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Non Banking Financial Companies in India: Types, Needs, Challenges and Importance in Financial Inclusion

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Abstract

Traditionally, India has had a bank-dominated financial sector. Even so, there have always been NBFCs. These were in early times that small family used to run businesses for deposits acceptance and lending activities. Even today, the sector may be 'small' as compared to banking sector with a total asset size of just around 14 percent of that of scheduled commercial banks (other than RRBs) but there is no denying that the sector has grown tremendously over the years in size, form and complexity, with some of the NBFCs operating as conglomerates having business interests spread to sectors like insurance, broking, mutual fund and real estate. Concomitant with the above, interconnectedness and systemic importance of the NBFC sector also have increased.

Financial Inclusion has been the main focus of the RBI since its inception. Financial inclusion has been defined as the "provision of affordable financial services" to those who have been left unattended or under-attended by formal agencies of the financial system. These financial services include "payments and remittance facilities, savings, loan and insurance services". The RBI has taken measures from time to time to achieve this objective such as nationalization of banks in 1969 and 1980, privatization of banks in 1991, 2003 and 2013, Swabhimann, Swawlamban, Regional Rural Banks, Wholesale Banks, Payment Banks etc. But the performance of financial inclusion initiatives has been far from satisfactory. Non Banking Financial Companies can play a vital role in achieving this objective of the RBI. The current paper analyses the need of NBFCs in Indian economy, their importance in the Financial Inclusion, what challenges do they face and what measures must be taken to enhance their effectiveness.

Keywords: NBFC, RBI, financial inclusion, financial sector.

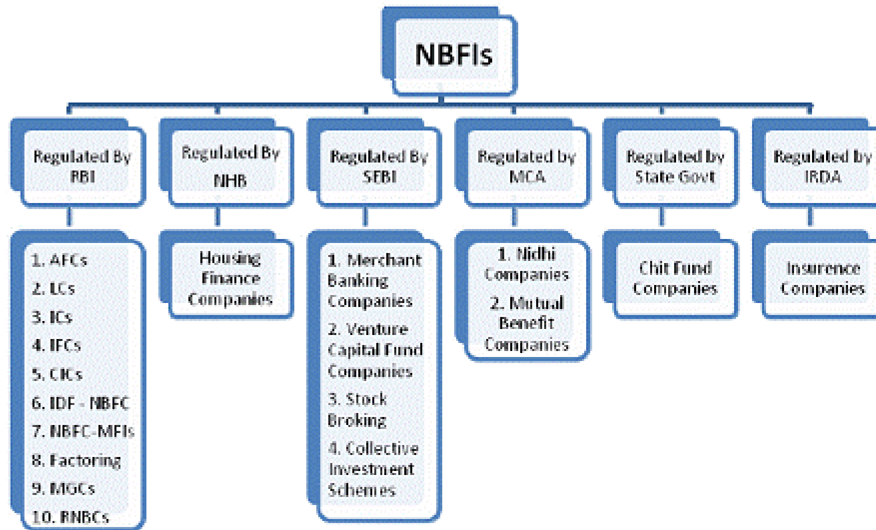
Introduction

Section 45I of the Reserve Bank of India Act, 1934 defines a ''non-banking financial company'' as follows:

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares / stocks / bonds / debentures / securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property. A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

Categorization of NBFCs

Chart 1: The NBFI Universe



NBFCs are categorized

a) In terms of the type of liabilities into Deposit and Non-Deposit accepting NBFCs,
b) Non deposit taking NBFCs by their size into systemically important and other non-deposit holding companies (NBFC-NDSI and NBFC-ND) and
c) By the kind of activity they conduct.

As depicted by the chart, NBFCs regulated by the RBI are of 10 types which are described below:

i. Asset Finance Company(AFC) : An AFC is a company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60% of its total assets and total income respectively.

ii. Investment Company (IC) : IC means any company which is a financial institution carrying on as its principal business the acquisition of securities,

iii. Loan Company (LC): LC means any company which is a financial institution carrying on as its principal business the providing of finance whether by making loans or advances or

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otherwise for any activity other than its own but does not include an Asset Finance Company.

iv. Infrastructure Finance Company (IFC): IFC is a non-banking finance company a) which deploys at least 75 per cent of its total assets in infrastructure loans, b) has a minimum Net Owned Funds of Rs. 300 crore, c) has a minimum credit rating of 'A 'or equivalent d) and a CRAR of 15%.

v. Systemically Important Core Investment Company (CIC-ND-SI): CIC-ND-SI is an NBFC carrying on the business of acquisition of shares and securities which satisfies the following conditions:-

(a) It holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;

(b) Its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its Total Assets;

(c) It does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;

(d) It does not carry on any other financial activity referred to in Section 45I(c) and 45I(f) of the RBI act, 1934 except investment in bank deposits, money market instruments, government securities, loans to and investments in debt issuances of group companies or guarantees issued on behalf of group companies.

(e) Its asset size is Rs 100 crore or above and

(f) It accepts public funds

vi. Infrastructure Debt Fund: Non- Banking Financial Company (IDF-NBFC): IDF-NBFC is a company registered as NBFC to facilitate the flow of long term debt into infrastructure projects. IDF-NBFC raise resources through issue of Rupee or Dollar denominated bonds of minimum 5 year maturity. Only Infrastructure Finance Companies (IFC) can sponsor IDF-NBFCs.

vii. Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI): NBFC-MFI, introduced in Dec 2011, is a non-deposit taking NBFC having not less than 85%of its assets in the nature of qualifying assets which satisfy the following criteria:

(a) Loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs. 60,000 or urban and semi-urban household income not exceeding Rs. 1,20,000;

(b) Loan amount does not exceed Rs. 35,000 in the first cycle and Rs. 50,000 in

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subsequent cycles;

(c) Total indebtedness of the borrower does not exceed Rs. 50,000;

(d) Tenure of the loan not to be less than 24 months for loan amount in excess of Rs. 15,000 with prepayment without penalty;

(e) Loan to be extended without collateral;

(f) Aggregate amount of loans, given for income generation, is not less than 75 per cent of the total loans given by the MFIs;

(g) Loan is repayable on weekly, fortnightly or monthly installments at the choice of the borrower

viii. Non-Banking Financial Company – Factors (NBFC-Factors): NBFC-Factor, introduced in July 2012, is a non-deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring business should constitute at least 75 percent of its total assets and its income derived from factoring business should not be less than 75 percent of its gross income.

The remaining two NBFCs are Mortgage Guarantee Companies (MGCs) and Residuary Non-Banking Companies (RNBCs).

Banks vs. NBFCs

NBFCs lend and make investments and hence their activities are akin to that of banks; however there are a few differences between these two which are given below:

- NBFC cannot accept demand deposits;
- NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself;
- Deposit insurance facility provided by the Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in the case of banks.
- Scope of business for banks is limited by sec 6 (1) of the Banking Regulation Act whereas there is no bar on NBFCs carrying activities other than financial activities.
- Banks can exercise powers of recovery under SARFAESI and DRT law. Such powers are not available to NBFCs.

List of major products offered by NBFCs

- Funding of commercial vehicles
- Funding of infrastructure assets
- Retail financing
- Loan against shares

- Funding of plant and machinery
- Small and Medium Enterprises Financing
- Financing of specialized equipment
- Operating leases of cars

Governance of NBFCs

Three years after a panel headed by former Reserve Bank of India deputy governor Usha Thorat proposed stringent norms for non-banking financial companies, the RBI has finally acted. The central bank has implemented higher capital requirements, regulatory alignment with banks, enhanced disclosure requirements and tighter corporate governance norms — all measures that will strengthen the NBFC sector structurally and safeguard the interests of customers and investors.

The latest RBI measures will impact profitability and asset quality of NBFCs in the short term, but they will bring in more transparency and improve NBFCs ability to withstand asset quality shocks in the long run, analysts and rating companies say.

The central bank has reduced the limit on deposit acceptance to 1.5 times of Owned Funds from 4 times of Owned Funds for deposit-taking asset financing companies and made mandatory investment grade credit rating for accepting public deposits.

The RBI has ensured checks and balances for NBFCs which collect deposits and important non-deposit taking NBFCs. Deposit taking NBFCs (NBFC-D) with deposits over Rs 20 crore should constitute an audit committee, a nomination committee to ascertain the fit and proper status of directors and the risk management committee.

Non-deposit taking NBFCs (NBFC-ND) with assets of Rs 50 crore and above should constitute an audit committee, while NBFC-ND with asset over Rs100 crore should constitute a nomination committee and risk management committee in addition to the audit committee. NBFC-D with deposits over Rs 50 crore should rotate the partners in the statutory audit firm, once in every three years.

Size if the Sector

The share of NBFCs' assets in GDP (at current market prices) increased steadily from just 8.4 per cent as on March 31, 2006 to 12.5 per cent as on March 31, 2013; while the share of bank assets increased from 75.4 per cent to 95.5 per cent during the same period (Table 1). In fact, if the assets of all the NBFCs below Rs.100 crore are reckoned, the share of NBFCs' assets to GDP would go further.

Table 1: Assets of NBFC and Banking (SCBs) Sectors as a % to GDP

Ratio	Year							
	2006	2007	2008	2009	2010	2011	2012	2013
NBFC Assets to GDP (%)	8.4	9.1	10.1	10.3	10.8	10.9	11.9	12.5

Bank Assets to GDP (%)	75.4	80.6	86.8	93.0	93.0	92.2	92.7	95.5

Source: (i) Reports on Trend and Progress of Banking in India, 2006-2013; (ii) Hand Book of Statistics on Indian Economy, 2012-13
Note: Assets of NBFC sector include assets of all deposit taking NBFCs and Non-Deposit Taking NBFCs having assets size Rs. 100 crore and above (NBFCs-ND-SI)

Need and Importance of NBFCs

With the rise of middle class in India which has reached a certain stage of discernible economic development, there is a growing demand for property ownership, small-scale investment, and saving for retirement and a growing need for housing finance, contractual savings, insurance services, pension plans management and asset management. These varied requirements cannot be met by the banking system alone as commercial banks in India are not functioning as a full-fledged 'universal banking'. This is being met by opening non-banking financial subsidiaries by practically all the major banks in India. These subsidiaries are in the form of merchant banks, mutual funds, insurance companies, primary dealers and other NBFCs. Thus, NBFIs play a crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector (RBI, 2005).
With the growing importance assigned to financial inclusion, NBFCs have come to be regarded as important financial intermediaries particularly for the small-scale and retail sectors. NBFCs play an important role in promoting inclusive growth in the country, by catering to the diverse financial needs of bank excluded customers. They promote the 'habit of saving' among the individuals. By financing real assets and extending credit to infrastructure projects, NBFCs play a pro-active role in the development process of the country. Activities undertaken by the NBFCs for achieving inclusive growth in the country are described below:

Credit to MSMEs

Statistics based on 4th Census on MSME sector revealed that only 5.18% of the units (both registered and un-registered) had availed finance through institutional sources. 2.05% got finance from non-institutional sources the majority of units say 92.77% had no finance or depended on self-finance. The fact that a large segment in the micro and small industries sector does not have access to formal credit provides a window of opportunity for the NBFCs to design suitable innovative products.

Micro Finance Institutions

NBFC-MFIs provide access to basic financial services such as loans, savings, money transfer services, micro-insurance etc. to poor people and attempt to fill the void left between the mainstream commercial banks and money lenders. Over the last few years NBFC-MFIs have emerged as fast growing enablers in providing the financial services to the poor people by providing capital inputs to poor which generates self-employment, and thereby promotes inclusive growth.

To encourage MFIs, as per the Malegam committee recommendations, RBI has created separate category under NBFCs. As on date, around 33 MFIs have been registered with RBI.

Monetization of Gold

NBFCs provide loans against security of gold jewellery. Although banks are also involved in gold loan business, NBFCs' gold loans witnessed phenomenal growth due to their customer friendly approaches like simplified sanction procedures, quick loan disbursement etc. Gold loan NBFCs help in monetization of idle gold stocks in the country and facilitate in creating productive resources. Branches of gold loan NBFCs increased significantly during the last couple of years mostly housed at semi-urban and rural centers of the country.

Second Hand Vehicle Financing

Apart from providing loan against property, NBFCs also engage in financing used/ second hand vehicles, reconditioned vehicle, three-wheelers, construction equipment besides secured / unsecured working capital financing etc. Incidentally, in India except NBFCs no other financial sector player finance second hand vehicles; which are very popular with road transport operators essentially in the self-employed segment.

Affordable Housing

Another area where NBFCs are participating in the inclusive growth agenda is affordable housing. Large NBFCs are setting up units to extend small-ticket loans to home buyers targeting low-income customers across the country. Firms are offering loans of Rs. 2-6 lakh to borrowers with monthly income of Rs.6000 – 12000 who find it difficult to borrow from the commercial banks. Firms offer easier know-your customer (KYC) norms such as relaxation in documentation requirements to facilitate easy access to low-income borrowers.

To sum up, NBFCs' role in financial inclusion as explained above, indicate the fact that they have been game changers in certain areas like financial inclusion especially micro finance, affordable housing, second-hand vehicle finance, gold loans and infrastructure finance.

Challenges to NBFCs

The NBFCs in India face some challenges which restrict them it achieving their objectives effectively. Some of the major challenges are as follows:

Customer Protection Issues

Protection of customers against unfair, deceptive or fraudulent practices has become top priority internationally after the crisis. Incidentally, the Bank has received and is receiving number of complaints against charging of exorbitant interest rates, raising of surrogate deposits under the garb of non-convertible debentures, various types of preference shares, Tier II Bonds, etc. Aggressive practices in re-possessing of automobiles in the case of auto loans and

improper/opaque practices in selling the underlying gold jewellery in the case of gold loans are the two categories in which relatively more complaints are being received by the Reserve Bank. NBFCs are often found not to practice Fair Practices Code(FPC) in letter and spirit. Developing a responsive and proper grievance redressal mechanism is the more important agenda in the context of this action point.

Camouflaging Public Deposits

NBFCs have been prone to adopt variety of instruments/ways of accepting camouflaged public deposits for resource mobilization viz., use of Cumulative Redeemable Preference Shares (CRPS)/ Convertible Preference Shares (CCPS) / NCDs / Tier 2 capitals. These instruments are generally marketed as any other deposit products mostly by agents.

Furthermore, complaints are received that deposit receipts issued to customers reveal that the deposits are accepted on behalf of other group companies, whose operations are very opaque.

No Single Representative Body for the Industry

In the case of NBFCs, there are multiple representative bodies such as ‘Finance Industry Development Council (FIDC) for Assets Finance Companies’, ‘Association of Gold Loan Companies (AGLOC) for Gold Loan NBFCs’, etc. In addition, RBI has recently issued guidelines for ‘Self-Regulatory Organization for Micro Finance Institutions’. This leads to the unclear rules and regulations which hamper the growth trajectory of the NBFCs.

Less Asset Reconstruction Powers

NBFCs do not enjoy much power in the asset reconstruction framework. NBFCs are not covered by the SARFAESI Act.

Powers of Regulators

The regulators do not have sufficient power in regulating the NBFCs. NBFCs, as the entities, especially the unincorporated ones, can sprung in any nook and corner of the country and can operate with impunity unnoticed, but endangering their customers’ interest.

Suggestions

Improving Corporate Governance Standards

To become real game changers, business transparency is inevitable for any financial entity. In the case of NBFCs, there is an imperative for adopting good corporate governance practices. RBI has already prescribed a governance code for NBFCs as part of their best practices; these include constitution of Risk Management, Audit and Nomination Committees, disclosure and transparency.

Capacity Building

NBFCs on both individual and collective basis need to work towards building a responsive ecosystem for capacity building; since in the medium to long term, it is the quality of staff which to a large extent, determines the health of the sector.

Greater Innovation

Although NBFCs have been designing innovative products to suit the client and market conditions, the sophistication of financial services has been gradually increasing in the recent past. There is an imperative need for NBFCs to aggressively involve in designing innovative products.

Coparceners with RBI and Other Regulators

NBFCs should become coparceners with RBI and other regulators and disclose the challenges they are confronting in the markets and provide valuable inputs to regulators for developing conducive regulatory environment.

White Label ATMs

As NBFCs already have significant business presence in semi-urban and rural centers, there is a case for them to explore business potential by establishing white label ATMs in such areas.

Enhanced Monitoring

The regulators should have a hands-on approach in unearthing the activities of unauthorized entities as also authorized entities undertaking non-permitted activities. In this context, wherever possible, laws should be amended to bestow the requisite regulatory and supervisory powers to the respective regulators.

Regulatory convergence

All the concerned regulators should bring about regulatory convergence among themselves, to avoid any possible regulatory arbitrage by the players.

Apart from these the people, particularly in rural areas, should be made aware of the benefits of the NBFCs. The RBI should work towards enhancing the financial literacy levels of the people. Besides, people should be able to get help from the NBFCs easily.

Conclusion

NBFCs have turned out to be engines of growth and are integral part of the Indian financial system, enhancing competition and diversification in the financial sector, spreading risks specifically at times of financial distress and have been increasingly recognized as complementary of banking system at competitive prices. The Banking sector has always been highly regulated, however simplified sanction procedures, flexibility and timeliness in meeting the credit needs and low cost operations resulted in the NBFCs getting an edge over banks in

providing funding. Since the 90s crisis the market has seen explosive growth, as per a Fitch Report, the Compounded Annual Growth Rate of NBFCs was 40% in comparison to the CAGR of Banks which was only 22%.

In June 2014, The Reserve Bank of India permitted banks to appoint NBFCs which do not accept deposits as their Business Correspondents (BCs), a move which could help extend banking services to remote areas. More such measures should be considered by the RBI to enhance the financial inclusion.

NBFCs can truly become game changers provided they exhibit the requisite nimbleness and innovative zeal in reaching a complete suite of financial products such as shares, mutual funds, depository services etc., as also insurance products – both life and non-life together with their current product offerings, to the common man.

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