

Effect of Financial Leverage on the Financial Performance and Sustainability of NBFCs in India

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Abstract

Financial leverage plays a crucial role in determining the profitability, growth, and long-term sustainability of financial institutions, especially Non-Banking Financial Companies (NBFCs). NBFCs rely heavily on borrowed funds to expand lending operations and enhance market competitiveness. However, excessive leverage may increase financial risk, reduce liquidity, and negatively affect sustainability during economic downturns. This research paper examines the impact of financial leverage on the financial performance and sustainability of selected NBFCs in India. The study uses secondary data collected from annual reports, RBI publications, and financial databases for the period 2018–2025. Key financial indicators such as Debt-Equity Ratio, Return on Assets (ROA), Return on Equity (ROE), Net Profit Margin, and Interest Coverage Ratio are analysed. The findings reveal that moderate leverage positively influences profitability, whereas excessive dependence on debt adversely affects financial sustainability and risk management. The paper concludes that NBFCs must maintain an optimal capital structure to ensure long-term financial stability and sustainable growth.

Keywords: Financial Leverage, NBFCs, Financial Performance, Financial Sustainability, Debt-Equity Ratio, Profitability, Capital Structure, India.

I. INTRODUCTION

A. Concept of Financial Leverage

Financial leverage refers to the strategic use of borrowed funds or debt to finance business operations, investments, and expansion activities. It enables companies to increase their operational capacity and profitability without depending entirely on shareholders' equity. In simple terms, leverage acts as a financial tool that allows firms to generate higher returns by utilizing external financing sources such as loans, debentures, and bonds.

In the financial sector, especially among Non-Banking Financial Companies (NBFCs), leverage plays a particularly significant role because their primary business model revolves around borrowing funds at lower interest rates and lending them at comparatively higher rates. This difference between borrowing cost and lending return forms the foundation of NBFC profitability.

However, leverage is often described as a “double-edged sword.” While appropriate leverage improves earnings, market expansion, and shareholder wealth, excessive debt exposure may lead to liquidity crises, higher financial risk, rising interest obligations, and even insolvency during economic slowdowns. Therefore, effective leverage management becomes essential for maintaining financial stability and sustainable growth.

Key Features of Financial Leverage

- Enhances return on equity (ROE)
- Supports business expansion
- Reduces dependence on equity financing
- Increases financial risk if debt levels become excessive
- Influences capital structure decisions

DEBT VS EQUITY FINANCING

Which is better for your company right now?



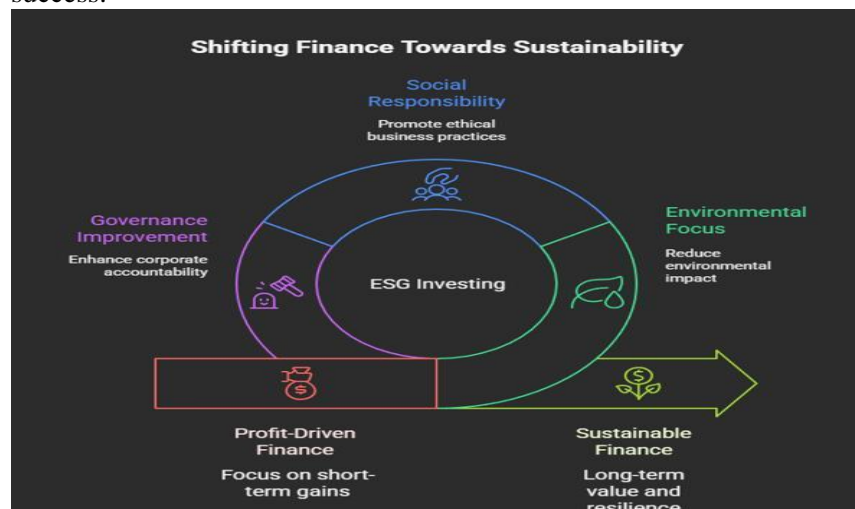
B. Meaning of Financial Sustainability

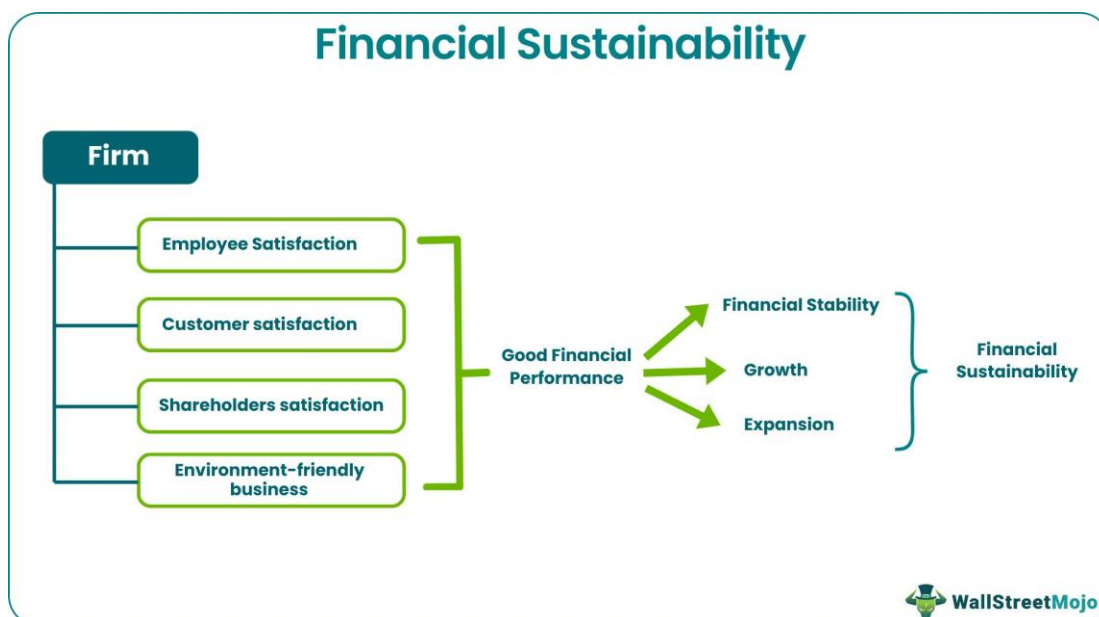
Financial sustainability refers to the long-term ability of an organization to maintain stable financial performance, fulfill financial obligations, manage operational risks, and continue business activities without facing financial distress. It reflects the financial strength and resilience of a company over an extended period. For NBFCs, financial sustainability is not limited to profitability alone. It also includes:

- Effective liquidity management
- Solvency maintenance
- Asset quality management
- Risk diversification
- Stable cash flow generation
- Long-term operational continuity

A financially sustainable NBFC can survive economic downturns, credit defaults, market fluctuations, and regulatory changes while continuing to serve customers efficiently. Sustainable financial performance also increases investor confidence, improves credit ratings, and strengthens market reputation.

In the post-COVID financial environment, sustainability has become even more important because many financial institutions faced loan repayment delays, liquidity shortages, and rising non-performing assets (NPAs). Therefore, balancing profitability with financial stability is now considered essential for NBFC success.





C. Importance of NBFCs in India

Non-Banking Financial Companies (NBFCs) have become one of the most important pillars of the Indian financial system. These institutions complement traditional banking services by providing credit facilities and financial assistance to individuals, small businesses, rural populations, and sectors that often remain underserved by commercial banks.

NBFCs contribute significantly to:

- Financial inclusion
- Infrastructure financing
- MSME development
- Rural and agricultural financing
- Vehicle and housing loans
- Gold loans and microfinance services

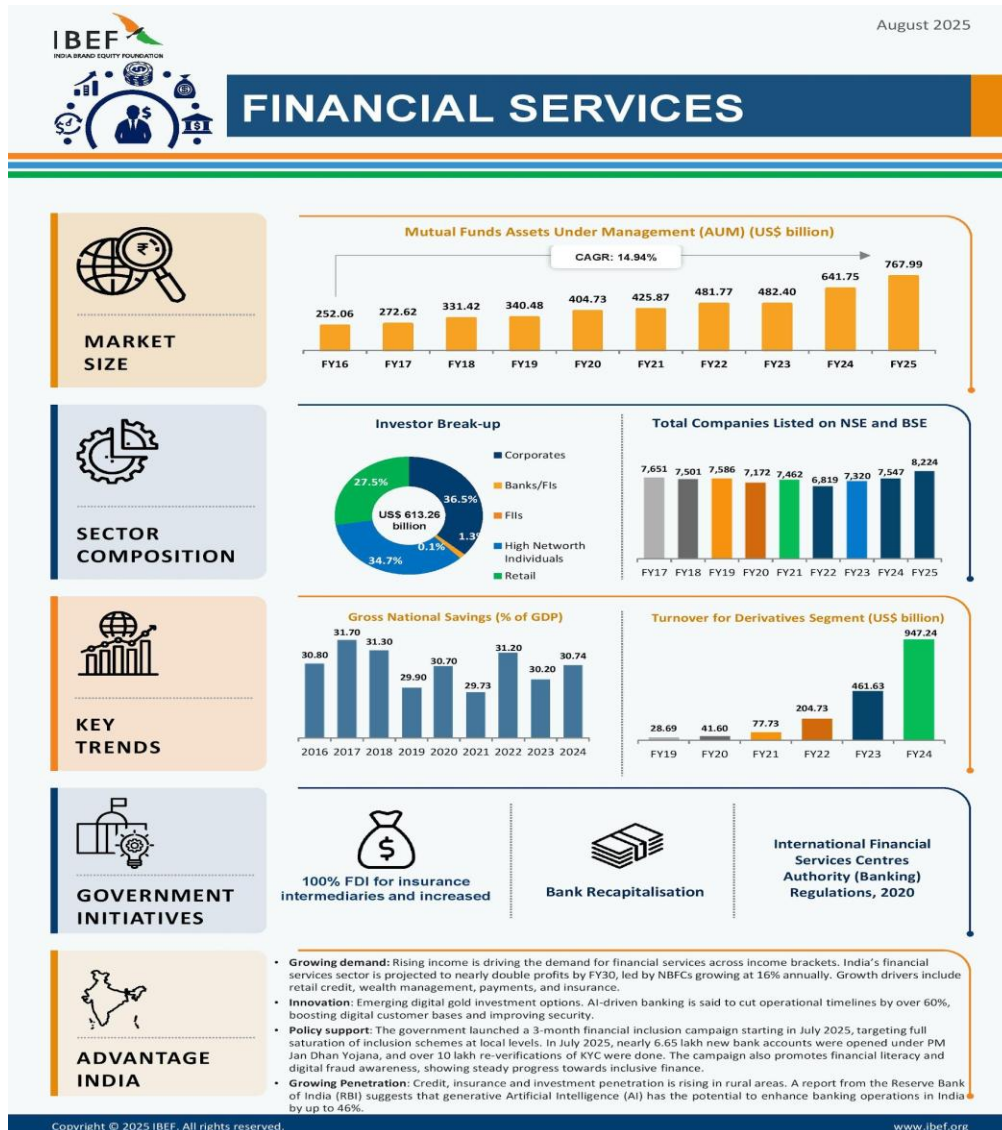
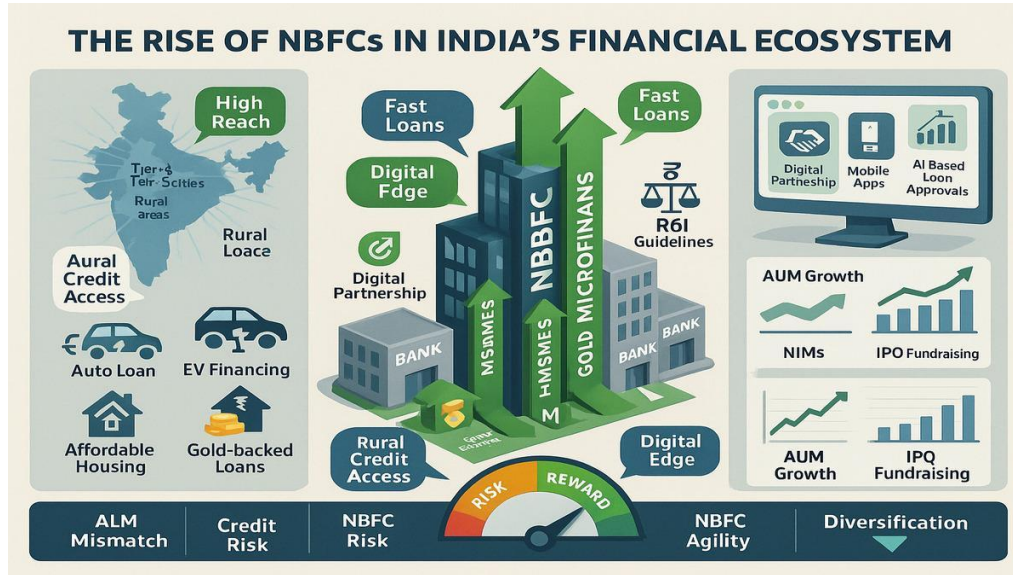
The rapid growth of digital finance, fintech innovations, and government initiatives promoting financial inclusion have further strengthened the role of NBFCs in India's economic development. Their flexible lending procedures and customer-focused services have made them highly accessible to a broad section of society.

Some leading Indian NBFCs include:

- Bajaj Finance
- Shriram Finance
- Muthoot Finance
- Mahindra Finance
- Cholamandalam Investment and Finance Company

Major Services Provided by NBFCs

Area	Services
Retail Finance	Personal loans, consumer loans
Vehicle Finance	Commercial and passenger vehicle loans
Housing Finance	Home loans and property finance
Gold Loans	Secured loans against gold
MSME Finance	Business and working capital loans



D. Need for the Study

NBFCs generally operate with relatively high levels of financial leverage compared to many other industries because debt financing forms the backbone of their business model. While leverage helps NBFCs expand lending activities and increase profitability, excessive dependence on borrowed funds may expose them to severe financial risks.

Several major financial events in India have demonstrated the dangers associated with poor leverage management. The collapse of infrastructure financing giant Infrastructure Leasing & Financial Services (IL&FS) created a major liquidity crisis in the Indian financial market and highlighted the vulnerability of highly leveraged financial institutions. Similarly, the COVID-19 pandemic disrupted loan repayment cycles and weakened the financial health of several NBFCs.

These situations emphasized the importance of:

- Maintaining optimal debt-equity balance
- Ensuring liquidity management
- Strengthening risk assessment practices
- Building long-term financial sustainability

Therefore, studying the relationship between financial leverage and sustainability is highly relevant for understanding how NBFCs can achieve profitability while maintaining financial stability in a competitive and uncertain economic environment.

Understanding the NBFC Liquidity Crisis



II. REVIEW OF LITERATURE

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III. RESEARCH OBJECTIVES

Main Objective

To analyse the effect of financial leverage on the financial performance and sustainability of NBFCs in India.

Secondary Objectives

1. To examine the relationship between leverage and profitability of NBFCs.
2. To analyse the impact of leverage on financial sustainability.
3. To study leverage management practices adopted by Indian NBFCs.
4. To evaluate the effect of debt on liquidity and solvency.
5. To suggest measures for maintaining optimal capital structure.

IV. RESEARCH METHODOLOGY

Particulars	Details
Research Type	Descriptive and Analytical
Nature of Data	Secondary Data
Data Sources	Annual Reports, RBI Reports, NSE/BSE Data
Study Period	2018–2025
Sample Companies	Bajaj Finance, Muthoot Finance, Shriram Finance
Tools Used	Ratio Analysis, Comparative Analysis

The study is based entirely on secondary data collected from published financial statements and official reports. Ratio analysis is used to examine leverage and performance indicators.

V. FINANCIAL LEVERAGE IN NBFCs

A. Meaning of Leverage in NBFCs

NBFCs borrow funds from banks, debenture holders, and financial markets to provide loans and credit facilities. Since lending activities generate interest income, debt becomes an important source of operational expansion.

B. Types of Financial Leverage

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1. Operating Leverage

Operating leverage refers to the use of fixed operating costs in business operations. Companies with high operating leverage rely heavily on fixed expenses such as rent, salaries, machinery, and infrastructure costs. A small increase in sales can lead to a significant rise in profits because fixed costs remain constant. However, during periods of low revenue, high fixed costs may negatively affect profitability and operational efficiency.

2. Financial Leverage

Financial leverage refers to the use of borrowed funds or debt financing to enhance shareholder returns and expand business operations. NBFCs extensively use financial leverage because their lending activities depend largely on external borrowings. Proper utilization of debt can improve profitability and Return on Equity (ROE), but excessive borrowing may increase financial risk, interest obligations, and repayment pressure.

3. Combined Leverage

Combined leverage is the combined effect of operating leverage and financial leverage. It measures how changes in sales affect the overall earnings available to shareholders. Firms with high combined leverage experience greater fluctuations in profitability because both fixed operational costs and debt obligations influence financial performance simultaneously.

C. Debt–Equity Relationship

The Debt–Equity Ratio is one of the most widely used financial indicators for measuring the extent of leverage in a company. It reflects the proportion of borrowed funds in comparison to shareholders' equity and helps assess the financial risk and capital structure of a firm.

Debt–Equity Ratio = Total Debt ÷ Shareholders' Equity

A higher Debt–Equity Ratio indicates greater dependence on borrowed funds, which may increase profitability as well as financial risk. Conversely, a lower ratio reflects stronger financial stability and lower debt burden. In the case of NBFCs, maintaining an optimal Debt–Equity Ratio is essential for ensuring liquidity, solvency, and long-term financial sustainability.

VI. FINANCIAL PERFORMANCE INDICATORS

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Financial performance indicators are essential tools used to evaluate the profitability, efficiency, liquidity, and overall financial health of NBFCs. These indicators help in analysing how effectively a company utilizes its resources and manages financial obligations. In this study, the following financial indicators are used to examine the impact of financial leverage on the performance and sustainability of NBFCs.

A. Return on Assets (ROA)

Return on Assets (ROA) measures the profitability of a company in relation to its total assets. It indicates how efficiently the management utilizes assets to generate net income. A higher ROA reflects better asset utilization and operational efficiency.

$ROA = (\text{Net Income} \div \text{Total Assets}) \times 100$

Interpretation:

- Higher ROA indicates efficient asset management.
- Lower ROA suggests poor utilization of assets and lower profitability.

B. Return on Equity (ROE)

Return on Equity (ROE) measures the returns generated on shareholders' investments. It reflects the company's ability to generate profits using shareholders' funds. Financial leverage often directly influences ROE because debt financing can enhance shareholder returns when managed effectively.

$ROE = (\text{Net Profit} \div \text{Shareholders' Equity}) \times 100$

Interpretation:

- Higher ROE represents better returns to shareholders.
- Excessively high ROE may also indicate overdependence on debt financing.

C. Interest Coverage Ratio

The Interest Coverage Ratio measures the ability of a company to meet its interest payment obligations from its operating earnings. It is an important indicator of financial stability and solvency.

Interest Coverage Ratio = $\text{EBIT} \div \text{Interest Expense}$

Interpretation:

- A higher ratio indicates strong repayment capacity and lower financial risk.
- A lower ratio reflects difficulty in meeting interest obligations and increased financial vulnerability.

D. Net Profit Margin

Net Profit Margin measures the percentage of profit earned from total revenue after deducting all expenses, taxes, and interest costs. It reflects the operational efficiency and profitability of the company.

Net Profit Margin = $(\text{Net Profit} \div \text{Revenue}) \times 100$

Interpretation:

- A higher Net Profit Margin indicates better cost control and operational efficiency.
- A lower margin suggests higher expenses and weaker profitability performance.

VII. IMPACT OF LEVERAGE ON NBFC PERFORMANCE

A. Positive Impact of Financial Leverage

Financial leverage plays a significant role in improving the financial performance of NBFCs when used efficiently and in a controlled manner. Moderate leverage enables NBFCs to expand their lending operations without depending entirely on shareholders' funds. By borrowing funds at lower interest rates and lending them at comparatively higher rates, NBFCs are able to generate higher interest income and improve overall profitability. This contributes positively to key financial indicators such as Return on Equity (ROE) and earnings per share.

Leverage also supports rapid business expansion and market penetration. Through debt financing, NBFCs can increase their operational scale, diversify their loan portfolios, and extend financial services to a larger customer base. This helps financial institutions strengthen their market position and improve competitive advantage in the financial sector.

Another important advantage of leverage is the tax benefit associated with debt financing. Interest paid on borrowed funds is treated as a deductible business expense, which reduces the taxable income of the company. As a result, NBFCs may experience lower tax liabilities and improved net profitability.

B. Negative Impact of Financial Leverage

Although financial leverage offers several benefits, excessive dependence on borrowed funds can create serious financial challenges for NBFCs. High leverage increases financial risk because companies become more dependent on regular cash flows to meet interest and repayment obligations. During economic slowdowns or financial crises, reduced borrower repayments and rising defaults may significantly affect the financial stability of NBFCs.

Excessive leverage may also create liquidity problems. Large debt obligations increase repayment pressure and may reduce the availability of liquid funds for day-to-day operations. In situations where market conditions become unfavorable, highly leveraged NBFCs may face difficulties in maintaining adequate liquidity and solvency.

Furthermore, overdependence on debt financing can negatively affect long-term financial sustainability. Continuous borrowing increases financial burden and vulnerability to market fluctuations, rising interest rates, and credit risks. If leverage is not managed properly, it may weaken investor confidence, reduce credit ratings, and threaten the long-term survival and stability of the organization.

VIII. FINANCIAL SUSTAINABILITY OF NBFCs

A. Importance of Sustainability

Financial sustainability ensures long-term survival, investor confidence, and operational stability.

B. Factors Affecting Sustainability

1. Capital Adequacy
2. Liquidity Management
3. Asset Quality
4. Debt Management
5. Profit Stability

C. Post-COVID Challenges

After COVID-19, many NBFCs faced:

- Loan repayment delays
- Rising NPAs
- Liquidity shortages
- Reduced borrower capacity

This highlighted the importance of balanced leverage strategies.

IX. CASE ANALYSIS OF SELECTED NBFCs

A. Bajaj Finance

Maintained balanced leverage with strong profitability and stable growth. Efficient risk management improved sustainability.

B. Muthoot Finance

Relied heavily on secured gold loans, resulting in lower default risk and stable financial performance.

C. Shriram Finance

Experienced higher leverage due to commercial vehicle financing exposure but managed profitability through diversified lending.

X. FINDINGS OF THE STUDY

1. Financial leverage significantly influences profitability in NBFCs.
2. Moderate leverage improves ROE and business growth.
3. Excessive debt negatively impacts liquidity and sustainability.
4. Efficient risk management helps maintain financial stability.
5. NBFCs with diversified portfolios perform better during economic uncertainty.

XI. SUGGESTIONS

1. NBFCs should maintain an optimal Debt-Equity Ratio.
2. Strong liquidity reserves should be maintained.
3. Risk assessment mechanisms must be strengthened.
4. Diversification of loan portfolios should be encouraged.
5. Regulatory monitoring by the Reserve Bank of India should continue for financial stability.

XII. CONCLUSION

Financial leverage is both an opportunity and a challenge for NBFCs in India. Proper use of leverage improves profitability, expands operational capacity, and enhances shareholder returns. However, excessive dependence on borrowed funds increases financial risk and threatens sustainability. The study concludes that maintaining an optimal balance between debt and equity is essential for long-term financial performance and sustainability. Indian NBFCs must adopt prudent financial strategies, strong governance, and effective risk management systems to ensure stable growth in a competitive financial environment.

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