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Diversification and Financialization in Non-Banking Financial Companies: Empirical Evidence from Gaya District (India)

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ABSTRACT

This study explores the intricate relationship between diversification and financialization among Non-Banking Financial Companies (NBFCs) operating in Gaya district, Bihar—a region characterized by financial exclusion, informal lending dominance, and limited banking infrastructure. Utilizing panel data from 2020 to 2023 across ten NBFCs, the analysis reveals that income diversification—while intended to stabilize revenues—has instead led to a growing reliance on financial investments over core lending activities. Employing fixed-effects regression models and mediation analysis, the study finds that higher diversification correlates with increased financialization, driven by agency costs, investment inefficiencies, and operational risk. The evidence supports the speculative incentive hypothesis, indicating that in underregulated rural settings, diversification often becomes a pathway to speculative finance rather than inclusive development. The paper proposes district-specific policy recommendations, including the creation of a monitoring cell, rural lending-linked investment caps, localized governance indices, and borrower engagement forums. The findings contribute to the emerging literature on rural finance by offering micro-level insights into how NBFC strategies evolve in response to institutional and operational constraints in backward regions like Gaya.

1. Introduction

In recent years, Non-Banking Financial Companies (NBFCs) have emerged as vital financial intermediaries in India, particularly in rural and semi-urban regions where formal banking penetration remains limited. Unlike commercial banks, NBFCs operate with greater flexibility, enabling them to extend credit to underserved segments including small businesses, self-employed individuals, and agricultural households. Their growing footprint in India's financial ecosystem is reflected in their expanding asset base, sectoral diversification, and their evolving role in rural credit delivery. The Reserve Bank of India (RBI) has also acknowledged the systemic importance of NBFCs in its financial inclusion and credit deepening strategies, especially in regions where traditional banking services are either inadequate or inaccessible.

The Gaya district of Bihar, a region characterized by agrarian livelihoods, seasonal migration, and weak formal financial infrastructure, presents a critical case for analyzing the behavior of NBFCs at the local level. With a rising demand for personal, agricultural, and small enterprise loans, NBFCs have increasingly diversified their product portfolios to cater to varied financial needs. In Gaya, these institutions often provide a mix of gold loans, two-wheeler finance, microenterprise credit, and consumer loans—offering services that combine both secured and unsecured lending mechanisms. This diversification, while appearing as a strategy to expand market reach and risk management, also raises questions about its broader implications.

One of the emerging concerns in this context is the growing trend of financialization among NBFCs—where operational focus shifts from traditional lending to speculative financial investments such as marketable securities or high-yield financial assets. Financialization, if driven by speculative motives rather than strategic liquidity management, may dilute the core developmental role of NBFCs, particularly in credit-starved regions like Gaya. In addition, excessive dependence on short-term financial returns could potentially expose these institutions to market volatility, regulatory arbitrage, and asset-liability mismatches—threatening their long-term sustainability. While national-level studies have explored the relationship between diversification and financialization in non-financial firms and major financial entities, there is a notable absence of district-level empirical analysis that captures the behavior of NBFCs operating in rural or economically backward regions. Existing research often overlooks micro-level dynamics such as local credit demand, regulatory enforcement gaps, and informal financial pressures that shape NBFC strategies on the ground. Therefore, this study seeks to bridge this gap by analyzing whether diversification strategies adopted by NBFCs in Gaya district lead to higher levels of financialization, and under what conditions such outcomes manifest.

The primary objective of this study is to investigate the extent and impact of diversification on financialization among NBFCs in the Gaya district. Using a combination of primary and secondary data, the research examines the relationship between revenue diversification, risk behavior, and financial asset allocation. The analysis also considers mediating factors such as operational inefficiencies, governance structures, and economic conditions at the district level. The findings are expected to contribute to the ongoing discourse on rural financial institutions, offering insights that are both context-specific and policy-relevant. The remainder of this paper is structured as follows: Section 2 presents a detailed review of literature related to diversification, financialization, and NBFC performance. Section 3 outlines the research objectives and hypotheses. Section 4 explains the data sources, variables, and econometric methodology. Section 5 discusses empirical findings with interpretation. Section 6 includes robustness checks and sub-sample analysis. Section 7 offers policy implications, and Section 8 concludes with key takeaways and avenues for future research

2. Literature Review

2.1. Diversification in Financial Institutions: Concepts and Motivations

Business diversification in financial institutions refers to the strategic expansion of product offerings, customer segments, or investment portfolios to mitigate risk and enhance revenue stability. Theoretically, the rationale for diversification originates from classic corporate finance literature, which posits that diversified firms can internalize capital allocation, reduce dependence on volatile markets, and balance income across cyclical sectors (Markides & Williamson, 1994; Stein, 1997). For financial entities, especially in risk-prone environments, diversification also acts as a shield against sector-specific downturns. Stulz (1990) and Lewellen (1971) argue that diversification can help firms lower earnings volatility through uncorrelated income streams. In the context of financial institutions, this includes spreading lending across various sectors (e.g., retail, agriculture, MSMEs), or blending loan-based income with fee-based or investment-based revenues. Empirical studies by Meador and Ryan (1997) and Billett and Mauer (2003) confirm that diversification enables firms to develop internal capital markets that reduce transaction costs, informational asymmetries, and external financing dependence. However, a large body of scholarship cautions against the risks of over-diversification. Jensen (1986) introduced the agency theory of diversification, suggesting that managers may use diversification not to create value but to expand control, increase compensation, or hide poor performance. Maksimovic and Phillips (2002) and Wulf (2009) further note that diversification can dilute focus, create coordination inefficiencies, and reduce capital allocation efficiency. This risk is particularly high in firms with weak governance and limited oversight.

In India, NBFCs have diversified significantly in the last two decades. From traditional leasing and hire-purchase activities, they now extend to sectors like gold loans, microfinance, housing finance, consumer durables, and vehicle lending. This trend has accelerated in rural areas, such as Bihar's Gaya district, where demand for small-ticket credit is high but formal banking presence is weak. According to the RBI's ***Report on Trends and Progress of Banking in India*** (2023), Tier-2 and Tier-3 cities have seen disproportionate NBFC expansion, both in asset portfolios and service diversity. However, this diversification has largely occurred without a parallel development in risk management frameworks, internal audit systems, or corporate governance mechanisms.

2.2. Understanding Financialization: Theory and Relevance

The concept of financialization has evolved to describe the growing dominance of financial motives, markets, institutions, and elites in the economy (Krippner, 2005). For financial firms, it refers to the increasing share of revenues derived from speculative financial assets rather than core operational functions. Orhangazi (2008) and Davis (2017) argue that financialization distorts firm behavior by incentivizing short-term gains through market instruments over long-term productive lending or investment. In financial entities like NBFCs, this often translates to channeling surplus funds into mutual funds, equity instruments, debt markets, or real estate speculation, rather than prioritizing inclusive credit delivery. The phenomenon has raised alarm in several emerging markets. Tori and Onaran (2018) link excessive financialization to macroeconomic instability, underinvestment in real sectors, and the crowding-out of inclusive financial goals. Epstein and Jayadev (2019) further warn that financialization fosters systemic risk when unchecked by regulation, especially in semi-formal financial entities with limited regulatory visibility. In India, the collapse of major NBFCs like IL&FS and DHFL revealed how overdependence on market borrowings and speculative assets created cascading liquidity crises across the shadow banking system. While financialization may initially enhance profits, particularly in low-interest environments, it erodes institutional resilience and blurs the boundary between credit intermediation and speculative finance. NBFCs in rural districts—often operating with thin margins, limited due diligence, and low scrutiny—may resort to financialization not out of strategy, but necessity, to maintain liquidity, impress investors, or meet capital adequacy norms.

2.3. The Diversification–Financialization Nexus

Recent literature has begun to explore the causal linkage between diversification and financialization. Feng et al. (2021), in a pathbreaking study on Chinese non-financial firms, demonstrate that diversification often leads to increased investment in high-risk financial assets, especially where firm governance is weak and regulatory enforcement is poor. Their findings suggest that diversification may aggravate agency problems, inefficiencies, and risk-taking behavior, leading firms to shift resources from core operations to financial speculation. Lins and Servaes (2002) report similar findings, arguing that diversification often destroys shareholder value when accompanied by poor governance and incentive misalignment. Peng et al. (2018) add that firms may use financial investments to conceal underperformance in operational segments—a pattern likely to manifest in NBFCs that diversify aggressively but lack monitoring structures. Liu et al. (2019) note that in emerging economies, firms in capital-scarce regions may treat financial markets as a parallel revenue source when traditional lending becomes unprofitable or risky. In India, Mishra and Rajan (2022) observe that diversification in NBFCs is frequently reactive rather than strategic, leading to fragmented business lines and inconsistent asset quality. Their study emphasizes that NBFCs facing stress in one segment often redirect funds to short-term financial instruments to stabilize balance sheets—a form of latent financialization that undermines credit discipline.

2.4. Contextualizing the Gap: Gaya District and the Need for Micro-Level Analysis

Despite these growing concerns, few studies have examined how diversification and financialization interact in small, district-level NBFCs, especially in rural states like Bihar. Most Indian studies focus on large, listed NBFCs or national datasets, neglecting localized dynamics. Gaya district, characterized by widespread financial exclusion, high demand for micro-credit, and presence of both formal and informal lenders, presents a unique setting to study this linkage.

NBFCs in Gaya operate in an environment with:

- Low regulatory visibility from central institutions like RBI and SEBI.
- High informal credit penetration (moneylenders, chit funds).
- Limited financial literacy and high dependence on cash-based transactions.
- Poor institutional accountability, with minimal credit scoring or third-party audit.

In such a setting, diversification may be seen as a business necessity, but it may also act as a veil for reallocating capital into speculative or low-transparency financial assets. No published research, to our knowledge, has empirically examined this behavior in the Gaya context, nor linked it with agency mechanisms or operational inefficiencies.

2.5. Contribution of the Present Study

This paper addresses the significant gap in literature by offering the first district-level empirical study on the diversification-financialization relationship in NBFCs. It contributes to the existing body of knowledge in the following ways:

- It introduces a micro-regional perspective to the study of NBFC behavior, rarely explored in Indian financial literature.
- It tests channel mechanisms (agency costs, investment inefficiency, operational risk) that mediate the impact of diversification on financialization.
- It provides policy-relevant insights for regulators, especially RBI and state financial bodies, by highlighting how NBFCs in low-income regions adapt their strategies under weak institutional environments.
- It lays the groundwork for further rural financial sector research, applicable to other backward districts across India.

3. Research Objectives and Hypotheses

The growing presence of NBFCs in India's rural and semi-urban regions has reshaped local credit systems, particularly in financially underserved districts such as Gaya in Bihar. These institutions often diversify their loan portfolios across multiple sectors (including personal lending, MSME credit, gold loans, and vehicle finance) to manage operational risks and meet heterogeneous credit demands. However, this diversification raises a critical question: does it contribute to more stable, inclusive financial intermediation, or does it increase the tendency of NBFCs to shift resources toward speculative financial investments—indicating a process of financialization?

The literature presents two contrasting perspectives. On one hand, diversification is viewed as a prudent strategy that enhances institutional resilience and reduces reliance on external capital markets. On the other hand, several scholars argue that diversification may increase managerial discretion, reduce accountability, and lead to inefficient allocation of internal resources—encouraging financial speculation to compensate for poor operational performance. In rural districts with weak governance structures and limited regulatory oversight, this risk may be amplified.

In this context, the present study aims to explore the relationship between diversification and financialization among NBFCs operating in Gaya district. The study is guided by the following specific research objectives:

3.1 Research Objectives

RO$_1$: To assess the level and pattern of service diversification among NBFCs in Gaya district.

RO$_2$: To evaluate the extent of financialization among NBFCs by analyzing their investment in non-core financial assets.

RO$_3$: To analyze the impact of diversification on financialization, with attention to organizational characteristics such as size, asset quality, and governance structure.

RO$_4$: To examine whether agency problems, investment inefficiencies, and operational risks mediate the relationship between diversification and financialization.

3.2 Hypotheses

Based on the above objectives and existing literature, the study formulates the following hypotheses:

H$_0$: There is no significant relationship between diversification and financialization among NBFCs operating in Gaya district.

H$_1$: There is a significant relationship between diversification and financialization among NBFCs operating in Gaya district.

To further explore the direction and mechanism of this relationship, the following specific hypotheses are proposed:

H1a: Diversification reduces the tendency of NBFCs to financialize by stabilizing income streams and lowering operational risks.

H1b: Diversification increases financialization by encouraging speculative behavior, particularly in firms facing weak governance and inefficiencies.

H2: Agency problems, inefficient investment decisions, and operational risks significantly mediate the relationship between diversification and financialization.

These hypotheses will be empirically tested using data collected from a representative sample of NBFCs operating in Gaya district. The results will offer insights into whether diversification serves as a tool for financial resilience or becomes a channel through which financialization accelerates, particularly in the context of underregulated rural financial markets

4. Data and Methodology

This study investigates the relationship between diversification and financialization among NBFCs in Gaya district, Bihar. A mixed-method approach is adopted, combining quantitative analysis with qualitative insights to examine institutional behavior in a rural financial setting.

4.1 Data Sources and Sampling

The study is based on both primary and secondary data from 2020 to 2023:

- **Primary data** was collected through structured interviews and questionnaires administered to 20 purposively selected NBFC branches in Gaya district, including asset finance, gold loan, microfinance, and multi-product NBFCs.
- **Secondary data** was obtained from:
  - Audited reports of NBFCs
  - RBI publications
  - District Credit Plan and Lead Bank Office
  - District Statistical Handbook

4.2 Variables and Measurement

Dependent Variable: Financialization (FIN_INV): Measured as the ratio of income from financial investments to total operating income. When unavailable, the ratio of financial assets to total assets is used.

$$\mathbf{FIN\_INV_{it}} = \frac{\textbf{Income from financial investments}}{\textbf{Total operating income}}$$

Independent Variable: Diversification

Measured using:

- **Herfindahl–Hirschman Index (DIV_HHI):**

$$\mathbf{DIV\_HHI_{it}} = 1 - \sum_{j=1}^{n} (P_{j,\,it})^{2}$$

Entropy Index (DIV_ENTROPY):

$$\mathbf{DIV\_ENTROPY_{it}} = -\sum_{j=1}^{n} (P_{j,\,it})\,.\ln(P_{j,it})$$

Higher values reflect greater income diversification across lending products.

Mediating Variables:

- **Agency Cost:** Managerial expenses as a share of total costs.
- **Investment Inefficiency:** Residuals from expected credit growth models.

- **Operational Risk:** Standard deviation of lending cash flows over three years.

Control Variables

The following control variables are included to isolate the effect of diversification:

Variable	Description
SIZE	Log of total assets of the NBFC
LEVERAGE	Total liabilities divided by total assets
ROA	Return on assets (net profit to total assets)
BR_AGE	Age of branch (years since establishment)
NPA_RATE	Non-performing asset ratio
GOV_INDEX	Qualitative score for governance strength
REGION	Dummy variable (urban = 1; rural = 0)

4.3 Empirical Model

A fixed-effects panel regression is used:

$$\mathbf{FIN\_INV_{it}} = \boldsymbol{\alpha} + \boldsymbol{\beta 1 DIV_{it}} + \sum \gamma k \cdot \mathrm{CONTROL}_{kit} + \mu_i + \lambda_t + \varepsilon_{it}$$

Where:

- μ_i : Firm-specific effects
- $\lambda_{t:}$ Time effects
- ε_{it} : Error term

Mediation is tested using a two-step regression approach.

4.4 Instrumental Variable Estimation

To address endogeneity, an IV regression is employed using the average diversification level of peer firms in the same sector as the instrument.

5. Results and Discussion

This section presents the empirical analysis and interpretation of the study on the relationship between diversification and financialization among NBFCs operating in Gaya district. The results are derived from both descriptive and inferential statistical analysis of panel data covering ten NBFCs over a four-year period (2020–2023). The findings are systematically discussed in relation to the research objectives and hypotheses, with reference to both quantitative evidence and theoretical implications.

5.1 Descriptive Analysis of Variables

Table 1 summarizes the descriptive statistics of the key variables used in the study. These variables are central to understanding the financial behavior, strategic choices, and risk profile of NBFCs in the context of a semi-rural financial ecosystem like Gaya.

Table 1: Descriptive Statistics of Key Variables (2020–2023)

Sample: 10 NBFCs × 4 years = 40 observations

Variable	Mean	Std. Dev.	Min	Max
Financialization	0.193	0.076	0.058	0.292
Diversification (Entropy)	1.291	0.183	1.003	1.572
Agency Cost	0.097	0.031	0.054	0.149
Investment Inefficiency	0.051	0.015	0.026	0.078
Operational Risk	0.029	0.012	0.010	0.047
ROA	0.046	0.021	0.010	0.079
Leverage	0.683	0.097	0.504	0.889
NPA Rate	0.087	0.039	0.033	0.147
Total Assets (crore ₹)	30.04	13.62	14.32	47.96

The data shows a moderate level of financialization**,** with the average NBFC earning approximately 19.3% of its income from non-core financial investments. The entropy index**,** which measures product diversification, ranges from 1.00 to 1.57, suggesting significant variation across firms. Operational risk and inefficiency indicators also show measurable differences, indicating that some NBFCs are better at managing resources and risk than others.

5.2 Diversification and Financialization: Empirical Results

The core research objective was to evaluate whether NBFCs with more diversified revenue streams are more or less prone to financialization. The fixed-effects panel regression analysis revealed a positive and statistically significant relationship between the Entropy Index of diversification and the level of financialization ($\beta = 0.37$, $p < 0.05$). This finding supports Hypothesis H_1**,** indicating that as NBFCs expand their income sources across various loan products (e.g., gold loans, MSME finance, consumer loans), they tend to allocate a higher share of their assets into financial instruments such as bonds, mutual funds, or other market-linked securities.

The rationale behind this finding is twofold:

1. **Resource Surplus from Diversification:** Diversified NBFCs may accumulate surplus liquidity from multiple income sources, prompting them to invest excess funds in financial assets for higher returns.

2. **Managerial Discretion and Strategic Arbitrage:** Managers in more diversified firms have broader latitude in allocating funds, which may lead to speculative investments, particularly in districts where regulatory oversight is relatively weaker.

This result aligns with the Speculative Incentive Hypothesis (H1b) rather than the Risk Mitigation Hypothesis (H1a)**.** In other words, diversification, instead of insulating firms from external shocks, may increase financialization tendencies due to internal incentives.

5.3 Mediation Analysis: Exploring Underlying Mechanisms

To further explore Hypothesis H_2**,** the study conducted a two-stage mediation analysis using agency cost, investment inefficiency, and operational risk as mediating variables.

(i) Agency Cost: NBFCs with high diversification were observed to have increased administrative and managerial costs. Regression analysis shows that higher agency costs are positively associated with financialization ($p < 0.10$). This supports the argument that expanded operations provide room for discretionary spending and less monitoring, encouraging investment in non-core assets.

(ii) Investment Inefficiency: Investment inefficiency strongly mediates the diversification–financialization link. Firms unable to effectively allocate loans due to weak market assessment or poor monitoring mechanisms were more likely to shift funds into financial investments. This pattern was statistically significant at the 5% level, indicating that inefficiency in core operations often precedes financialization.

(iii) Operational Risk: Higher diversification was weakly associated with increased variability in cash flows from lending activities. Though this risk metric had a weaker direct effect on financialization ($p > 0.10$), it suggests that risk instability may indirectly nudge NBFCs toward safer or more liquid financial asset classes.

Together, these mediators confirm that the relationship between diversification and financialization is not direct alone but also shaped by internal organizational weaknesses**,** validating Hypothesis H_2**.**

5.4 Discussion: Theoretical and Policy Implications

The findings have important implications for financial theory and rural credit regulation:

Theoretical Insight: The results validate agency theory and behavioral finance perspectives, which caution against unchecked diversification in the absence of strong internal controls. While classical finance posits diversification as a risk-hedging tool, the current study demonstrates that, in practice, it can serve as a facilitator of speculative financialization, especially in rural NBFCs.

Policy Implications:

- **Regulatory Monitoring:** There is a clear need for closer scrutiny of how NBFCs utilize funds in underregulated districts. Branch-level compliance and financial reporting must be strengthened.
- **Productive Lending Incentives:** Policymakers may consider linking financial investment limits to credit delivery targets in sectors such as MSMEs, agriculture, and women-led enterprises.
- **Capacity Building:** NBFCs must be supported through training programs and technical assistance to enhance their operational efficiency and reduce investment inefficiencies.

This section confirms that NBFCs in Gaya district**,** while expanding their operational scope, may inadvertently increase their exposure to financialization risks due to internal inefficiencies and agency issues. These insights provide a foundation for formulating targeted policy interventions aimed at ensuring the developmental integrity of NBFCs in rural India.

6. Conclusion and Policy Recommendations

6.1 Conclusion

This study explored the relationship between diversification and financialization among NBFCs operating in Gaya district, Bihar. By using panel data from 2020 to 2023 and focusing on ten representative NBFCs, the study assessed how diversified financial strategies affect the core developmental role of NBFCs in a semi-rural region like Gaya. The findings revealed that income diversification—though traditionally considered a risk mitigation strategy—have led to increased financialization among NBFCs in the district. This shift toward financialization is significantly influenced by internal inefficiencies, such as rising agency costs, poor credit planning, and increasing operational risk. Instead of strengthening rural credit delivery, NBFCs appear to be reallocating funds toward financial instruments like mutual funds, equity investments, and market securities. This drift challenges the developmental objective of NBFCs, particularly in a district like Gaya where access to institutional credit is already limited and rural borrowers face persistent financial exclusion. The results confirm that while diversification can generate surplus liquidity, the absence of effective credit governance mechanisms and borrower monitoring often leads NBFCs to prefer financial investments over productive rural lending. This trend, if unchecked, could worsen credit access disparities and undermine financial inclusion efforts in the region.

6.2 Policy Recommendations for Gaya District

1. Establish a District-Level NBFC Monitoring Cell

A dedicated NBFC oversight cell should be established under the District Lead Bank or District Magistrate’s office. This cell should:

- Monitor the proportion of NBFC funds allocated to financial investments versus direct lending.
- Review rural lending coverage across blocks such as Barachatti, Sherghati, Atri, and Imamganj.
- Submit quarterly compliance and performance reports to the RBI and state regulatory authorities.

This initiative will enhance local accountability and ensure that NBFCs are aligned with financial inclusion goals.

2. Cap Financial Investments Based on Rural Credit Targets

The Reserve Bank of India, in coordination with the District Credit Committee, should introduce a policy linking financial investment limits to rural credit performance. For example:

"NBFCs may invest a maximum of 20% of their funds in financial assets only after achieving 75% rural credit disbursement targets in priority sectors."

Such a conditional cap will promote productive lending and discourage speculative investments.

3. Expand NBFC Presence in Underserved Blocks

To enhance financial access in underbanked areas like Banke Bazar, Atri, and Guraru, NBFCs should be incentivized to:

- Open rural service centers or mobile credit vans.
- Collaborate with SHGs and Farmer Producer Organizations (FPOs).
- Use digital micro-credit platforms to extend credit efficiently.

State government or NABARD could offer interest subvention or partial credit guarantees to NBFCs reaching high-risk rural populations.

4. Training and Risk Management for Branch-Level Staff

In collaboration with NABARD or the Bihar Rural Development Department, specialized training should be conducted for NBFC employees in Gaya on:

- Risk-based credit appraisal for agriculture and MSMEs.
- Early warning signals for defaults.
- Digital documentation and real-time loan monitoring.

This will reduce operational inefficiencies and improve loan recovery.

5. Develop a District NBFC Governance Index

A simple performance-based NBFC Governance Index can be introduced in Gaya to rate NBFC branches based on:

- Transparency in loan terms.
- Share of rural and women borrowers.
- Timely grievance redressal.
- Financial inclusion outreach.

Top-performing NBFCs can be recognized in the District Coordination Committee and given preference in government schemes like PM SVANidhi and MUDRA.

6. Strengthen Borrower Feedback Systems

Quarterly borrower forums at Panchayat or block level should be organized with NBFC representatives to:

- Listen to borrower experiences.
- Resolve complaints regarding interest rates, EMI collection, or miscommunication.
- Improve borrower–lender trust.

The study clearly shows that while diversification provides financial flexibility to NBFCs, it also increases the risk of mission drift—especially when internal inefficiencies and weak governance remain unaddressed. In Gaya district, this has resulted in an increased tendency toward financialization rather than a focused expansion of rural lending. To fulfill their role as financial intermediaries for rural development, NBFCs must be guided by stronger district-level monitoring, transparent lending practices, and local accountability systems. With proper regulation and strategic reforms, NBFCs in Gaya can become powerful agents of inclusive growth, financial stability, and rural entrepreneurship.

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