly on account of over pricing or inherent weakness of the issue. In either case the underwriter faces the risk of loss of funds committed.

Underwriting is no longer compulsory in Indian primary markets. This has led to reduced levels of underwriting and reduction in commissions as well. Moreover, few good issues are available for under writing, increasing the overall risk of devolvements. Competition levels are high on account of very low (non existent) entry barriers. Overall, the prospects and sustainability of this line of business can only be considered to be limited.

1.1.7 Corporate advisory services

The risk in this line of activity arises mainly from the company's ability to sustain future business volumes.

Advisory services are a relatively new activity for finance companies and the competition as of now is mainly from specialised agencies. There is a strong linkage between advisory services of NBFCs and their issue management activities.

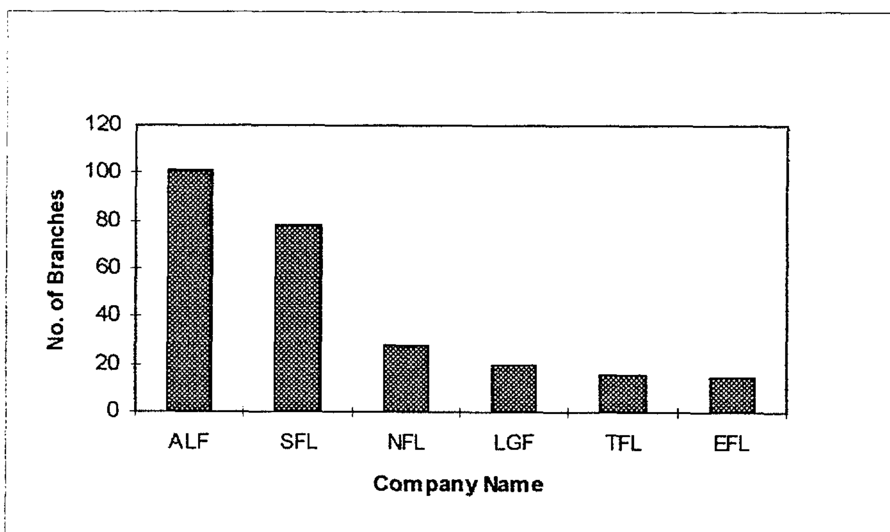
1.2 Size and track record

Size of a NBFC as measured by total funds deployed in the business is a critical parameter in assessing the business risk of a company. The companies with larger size have more stability in their business because of their ability to diversify income sources/ geographical base etc. and are better positioned to face economic downturns. Similarly track record of a NBFC is critical in assessing its risk profile. If a company has been successful in keeping its asset portfolio healthy in the past then it can be expected to be able to do so in the future as well.

1.3 Reach and geographic concentration

The number of branches of a sample of NBFCs is pictorially represented in Exhibit 2.

Exhibit 2 : Number of branches



ALF - Ashok Leyland Finance Ltd.
SFL - Sundaram Finance Ltd.
NFL - Nagarjuna Finance Ltd.
LGF - Lakshmi General Finance Ltd.
TFL - Tata Finance Ltd.
EFL - Escorts Finance Ltd.

A large and widespread branch network increases the company's reach. It reduces overdependence on particular locations for deposits as also geographical concentration of trading portfolio. Size also has implications for a company's ability to achieve growth. However, it is interesting to note that the largest NBFC, Kotak Mahindra Finance Ltd. has a relatively small branch network.

Majority of the NBFCs have their business concentration in South and West zones as these are zones perceived to have a lower credit risk. Among the sample of companies given in Exhibit 2 Ashok Leyland has an all India presence, Sundaram, Nagarjuna and Lakshmi are primarily South based companies, Tata has a major presence in the west and Escorts has a concentration in North India.

1.4 Service levels

NBFCs have generally set fairly high standards of customer service. The servicing of depositors by large and established companies with very large deposit bases is of very high quality which partly accounts for the stability of their deposit base.

2. Operating efficiency

The operating expenses of a NBFC are to a large extent fixed expenses. A NBFC with better operating efficiency and consequently lower expenditure would be in a better position to protect its margins during adverse economic conditions. The risk profile of NBFCs on the parameters of expense levels and systems & procedures is detailed below.

2.1 Systems and procedures

Systems and procedures assume a high degree of importance in assessing the risk profile of NBFCs, next only to nature of business and funding and financial flexibility. The critical issues here are adequacy of staffing levels with relation to size and growth of business , quality of information systems and systems for tracking risks.

2.1.1 Adequacy of staffing levels

A company with small sized operations can manage with informal procedures. However, with the increase in business a company needs to formalise its systems with sufficient managerial expertise and support for resource mobilisation, appraising, monitoring and collection.

2.1.2 Information systems

Application of computer technology with features like inter-branch networking, improve the MIS of a company. Information management through technological development is important for any finance company in the changing business environment. For example, a company with poor information systems may find it difficult to securitise a portion of its loan portfolio.

2.1.3 Systems for tracking risks

The NBFC should have adequate systems for tracking receivables and implementing recovery procedures. The receivables position can be kept at low levels through formal procedures for sending reminders and taking timely corrective action. Systems for monitoring asset liability mismatches are also equally important.

2.2 Expense levels

A measure of operating efficiency is administrative expenditure as a percentage of assets deployed. The expense ratio indicates the level of fixed cost of the finance company. The expense ratio of companies should also be viewed in conjunction with the nature of business of the NBFC. A company which has high component of fee based income such as from merchant banking or other fee based services would have high expense levels as compared to pure fund based lease/HP companies. While the profit margins in the former case might be higher, the stability of their earnings might be lower. For example, a merchant banking company in difficult stock market conditions.

The distribution of expense ratios of 150 NBFCs studied by CRISIL indicates that over 60% of them have expense ratios (expenses as a percentage of funds deployed) of less than 5%. There large variation in the expense ratios across companies can be explained by the difference in the business mix.

3. Management

The business of NBFCs is skill driven. The management evaluation is critical in assessing the risk profile. The important parameters are:

3.1 Extent of professionalism - integrity and competence

A NBFC with professional management is better placed to achieve sustainable competitive advantage.

3.2. Promoters : stake in the organisation, group support, track record

The competence and involvement of the promoters is essential for an NBFC from the point of view of sustenance and growth of its business. Group support can help the NBFC in raising resources and sourcing business.

3.3 Background and experience of key personnel

The financial services industry is skill based. Hence, the experience and qualification of the key personnel is important. The requirement of skill levels is specially higher for fee based activities like merchant banking and advisory services. The success of fund based activities also depends on the quick decision making ability of the key personnel.

3.4 Management attitudes to risks

A finance company can change its risk profile by changing the composition of its business in a short time frame since entry and exit barriers in the industry are low. The management's attitude to risks is an important factor in making a judgement that the company would continue to have a risk profile in line with current operations. However, this should be assessed in conjunction with the risk management ability of the company.

3.5 Proactiveness and ability to react to changing business environment

In the financial sector opportunities in certain activities last for only a short duration either on account of low entry barriers leading to increased competition in any new business activity or extraneous economic/monetary circumstances. The management needs to be proactive to exploit new business opportunities and continuously adapt to changing business environment to be successful.

4. Resources

The business of finance companies entails raising of funds and their deployment for a spread. On the funding side the key factors affecting the risk profile of NBFCs are the diversity of funding sources, the sustainability and outlook for main funding sources, track record and ability to replace funding sources, cost of funds and ability to raise funds at a short notice.

4.1 Diversity of funding sources

If the funding base is diversified, it reduces the risk of being overdependent on any particular source. For example, a company with overdependence on FDs may face funding constraints if RBI increases the maximum deposit rate for banks and not for NBFCs.

4.2 Sustainability and outlook for main funding sources

The traditional sources of funds for NBFCs are bank finance and FDs, which are currently under strain due to tight liquidity conditions. On the other hand, other funding sources like ICDs, are inherently riskier in terms of availability and cost. An important strength of some large south based companies is the stability of their deposit base.

4.3 Track record and ability to replace funding sources

A NBFC with a track record of raising funds through diversified sources has the ability to source funds from alternative sources in case the traditional sources get strained. For example, ICDs can be a source of financial flexibility in such situations.

4.4 Cost of funds

A NBFC which has higher cost of funds will be forced to lend at higher rates to maintain spreads. This could impair asset quality, since the businesses with high returns would invariably have higher risk.

Further, high cost of funding might indicate that the options of funding available to the company are limited. The cost of funds may also be high due to the inability of the management to manage its funding mix.

4.5 Ability to raise funds at short notice

This would be essential for the company to be able to exploit business opportunities emanating from a changing business environment. A company may be able to source large volumes of bill discounting business but may not be in a position to accept full business if it is not able to raise funds quickly for rediscounting.

4.6 Comparison of the resource position of a sample of leading NBFCs is given in Table 3

Table 3 : Funding profile of sample of NBFCs (as of March 31, 1995)

Rs. crore

	ALF*		SFL		ICFL		KMFL	
	Amount	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
Net worth	115.32	13.63	171.79	15.65	199.72	18.53	267.66	21.78
Cash credit	170.09	20.10	356.20	32.44	152.82	14.18	181.88	14.80
Fixed deposits	116.03	13.71	431.03	39.26	447.81	41.55	33.65	2.74
Term loans	105.87	12.51	80.28	7.31	24.51	2.27	178.40	14.52
Debentures	9.00	1.06	8.00	0.73	79.00	7.33	143.02	11.64
Inter corporate loan	10.35	1.22	7.08	0.65	146.19	13.57		
Deferred credit	188.30	22.25			4.89	0.45		
Creditors	113.26	13.38						
ST loan from banks	13.00	1.54	43.54	3.96	21.09	1.96	424.07	34.52
Others					1.80	0.17		
Total	846.22	100.00	1097.92	100.00	1077.63	100.00	1228.68	100.00

* as on June 30, 1995

ALF Ashok Leyland Finance Ltd.
SFL Sundaram Finance Ltd.
ICFL ITC Classic Finance Ltd.
KMFL Kotak Mahindra Finance Ltd.

4.6.1 Comments

By and large NBFCs have a fairly diversified funding mix with a higher reliance on bank financing (availed in the form of cash credit) and fixed deposits as sources of funding. However, the relative dependence of individual NBFCs on these sources varies.

Of the above given companies, Ashok Leyland and Sundaram have high dependence on banks while Kotak and ITC Classic have a relatively lower dependence on bank credit. This can be attributed to the higher proportion of lease and HP (assets forming the underlying security)in the business mix of the former companies as compared to the latter.

As regards fixed deposits, Sundaram and ITC Classic have a higher proportion of the same in their funding mix as compared to Ashok Leyland and Kotak. In the case of Sundaram, as a result of its extensive branch network fixed deposits have been its main source of funding on a sustained basis. ITC Classic, on the other hand, has developed an extensive network for accessing retail funds over the last few years.

Inter corporate loans form a substantial portion of ITC Classic's funding mix. This can be explained by the fact that it is a major player in the ICD lending business and is able to match the assets and liabilities by borrowing in the ICD market.

Due to conservative lending policies of financial institutions and banks to NBFCs, companies in this sector are increasingly focusing on FDs for their funding.

5. Asset quality

Asset quality is determined by the risk of delay in payments/defaults and risk of depreciation in investment.

5.1 Risk of delay in payments/defaults

An indicator of the asset quality of NBFCs is the level of debtors. The ability to sustain low debtor levels is critical for the risk profile of the NBFCs. The distribution of debtor levels of 100 NBFCs studied by CRISIL indicates that 60% of companies had debtor levels in terms of number of days billings of less than 50 days.

The key determinants of risk of default are quality of the credit appraisal systems and the underwriting norms, company wise and group-wise exposure norms, the system of loan recovery and the provisioning norms.

5.1.1 Credit appraisal systems

The procedures of credit origination and sanctioning vary depending on the size and nature of operations of the company. A judicious mix of delegation and centralisation of sanctioning procedures is required so that on one hand they do not inhibit growth of business and on the other hand prohibit indiscreet lending.

The existence of clearly laid out credit norms and adherence to the same affects the asset quality. A critical parameter here is the client profile of the companies. The sourcing of business by NBFCs can be done through direct client interface or market intermediaries with repeat business playing a major role. Adequate staffing and an extensive branch network obviates the need for intermediaries to a large extent and the clients background can be clearly known in such a case. Informal channels of sourcing customer information in addition to experience of customer behaviour is important for determining the creditworthiness. Many companies insist on referral and often a guarantee from an existing long standing client of the company.

A common phenomenon among the smaller size NBFCs is the dilution of credit norms to achieve the targeted disbursals and get better returns.

5.1.2 Underwriting norms

The loan cost ratio (LCR) of NBFCs varies depending on the business segment and the type of borrower. The LCR of the truck segment varies between 85% and 90% of the chassis cost that is between 65% and 75% of the cost of the vehicle. The used trucks are financed to the extent of 60% of their market value. The LCR of the car segment varies between 75% and 85% of the value while that for plant and machinery varies between 70% and 80% of the cost of machinery. The higher the LCR, the lower the equity of the borrower in the asset and greater the risk.

5.1.3 Exposure norms

Borrower-wise and region-wise diversification of the exposure of the NBFC determines the extent of risk. The more diversified the portfolio, the lower the risk.

According to the RBI norms, a NBFC cannot lend more than 15% of its net owned funds to a single company and 25% to a single group. Similarly sectoral concentration/diversification of the exposure also increases/reduces the risk of the company. For example, many NBFCs have come up in the Coimbatore and Salem regions of Tamil Nadu mainly to cater to the textile industry and hence their fortunes are inextricably linked to the fortunes of the textile companies of the region.

5.1.4 Loan recovery systems

Sound monitoring systems are required to track delays and initiate the process of recovery. The more professional finance companies have a trigger mechanism for activating suitable responses to delays/defaults.

5.1.5 Provisioning norms

From the financial year 1995-96, all NBFCs are required to maintain a four way asset classification as in the case of banks. Basically, loans are treated as non-performing assets if the interest on the loan remains past due for six months. Provisions are required to be made as prescribed.

5.2 Risk of depreciation in investment portfolio

5.2.1 Internal norms for investment

Many NBFCs have a focus on investment activities. These companies face a higher risk as their fortunes are linked to the changes in the capital market. Industry-wise and company-wise maximum exposure limits are required for risk diversification.

Investment operations should be regulated by presence of suitable internal systems which ensure that limits for investment by the concerned officers are clearly stated and their performance is suitably monitored by the top management. Some large NBFCs with a significant proportion of income from investment activities have an established treasury and clearly laid out norms for investment.

6. Current and prospective regulatory framework

The NBFC sector is vulnerable to changes in government policy which could dramatically change its business scenario/prospects. The risk of regulatory changes is an important element in the risk profile of the entire NBFC sector.

Some of the regulations and their impact on the business environment of NBFCs are listed below:

- Banks are allowed to lease assets : increased competition in leasing business.
- Underwriting is no longer compulsory : reduced business
- Increase/decontrol in bank deposit rates : raising funds through FDs becomes difficult for NBFCs
- RBI directs banks to reduce finance to NBFCs : funding constraints of NBFC increase

In the past, changes in the regulatory framework have often been in an adhoc fashion; this greatly increases the risk of this industry as compared to most industries in the manufacturing sector.

Financial risk

7. Capital adequacy

NBFCs have to achieve 8% capital adequacy by March 1996. As the guidelines were issued only in June 1995, the NBFCs will present this statement only from the current financial year onwards.

The NBFCs are well placed on the capital adequacy front. They are permitted to borrow only upto 10 times their networth. Therefore, if a company is fully leveraged then at least one part out of eleven parts of assets would be financed through capital funds which would amount to 9% capital adequacy if all the assets are assumed to have 100% risk weight and effect of contingent liability is not taken. In NBFCs majority of the assets are of 100% risk weight and the level of contingent liabilities is also very low. The presence of assets with lower risk weights or a gearing of less than 10 times would imply a higher capital adequacy.

Overall, it can be expected that most of the NBFCs would have a capital adequacy greater than 8% and this would become an area of concern only if RBI allows the NBFCs to raise debt funds beyond 10 times of networth.

8. Accounting quality

Key areas of accounting policy which need to be examined to judge accounting quality are:

- recognition of income
- appropriation of recoveries
- provisioning for bad debts
- valuation of investments
- depreciation accounting

Liberal accounting quality would indicate that the financial performance/position of the company has been overstated and the financial parameters of the company should be viewed cautiously.

9. Earnings

The ratio of profit after tax as a percentage of funds deployed has been analysed for 150 companies. For 60% of companies this ratio was less than 10%.

In estimating the future potential of an NBFC apart from the quantum of current and projected net profits, the likelihood of the variability in these profits is critical. The earnings should be viewed on a business specific basis and the judgement on the variability of the earnings would be in the context of the business risk analysis.

The financial risk profile of a NBFC would depend on past trends and outlook for:

- returns on each businesses in relation to industry figures
- cost of funds in relation to industry figures
- spreads in individual businesses
- expense levels

10. Asset liability management

10.1 Maturity risk and interest risk

Maturity risk arises if there is a difference in tenure between a NBFC's assets and liabilities. Funding long term assets through short term funds could lead to severe liquidity crisis during tight money market conditions. In such a case, the NBFC also faces an interest rate risk , as an increase in interest rates would have negative impact on the profitability of the company with an increase in the cost of funding. On the other hand, funding short term assets through long term funds would result in declining profitability in a reducing interest rates scenario.

In case of any asset liability mismatches, the company's ability to mitigate/manage the liquidity and interest rate risk determines its risk profile. For example, a company financing assets through lease/hire purchase may reduce the risk of interest rate movements by including interest variability clause in the contracts.

11. Liquidity

The financial flexibility in NBFCs is important from the point of view of ability to meet its debt service obligations and the company's ability to exploit new business opportunities. A company with high degree of financial flexibility can raise funds at short notice for deployment in activities like bill discounting, ICD lending, promoter funding, etc.

The key elements for a judgement on the financial flexibility are:

- capital structure
- relationships with bankers
- track record in ICD markets
- group support
- liquid assets
- unutilised sanctions

12. Conclusion

NBFCs are engaged in wide variety of businesses, which are significantly different from each other in terms of their risk profile. For this reason it is difficult to make generalised conclusions across the sector. The asset financing business has risk of loss of capital and low variability of earnings while share trading has high risk associated with recovery of capital and variability of earnings. However, there has been mushrooming growth of NBFCs and an increase in competition from banks and financial institutions. Further, given the strained outlook for funding from banks and financial institutions, ability to raise resources is an area of concern as fixed deposits are a costlier source of funding.

The fallout of proliferation of new NBFCs witnessed during last two to three years has been increased competition and an increasing pressure on margins. Clearly, all would not be able to survive. The liquidity crunch being currently faced by the Indian financial sector has further affected the business of NBFCs and it may hasten the crowding out of weaker companies.

III. Risk profile of the Banks

Introduction

The banks are by far the largest segment of the financial services sector with a deposit base of Rs. 4 lakh crore and a loan portfolio of Rs. 2 lakh crore. The banking industry in the country today can be broadly segmented into the following three categories : Public sector banks, Private sector banks and Foreign banks. Private sector banks can further be subdivided into older private sector banks and the new private sector banks (which have been formed after the reform process in the banking sector was initiated in 1992).

There are 27 public sector banks in the country. The largest bank is the State Bank of India (SBI) which alone accounts for 21% of the total deposits raised by the banking system. Seven of the 27 public sector banks are subsidiaries of the SBI. Of the remaining 20 banks, all but two are wholly owned by the Government of India. Public Sector banks are the predominant segment accounting for 86% of the total deposits raised by the banking sector as at March 31, 1995. Foreign banks and Private sector banks account for about 7% each of the total deposits raised by the banking sector. The first new private sector bank commenced operations only in the second half of 1994-95 and as such the 9 new private sector banks put together account for a very small portion of the deposits raised by the banking sector.

As the sources of funding for foreign banks are predominantly foreign currency deposits, they have been excluded from the scope of this study and the risk profile which follows addresses only the public sector, new private sector and old private sector segments of the banking industry.

The banking sector has seen widespread reform in the recent past covering a wide range of banking activities. The first steps were taken in 1992 with the liberalisation of branch licensing policies giving freedom to banks to relocate branches, set up specialised branches and open new branches without approval by the Reserve Bank . This was followed by introduction of prudential norms for income recognition, asset classification, provisioning for loan losses and capital adequacy. Over the next few years, a variety of reforms have been introduced. The limits stipulated for borrowings under certificates of deposit have been withdrawn. The entry of new private sector banks has been permitted with the objective of introducing greater competition in the banking system. The performance of the new private sector banks has been very encouraging. The Reserve Bank entered into Memoranda of Understanding (MOUs) with the nationalised banks providing for quantified performance parameters to be achieved by them in a time bound manner. A

partial rationalisation of directed credit by reduction in the number of categories and lowering the element of interest rate subsidy has been implemented. Interest rates on the deposit and lending sides have been partially deregulated. In April 1995, a loan system for delivery of bank credit was introduced to bring about discipline in the utilisation of bank finance and gain better control over credit flow; this is the first step in the transition from the cash credit system to a loan based system of bank credit. Over the years government pre-emption of banks' resources through SLR and CRR has come down.

Business risk

The business risks for banks can be analysed under the following heads : market position, operating efficiency, management, asset quality, resources and the regulatory framework.

1. Market position

The key determinants of market position of a bank are its size, business mix, client profile, reach, geographical concentration, and service levels.

1.1 Business mix

Unlike NBFCs, the business mix of a bank is regulated to a large extent by the RBI. The asset portfolio of a bank primarily consists of loans and investments. The proportion of loans in a bank's total assets are indicated by the Credit Deposit ratio (C/D ratio) and likewise the proportion of investments is indicated by the Investment Deposit ratio (I/D ratio).

Regulatory requirements specify that 25% of a bank's deposits have to be parked in investments specified by the Government like Central and State Government securities. The RBI has also imposed restrictions on other investments at 5% of incremental deposits raised by the bank during the last year. The investment portfolio of banks has however been higher than the prescribed requirements. The excess portfolio was built up over the last two years as banks invested in government securities (which carry zero risk weight) to reduce their risk weighted assets and achieve capital adequacy requirements. However, on account of the lower yields as compared to loans, investments are a less profitable avenue for banks. The average I/D ratio of the public sector banks as at March 31, 1995 was 43% while that for private sector banks was 36%.

The average C/D ratio as at March 31, 1995 for public sector banks was 51% whereas that for private sector banks was 53%. The loan portfolio of banks is also regulated by RBI to some extent. 40% of the net bank credit has to be lent to the "priority sector" which include agricultural credit, credit to small scale industries and credit to other specified areas like housing and small transport operators. In addition, there are also other restrictions like export credit accounting for 10% of net bank credit. However, not all banks have been able to achieve the 40% priority sector targets set by the central bank. From the current year onwards, the RBI plans to penalise banks which have not achieved the priority sector targets.

The loan portfolio of banks primarily consists of three types of loans - cash credit facilities which are loans to finance working capital, term loans which are medium to long term in nature and discounting of bills which is short term in nature. Though cash credit facilities theoretically have a maturity of one year and have to be reassessed each year, practically cash credit facilities are reinstated if not enhanced each year. As a result, cash credit financing is practically very long term funding and a higher proportion of cash credit financing can lead to asset liability mismatches. For public sector banks, the loan portfolio as at March 31, 1995 can be broken up in the ratio of 62: 25: 13 between cash credit, term loans and bills discounted. For private sector banks the ratio is 58:25:17. Over the last few years, there has been a shift towards term loans with the RBI specifying that a certain percentage of the working capital finance provided by banks have to be in the nature of a term loan.

Banks also provide consumer financing including housing loans and also undertake fee based activities like LCs, guarantees, merchant banking etc.

1.2 Client profile

The client profile of a bank varies from individuals to firms and companies. Though a major portion of the bank's clientele in terms of number of accounts would be loans to individuals, corporate loans would account for a major portion in value terms. Individual loans under priority sector schemes are perceived to be more problematic. Recovery and monitoring of such accounts also becomes uneconomical on account of the small ticket nature of such loans.

The depositor profile of a large bank would also largely consist of a large number of small ticket deposits. Though this does increase administrative costs, it provides a great deal of stability to the deposit base.

1.3 Size

Size is a major determinant of the business risk of a company. Banks which are bigger are in a better position to weather any unexpected shocks. Banks are well positioned in this regard as even the smaller banks are larger or of a comparable size with the larger NBFC or HFCs.

1.4 Reach

The biggest strength of the banking system as opposed to other financial intermediaries is the extensive branch network. The largest public sector bank in India, SBI has a network of 8,763 branches spread out over the breadth and width of the country. Even the smallest public sector bank has over 350 branches. 47% of the branches of public sector banks are in rural areas which are relatively untapped by either NBFCs or HFCs. This vast network of branches has also been established well in the past which gives banks a significant cost advantage as compared to other entities who would have to set up similar networks at current costs. New private sector banks are at a disadvantage on this front.

1.5 Geographical concentration

Most of the large public sector banks have a national presence. This isolates them from the risk of geographical concentration. Smaller public sector banks and older private sector banks have a concentration of branches in select states. The new private sector banks are concentrated only in metro and urban cities with the bulk of the business being sourced from one or two cities alone.

1.6 Service levels

Service standards in public sector banks are by and large at lower levels than private sector banks. The new private sector banks have been using technology and better service levels as a USP to attract business. However, the retail customer appears to prefer reach to better service levels and it is the larger public sector banks which score in this regard.

2. Operating efficiency

The key indicators of operating efficiency are the quality of systems and procedures and the expense levels.

2.1 Systems and procedures

Banks have fairly detailed procedures and systems and have well laid out sanctioning powers. However, the extent of computerisation is fairly low and management information systems are not adequate.

2.2 Staffing levels

Public sector banks are by and large overstaffed. A measure of staff productivity is the business per employee which is defined as the ratio of the sum of deposits and advances to the number of employees. One of the most productive public sector banks is Bank of Baroda which has a staff productivity of Rs 91 lakh. The average productivity for public sector banks is Rs. 59 lakh indicating the relative level of overstaffing. The average productivity for older private sector banks is higher at Rs. 73 lakh.

2.3 Expense levels

Expense levels for a bank can be indicated by the ratio of administrative expenses to average working funds. For public sector as well as private sector banks, this varies from 2.5% to 3.5%.

3. Management

The risk profile of a bank is determined to a large extent by the attitude of the management. The background and experience of the top management and the proactiveness of the management to adapt to a changing environment are key elements in assessing the risk profile of a bank.

The top position in any bank - whether private or public- has to be approved by the RBI. The RBI typically appoints senior personnel from large banks with sufficient exposure and experience in all areas of banking to head smaller banks. Recruitment policies at lower levels are constrained by the lack of functional autonomy.

Until very recently, the banking environment had been almost totally regulated. With the liberalisation in the sector, upgradation of skill levels in specialised areas would be required. The ability of the banks' management to adapt to the changing environment is crucial to the future performance of the sector.

4. Resources

The key factors affecting the risk profile of banks on the resources front are the diversity of funding sources, sustainability and outlook for main funding sources, the cost of funds and the ability to raise funds at a short notice.

4.1 Diversity of funding sources

The table below outlines the funding profile for the public sector as well as private sector banks.

Table I: Funding profile

(as on March 31, 1995)

	Public Sector Banks	Private Sector Banks
Net Worth	6%	4%
Deposits	80%	85%
Borrowings	5%	6%
Other liabilities and Provisions	10%	5%
Total Liabilities	100%	100%

The primary funding source for both private and public sector banks is deposits. As compared to other entities like NBFCs and HFCs, the banking industry is almost entirely dependent on a single funding source to finance its assets. Borrowings primarily consist of refinance provided by apex institutions like Exim Bank, Nabard, NHB, RBI and borrowings from the inter-bank market.

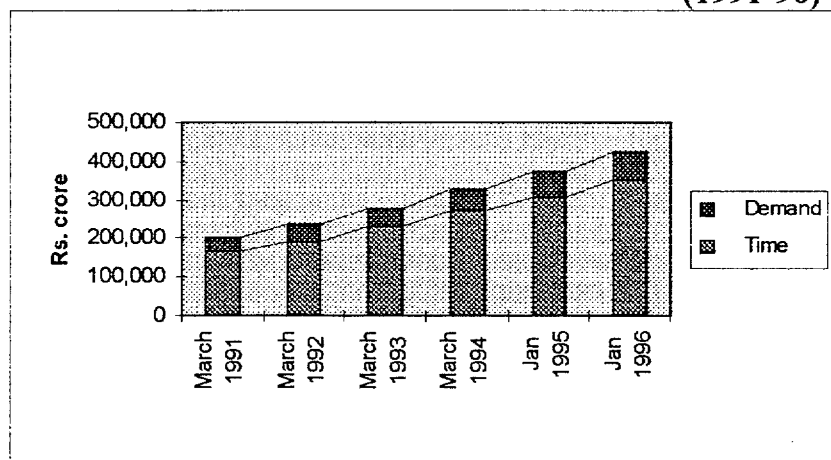
4.2 Sustainability and outlook for major funding sources

Older and established banks with a branch network are well positioned as far as the outlook for future funding is concerned. Banks are and will continue to be the primary channel of household savings into the economy. In the absence of any alternative avenue for investment at the grassroot level, investors would continue to rely heavily on the banking system. Savings and current accounts provide instant liquidity to individuals and corporates and can be offered only by banks.

Though inroads have been made into the funds raised by the banking system in other economies in the West by mutual funds, housing finance companies and other entities, a similar experience has not yet been experienced by Indian banks. Deposit growth rates in 1994-95 have been 15% for public sector banks and 31% for old private sector banks. Even during 1995-96 , despite tight liquidity conditions, the banking sector has shown a deposit growth rate of 13.6%. With increasing competition for funds from existing and new financial sector players, deposit growth rates for the banking system would be under pressure. The exhibit given below shows the growth in deposits for the banking system over the last five years.

Exhibit 1 : Growth in Deposits

(1991-96)



4.3 Average cost of funds

Due to a significant portion of current deposits (which carry no interest) and savings deposits (which carry an interest of 4.5%), the cost of funds for banks are much lower as compared to other entities in the financial services sector. The deposit rates offered by banks on term deposits are also lower than that of NBFCs or HFCs. However in the current year banks have increasingly resorted to certificates of deposit (CDs) which are typically costlier larger ticket deposits. Larger banks like SBI, Bank of Baroda, Canara Bank etc. have the strength of their wide branch network which gives them access to a wide

spectrum of corporate current deposits as well as retail savings deposits. The cost of funds for private sector banks on an average higher than that for public sector banks on account of a larger proportion of term deposits. New private sector banks however are at a major disadvantage as opposed to existing banks on account of their limited branch network. Access to retail deposits as well as corporate current accounts are therefore severely limited. This forces the new private sector banks to go in for expensive term deposits which increases their cost of funds.

4.4 Ability to raise funds at short notice

The financial flexibility provided by access to the inter-bank market places banks on a very sound footing as compared to HFCs or NBFCs.

5. Asset quality

5.1 Risk of delay in payments/defaults

The asset quality of the banking industry is well below that of other entities in the financial services sector. Non Performing Asset (NPA) levels in the banking industry are far higher than that seen in other segments. Though the banking industry has managed to bring down its NPA levels from 25% of total assets as at March 1994 to 20% as at March 1995, it is still very high compared to international standards as well as compared to NBFCs or HFCs.

The high level of NPAs are on account of the overhang from the past when banks had to undertake lending on a target based approach. The absence of sufficient provisioning in the past has also led to this high level of NPAs.

5.1.1 Credit appraisal systems

The problems associated with the asset portfolio of the banking sector originate at the appraisal stage. Credit appraisal systems are not well developed except in some of the new private sector banks.

5.1.2 Portfolio concentration

The loan portfolio of the banking sector is fairly diversified. RBI has issued guidelines regarding the loan portfolio of banks. A bank's exposure to a single company should not exceed 25% of its networth and its exposure to a particular group of companies should not exceed 50% of its networth. The RBI has also issued guidelines on industry wise exposure wherein not more than 15% of the total loans should be concentrated in one industry. Except for the larger sized public sector banks, most of the smaller public sector banks and almost all the private sector banks do exhibit a geographic concentration in a particular state or region.

5.1.3 Monitoring

Despite having a wide spread branch network, banks' management in the past have not concentrated on regular monitoring of the asset portfolio. This has led to the build-up in NPA levels. However, most banks have introduced specific recovery teams for collections. Banks' management have also begun educating employees at the grassroot level on the importance of follow up and monitoring in maintaining a low NPA level.

5.1.4 Provisioning norms

From March 1993, all banks were required to classify their asset portfolio based on the amount of time that the asset had remained non performing. Detailed provisioning norms were also put in place. The impact of the provisioning led to a large number of banks reporting losses. This was on account of non provisioning and therefore inflated profits being reported in the past. With the non performing assets being almost fully provided for, incremental provisions are not expected to be very high in the future.

5.2 Investment Portfolio - Risk of depreciation in investment portfolio

Investments in non SLR securities and shares and debentures of corporates are regulated by the RBI. Almost 90% of the investments of public sector banks are in approved securities i.e. securities which qualify for the purpose of maintenance of SLR. A large portion of these investments are in long dated low yielding securities.

The RBI has also asked all banks to categorise a certain percentage of their SLR investments as current and these current investments have to be marked to market. This percentage has been steadily increased from 30% as at March 1994 to 50% by March 1996. In an increasing interest rate scenario as is the case currently, this could lead to high provisioning requirements for banks.

6. Regulatory framework

The banking industry is one of the most regulated industries in the country today. The regulatory body for all banks in the country is the central bank, the RBI.

- The banking industry continues to be licensed and a new bank would have to be granted a license by the RBI before it can commence operations. The conditions for establishing a new bank include start-up capital of Rs. 100 crore and a dilution of promoter holding to less than 40% by way of a public issue within a year of operations.
- Licenses were also required for establishing new branches in the past. However, this has recently been deregulated subject to a bank achieving certain performance levels (capital adequacy of 8%, NPA levels below 20% and reporting of net profits for the last three years)
- Banks have to maintain a fixed percentage of their deposits in liquid assets like Government securities and cash. The RBI has specified a SLR (Statutory Liquidity Ratio) and a CRR (Cash Reserve ratio) which have to be maintained by banks. Deposit figures have to be reported to the RBI on a fortnightly basis.
- The lending portfolio of banks are also partially regulated with 40% of net bank credit having to be provided to the priority sector.

The high extent of regulation that exists in the banking sector provides a greater degree of comfort from a risk profile point of view.

Financial risk

The financial risk associated with the banking sector can be analysed under the following broad heads; capital adequacy, accounting policies, earnings, liquidity and asset liability management.

7. Capital adequacy

As per the RBI guidelines on capital adequacy, all banks in India have to achieve and maintain a capital adequacy of 8% from March 1996 onwards. By virtue of being the only segment in the financial sector which was exempt from a total limit on borrowings, it is the banking sector today which is struggling the most to achieve the required capital adequacy.

7.1 Public sector banks

Of the 27 public sector banks, all but 6 are expected to meet the March 1996 deadline for achieving the required capital adequacy. Of the 6 banks, 4 are expected to close the year very nearly achieving 8% capital adequacy and only 2 banks are expected to have capital far below the required levels.

Most of the public sector banks have been able to achieve the required capital adequacy on account of substantial equity infusion by the Government of India. Though the public sector banks have received a significant amount of government support by way of equity infusion in the past, the extent of government support has shown a declining trend (Rs.5287 crore in 1994-95 and Rs. 850 crore in 1995-96) and this support is expected to decline further in the future.

Given this scenario, future augmentation of the capital base of public sector banks would have to come from internal generation and access to capital markets. This, in turn, would be dependent on healthy bottom lines.

Although public sector banks have been permitted to access the capital markets, only two banks, State Bank of India and Oriental Bank of Commerce have adopted this route. Others were impeded by dull primary markets, poor balance sheets and large capital bases which would make servicing difficult. Reduction of capital by setting off accumulated losses is now permitted. This would benefit some banks (Bank of India and Dena Bank in 1995-96 and Indian Bank, Vijaya Bank and Indian Overseas Bank in 1996-97). Other banks like Bank of Baroda, Canara Bank and Corporation Bank have made proposals to return part of their capital to the government or convert it to perpetual preference shares. This would enable banks to shrink their equity base and approach the markets with large premia.

7.2 Private Sector banks

The guidelines for new private sector banks stipulate a minimum capital of Rs. 100 crore. As such, most of these banks would be in a comfortable position as far as capital adequacy is concerned for a few years. However, the large capital base would act as a deterrent for further access to the capital markets and the new private sector banks would have to depend largely on internal accruals to shore up their capital.

Most of the older private sector banks have approached the capital market during the last one year with equity issues and have been successful in achieving the capital adequacy requirements. Given the higher profitability of private sector banks, internal accruals are expected to provide a significant amount of the capital required for credit expansion in the future as opposed to public sector banks.

8. Accounting policies

Over the last few years, the RBI has attempted to standardise accounting policies across the banking industry. Income recognition and provisioning norms have been standardised, and investment valuation policies have also been put in place. Norms in all these three areas have been progressively made more stringent to be in line with international standards.

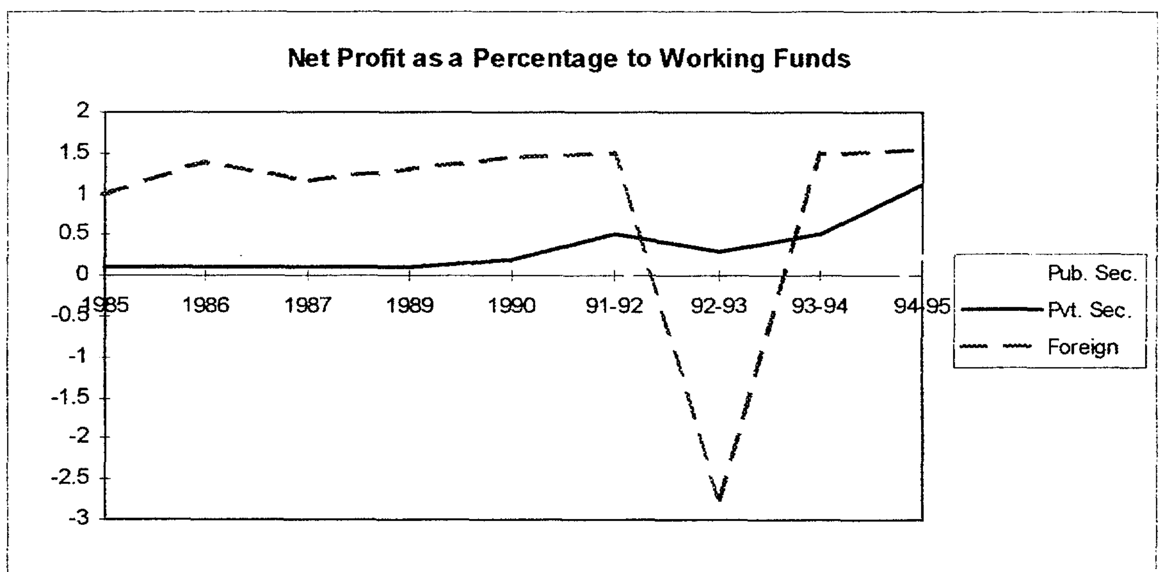
However, disclosure levels in published bank annual reports are not of a very high order. Banks do not disclose the total amount of provisions held on account of NPAs nor do they provide a break-up of total provisions into provisions for NPAs, provisions for depreciation in investments and provisions for taxation. The current format for bank annual reports has been prepared by the RBI. Given the increasing number of banks with public shareholding, it is expected that disclosure levels in published annual reports would increase in the future.

9. Earnings

The profitability of the banking sector critically depends on the interest spreads that banks obtain, non fund based income that the bank generates and the extent of control that the bank is able to exercise on expenses. The extent of NPAs that a bank has is also crucial to the earnings capacity of a bank as it affects both the extent of income that the bank accounts for as well as the provisions which the bank has to make on account of expected credit loss. A high C/D ratio is also crucial for improved earnings as the yield on loans is higher than the yield on investments.

The exhibit given below outlines the average profitability margins across the various segments of the banking industry.

Exhibit 2 : Trends in profitability margins



10. Asset liability management

Given the almost perpetual nature of the cash credit system of lending and the illiquid long term investment portfolios that most banks have, it is but natural that all banks suffer from a chronic asset liability mismatch. The liabilities side of the banks' balance sheet is also increasingly becoming of shorter duration which accentuates the problem. The risks associated with the mismatch are detailed below:

10.1 Maturity risk

The risk of having long term assets and shorter term liabilities does theoretically expose Indian banks to a liquidity risk wherein the banks would not be able to exit from their assets to ensure timely repayment of their liabilities. However, access to the inter-bank market as well as a steady growth in core deposits has ensured that the banking system has not defaulted in repayment of its liabilities.

10.2 Interest rate risk

As a significant portion of a bank's assets are long dated securities which are funded by deposits with a maximum maturity of five years, the bank is exposed to interest rate risk in an increasing interest rate scenario. As the bulk of the lending of a bank is done at variable interest rates and the borrowings in the form of deposits is at fixed rates of interest, banks are exposed to interest rate risk in a falling interest rate scenario as well.

Until a few years back, banks existed under a protected environment where both the lending and borrowing rates were dictated by the central bank. Consequently, banks have not concentrated on asset liability management to such an extent that most banks are not able to track the maturity profile of their liabilities. With the partial deregulation of interest rates, banks are now left to fend for themselves in determining both lending and borrowing rates. The ability of the banking sector to manage these risks which are inherent to the system would be a crucial factor in determining their future performance.

The public sector banks are yet to put in place systems for monitoring asset and liabilities with currency wise tracking of maturities and costs/yields. Accurate data on this would help banks reduce the margins being currently provided for fluctuations in interest rates, which could be passed on to customers without affecting profitability. Networking of branches would be required to improve the quality and speed of information. Foreign banks in India and the new private sector banks are relatively better placed in this regard.

11. Liquidity

The liquidity position of the banking sector is much higher than the other entities in the financial services sector on account of its access to the inter-bank market and the steadily growing base of core deposits. Banks also have refinance facility available from entities like NABARD, EXIM Bank and the RBI.

Conclusion

There is no doubt that the banking sector appears to be more robust today than at the start of the reform process due to adoption of prudential norms and cleaning up of books. The strong growth of the Indian economy has also thrown up tremendous opportunities for Indian banks. Increasing liberalisation and volatility of financial markets together with increased competition pose challenges for banks in improving the core strength of their operations in terms of technology, product diversification, cost control and risk management techniques. While the new private sector banks are expected to focus on niche areas, the foreign banks would continue to leverage on their top quality corporate clients and ability to offer sophisticated banking products which would be required with the globalisation of the Indian economy. The better public sector banks are putting their act together and are well poised to take advantage of their branch network and corporate relationships. In the long run, banks which do not adapt to the changing environment face the prospects of mergers or acquisitions by the other banks as happens internationally.