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The Role & Regulations of NBFCs (Non Banking Finance Companies) in India: The Structure and status profile

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ABSTRACT: Non-banking financial companies, or NBFCs, are financial institutions that provide banking services, but do not hold a banking license. This paper mainly focus on the role & regulations of NBFCs in India, its significance, the funding sources of NBFCs & its future prospects. Financial System in its composition, status, evolution, regulatory frame work, functional arena besides the nexus between the financial system and economical development. Many of the studies were already made and published to explore the functions and working of NBFCs and evaluation of NBFCs in India.. The operational profile, the growth focus, the dimensions of business volume over the years and also the financial performance of the NBFCs in India are also given a comprehensive focus to provide vital background peripheral to the study. An insight has also been given on recent structure financial sector reforms and its implications on the non banking financial institutions.

I. INTRODUCTION

The term “Finance” is often understood as being equivalent to “money”. However, finance exactly is not money; it is the source of providing funds for a particular activity. Providing or securing finance by itself is a distinct activity or function, which results in Financial Management, Financial Services and Financial Institutions. Finance therefore represents the resources by way funds are needed for a particular activity. We thus speak of 'finance' only in relation to a proposed activity. Finance goes with commerce, business, banking etc. Finance is also referred to as "Funds" or "Capital", when referring to the financial needs of a corporate body

Evolution of Non-Banking Financial Companies.

India soon after independence launched on a programmer of rapid industrialization which needed long term investment in capital assets. Industries which were essential and required huge investments were setup by the Government of India in the public sector. The government also extended guarantees whenever loan was obtained by the public sector industries from the foreign agencies. Public financial institutions were established for instance, the Industrial Development Bank of India and the statutory Finance Corporations. The development banks have been providing large and medium industrial concerns direct finance assistance and small and medium industrial concerns through the State Financial Institutions. These corporations issue bonds and debentures and also accept deposits from the public. But the private sector had to rely mostly on the commercial banks which were also not grown to such a scale as to provide corporate funds required by the promoters. Traditional banks have been financing manufacturing activity by providing working capital. With the shortage of financial resources against Expanding activities the companies were mostly depending on credit deals. Capital goods Such as machinery, equipment etc., were imported on deferred payment terms

It is well acknowledged in the academic literature that an efficient and well-developed financial system is important for influencing economic growth. The positive effects of financial development on growth are basically credited to the functions1 it plays particularly in the mobilization and allocation of resources needed to undertake productive investment activities by various economic agents. Theoretical literature argued that the increased availability of financial instruments and institutions greatly reduces transaction and information costs in economy which in turn influences savings rate, investment decisions and undertaking of technological innovations.

A large number of empirical works have also tested the finance-growth relationship employing different methodological techniques using different indicators of financial development in cross-country or time series studies. The empirical findings are generally in consensus that a well-functioning and efficient financial system has beneficial impacts on economic growth.

The activities of non-banking financial companies (NBFCs) in India have undergone qualitative changes over the years through functional specialization. The role of NBFCs as effective financial intermediaries has been well recognized as they have inherent ability to take quicker decisions, assume greater risks, and customize their services and charges more according to the needs of the clients. While these features, as compared to the banks, have contributed to the proliferation of NBFCs, their flexible structures allow them to unbundle services provided by banks and market the components on a competitive basis. The distinction between banks and non-banks has been gradually getting blurred since both the segments of the financial system engage themselves in many similar types of activities. At present, NBFCs in India have become prominent in a wide range of activities like hire-purchase finance, equipment lease finance, loans, investments, etc. By employing innovative marketing strategies and devising tailor-made products, NBFCs have also been able to build up a clientele base among the depositors, mop up public savings and command large resources as reflected in the growth of their deposits from public, shareholders, directors and other companies, and borrowings by issue of non-convertible debentures, etc

Framework Financial System in India

The Financial Intermediaries in the Financial System can broadly be said to comprise of:

-Banks

-NBFCs

More often financial markets are classified as money markets and capital markets. While the money market deals in the short-term claims (with a period of maturity of one year or less), the capital market does so in the long-term (maturity period above 1 year) claim Commercial banks, for example, belong to both. While Treasury Bills Market, Call Money Market, and Commercial Bills Market are examples of the money market, Stock Market and Government Bonds Market are examples of the capital market. Financial asset represent a claim to the payment of a sum of money sometime in future (repayment

Of principal) and /or a periodic (regular or not so regular) payment in the form of interest

Or dividend.

(i) **Banking**: Reserve Bank of India (RBI), Commercial Banks, Co-operative Credit Societies, Co-operative Banks, Post-office Saving Banks.

(ii) **Non-Banking** : Provident and Pension Funds, Small Savings Organizations, Life Insurance Corporation (LIC), General Insurance Corporation (GIC), Unit Trust of India(UTI), Mutual Funds, Investment Trusts, Investment Companies, Finance Corporations, Nidhis, Chit Funds, Hire-Purchase Finance Companies, Lease Finance Companies, National Housing Bank (NHB), Housing and Urban Development Corporation (HUDCO), Housing Development Finance Corporation (HDFC), and other housing finance companies, Manufacturing companies accepting public deposits, Venture Capital Funds and National Cooperative Bank of India(NCBI).

And NBFCs can be further classified into different types depending on their nature of business.

Further, total Finance sector in India may be classified into Formal and Informal Finance.

The informal sector of finance may be said to refer to all economic activities that fall outside the formal sector that is regulated by economic and legal institutions e.g money lenders, some channels of micro finance and the other not necessarily regulated sectors. Landlords, local shopkeepers, traders, suppliers and professional money lenders, and relatives are the informal sources of micro-finance for the poor, both in rural and urban areas. The Formal sector can be said to comprise of the Formal and necessarily regulated channels of financing like, finance provided by Banks, Financial Institutions, Non-Banking Financial Institutions, and Micro finance institutions.

What is a Non Banking Financial Institution (NBFI)?

A Non Banking Financial Institution/ Non Banking Financial Intermediary have different definitions in different countries:

-Any institution which is not a bank but is involved in finance.

-Financial institutions not taking demand deposits

-Financial institutions not taking any deposit

NBFIs are different types of financial institutions that provide the following Types of services:

- Payments

-Liquidity / credit

-Divisibility: break up large denomination and aggregate small denomination

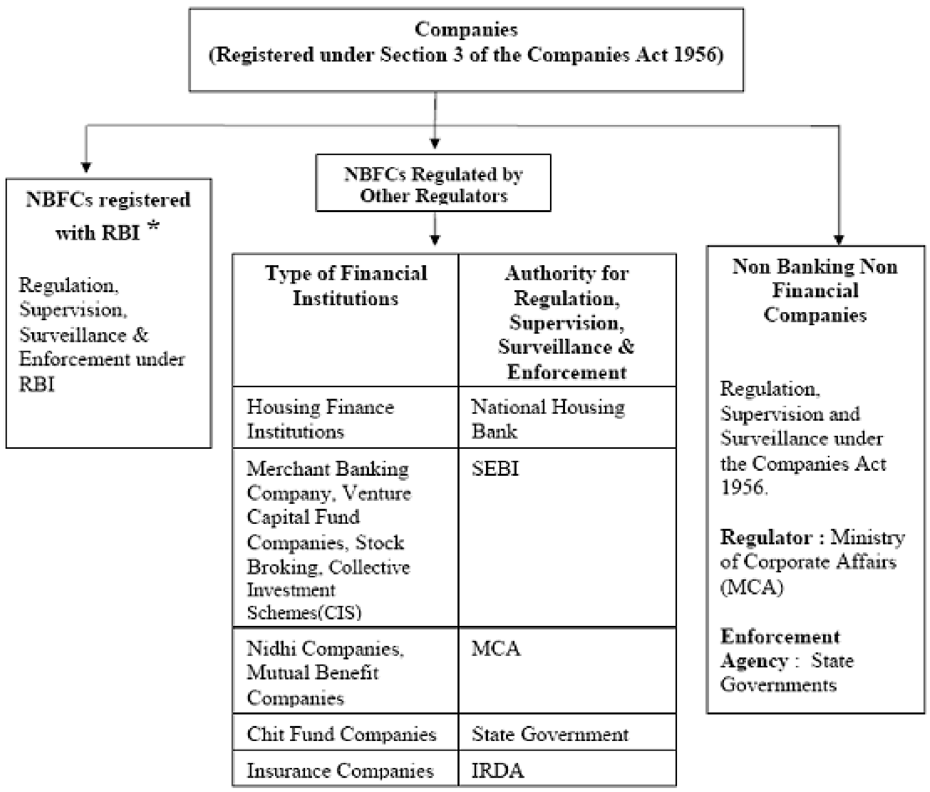
-Store of value

-Information: processing and assessing risks

-Risk pooling: lower the risks of investors

CHART - I

Overview of Regulators of Non-Banking Companies



Types of NBFI

NBFIs can be classified by the main services they provide:

-Deposit taking institutions (e.g Thrifts, credit unions, savings& loans.)

- Risk-pooling institutions (e.g insurance co.)
- Contractual savings institutions (e.g Mutual funds, pension funds, other investment institutions)

-Market makers (e.g Investment banks, stockbrokers.)

- Specialized sectoral financiers (e.g leasing companies, real state finance co.micro-finance institutions.)
- Financial service providers (e.g Brokers, investment advisers).

Risks Associated with NBFIs and why they need to be regulated:

While NBFIs can contribute to the economy, they also bring risks and the only way to contol these risks is through proper regulation. Risk will vary depending upon the economic functions performed by NBFIs. The challenge for regulation is striking the right balance between the risks and benefits. On the one hand, too little or no regulation can lead to crisis and severely impact the vulnerable and the economy. This has been a major attribute to the Asian crisis in the late 90s – finance companies in Thailand and merchant banks in Korea. On the other hand, too strict or inappropriate regulation can hinder innovation and development. The call for 'deregulation' in developed economies reflects this. Getting the right balance is a perpetual challenge for financial regulators and supervisors, not only in the developing countries, but also in developed and advanced economies.

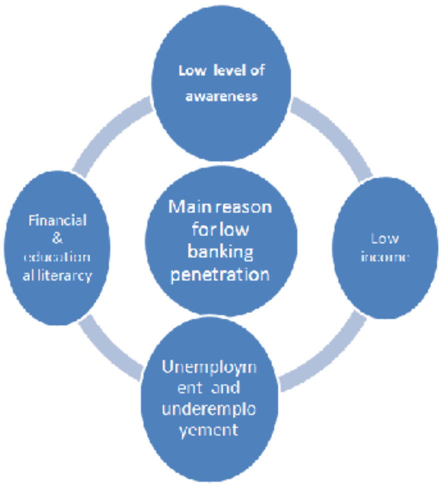


Chart 2 : The main reasons behind low penetration of banking have been as shown above.

Role of NBFCs

NBFCs like banks and other financial institutions act as intermediaries between the ultimate savers and the ultimate borrowers. The rationale of their existence derives from the fact that in an economy there are surplus units which save and deficit units which are in need of such savings and a mechanism is needed to bring the two together. Surplus units (savers) can lend to the deficit units (borrowers) directly. This, however, is normally inconvenient to both the savers and borrowers and is certainly not the most efficient means of flow of funds between the units. With the mediation of financial institutions, there is a reduction in the degree of risks involved and there is also a more efficient utilization of the resources in the economy. Financial intermediaries can provide a more economical service because of the economies of scale, their professional expertise and their ability to spread the risk over a large number of units. Thus, their operations give to the saver the combined benefits of higher return, lower risk and liquidity. The borrowers on the other hand also get a wider choice on account of intermediation of financial institutions. It may be of relevance to note that while the loans granted by commercial banks are, by and large, for industrial, commercial and agricultural purposes, those granted by NBFCs are generally for transport, trading, acquisition of durable consumer goods, purchase and repair of houses or just for plain consumption. Since their activities are not controlled by monetary authorities to the same extent as those of commercial banks, the credit extended by NBFCs may not necessarily be in consonance with national objectives and priorities. The major function of financial intermediaries is to transfer the savings of surplus units to deficit units; hence, they can play a useful role in the economy of the country. To the extent that they help in monetizing the economy and transferring unproductive financial assets into productive assets, they contribute to the country's economic development. In fact, the nature and diversity of financial institutions themselves have become measures of economic development of a country. The Reserve Bank of India expert committees identified the need of non banking financial companies in the following areas:

-Development of sectors like transport and infrastructure

-Substantial employment generation

-Help and increase wealth creation

- Broad base economic development

-Irreplaceable supplement to bank credit in rural segments

-Major thrust on semi-urban, rural Areas and first time buyers/users

-To finance economically weaker sections.

-Huge contribution to the state exchequer.

Regulation of NBFCs

While NBFCs have been rendering many useful services, several advances, unhealthy features of their working also have been observed. At present all NBFCs except HFCs are regulated by the RBI. With enactment of RBI (Amendment) act 1997, all of them with net owned funds of ì.25Lakhs and above have to register with the RBI now. The BFS with the help of department of supervision of the RBI began supervising NBFCs from July 1995. HFCs are regulated by NHB. The major regulatory provisions are:-

(i) The minimum net worth funds of 25 Lakh and the NBFC should achieve the minimum net worth norm in 3 years or extended 3years more at the discretion of RBI.

(ii) NBFCs have to maintain 10%and15% of their deposits in liquid assets.

(iii) They have to create reserve fund and transfer not less than 20% of their net deposits to it every year.

(iv) The RBI directs them on issues of disclosures, prudential norms, credit, investments etc.

(v) Nomination facility is available to depositors of these companies. 90

(vi) Unincorporated bodies engaged in financial activity cannot accept deposits from the public from April, 1997.

(vii) They have to achieve a minimum capital adequacy norm of 8% by March, 1996.

(viii) They have to obtain a minimum credit rating from any one of 3 credit rating agencies.

(ix) A ceiling of 15% interest on deposits has been prescribed for MBFCs or Nidhis.

(x) The interest rate ceiling on deposits as also the ceiling on quantum of deposits for NBFCs (other than Nidhis) have removed.

CONCLUSION

To conclude, the NBFCs are playing significant role in meeting financial requirements of the medium sized and small sized industries and development of Indian economy indirectly. This paper mainly focus on the role & regulations of NBFCs in India, its significance, the funding sources of NBFCs & its future prospects. Financial System in its composition, status, evolution, regulatory frame work, functional arena besides the nexus between the financial system and economical development .On the other hand, policies of NBFCs are also providing investment security for the investors. It is highlighted that due to the regulations of the Reserve Bank of India, still the NBFCs are not extending more credit. It is suggested to the NBFC credit policy to reduce rate of interests, which helps to small enterprises to get loans for their different capital requirements. The review made above shows that the research in NBFCs is not so progressive as many of the published research papers shows only basics of the NBFCs and still it is essential to study the evaluate the performance of NBFCs in India.

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