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# A STUDY ON THE FUNCTIONS OF NON BANKING FINANCIAL COMPANIES (NBFC)

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## ABSTRACT

*Non-bank financial companies (NBFCs) are financial institutions that provide banking services without meeting the legal definition of a bank, i.e. one that does not hold a banking license. These institutions typically are restricted from taking deposits from the public depending on the jurisdiction. Nonetheless, operations of these institutions are often still covered under a country's banking regulations.*

*The specific banking products that can be offered by NBFCs depends on the jurisdiction, and may include services such as loans and credit facilities, savings products, investments and money transfer services. In some jurisdictions, such as New Zealand, any company can engage in banking business, except they are not allowed to use the word bank in their name. A company can only call itself a bank if it is a registered as such with the nation's central bank.*

***Classification***
*Based on their Liability Structure, NBFCs have been divided into two categories.*

*1. Category 'A' companies (NBFCs accepting public deposits or NBFCs-D),*
*2. Category 'B' companies (NBFCs not raising public deposits or NBFCs-ND).*

*NBFCs-D are subject to requirements of Capital adequacy, Liquid assets maintenance, Exposure norms (including restrictions on exposure to investments in land, building and unquoted shares), ALM discipline and reporting requirements; In contrast, until 2006 NBFCs-ND were subject to minimal regulation. Since April 1, 2007, non-deposit taking NBFCs with assets of `1 billion and above are being classified as Systemically Important Non-Deposit taking NBFCs (NBFCs-ND-SI), and prudential regulations, such as capital adequacy requirements and exposure norms along with reporting requirements, have been made applicable to them. The asset liability management (ALM) reporting and disclosure norms have also been made applicable to them at different points of time.*

***Keywords:*** *NBFC, Financing, Liberalization, Funds, Investments, Government.*

## INTRODUCTION

The financial services scenario in India in the last twenty five years has undergone drastic changes. In the sleepy sixties a traditional pattern existed in the financial sector characterized by dearth of instruments. Most companies followed a strictly regimented debt-equity pattern. The primary capital markets remained inactive and the secondary capital market was somewhat disorganized. Financial institutions and handful of brokers dominated the financial services sector. With the passing of the FERA in 1973 there was a spurt in public issues and the investing public was given an opportunity to invest in some of the blue chip multinational companies. This created investor confidence in the primary capital market and the shareholders population started increasing. But a characteristic of such growth leading to expansion in financial services is that it has mostly been market driven and not planned or motivated by a central agency.

The expansion of financial services at a very fast pace has left its impact on the financial services sector in the country. The organised players in the financial services sector were to few to cope with demands placed on them from the economy and as a result the present position shows the effect of unplanned growth.

It is the last few years that co-ordinated efforts are being made to reorganize and restructure the financial services industry. Such efforts have been spearheaded by a spate of committed set up by the Government to look into specific areas of the financial sector.

Besides these public and private sector banks, non-banking financial companies (NBFCS) have started playing a very important role in the world. These non-banking financial companies facilitate various business activities.'

## MEANING AND CLASSIFICATION OF NABFCs

The term non-bank financial intermediary is applicable to all financial institutions excluding commercial banks, that receive funds from savers and lends them to borrowers. It includes institutions like mutual savings banks, savings and loan associations, insurance companies, finance companies, pension trusts and investment trusts. The working group has excluded from the definition of non-banking finance companies, those carrying on insurance business. This business is included in the existing definition of NBFCs.

Non banking companies are classified as (i) non-financial companies, engaged in trading or industrial or other non-financial activities and (ii) financial companies, engaged mainly in fmancing of hire-purchase, advancing loans to industries, trading in shares and securities, and companies whose principal business is the acquisition of shares, stocks, debentures or other securities. These may be organised as quasi-government bodies, large-sized joint stock companies, investment trusts, para-banking institutions like finance corporations, chit funds and nidhis. Then there are call loan brokers and general finance and stock brokers who may be termed as financial intermediaries. The post offices also operate Public Accounts, Security Deposit Accounts, Provident Fund Accounts and some other accounts.

**SCOPE OF THE NBFCs**

The process of liberalisation initiated by the Indian government has thrown open several business opportunities. One such industry to gain from the liberalisation is the financial service sector. Opening up of the economy and financial reforms have given tremendous impetus to this sector.

**FUND BASED**

- Commercial Banking
- Leasing
- Hire Purchase
- Factoring
- Vyaj badla
- Share Investment

**NON-FUND BASED**

- Merchant banking including public issue management under writing etc.,
- Portfolio management
- Stock and Security broking, mergers and acquisitions.
- Lease and hire purchase broker.
- Foreign exchange broker
- Bills discounting

In India, finance companies have concentrated on leasing and hire purchase and in the recent past, on bills discounting too. Other activities have been played at a relatively low level.

Deposits with NBFCs have come into existence only in recent years, though it has been a traditional source of finance in India to supplement their needs and requirements of working capital.

The important factors responsible for prominence of public deposits with NBFCs are:

(i) Credit is available at cheaper rates to NBFCs and at the same time returns to the depositors are higher because of the elimination financial intermediaries.

(ii) Timely and easy credit is available to non-banking financial companies.

(iii) Production bottlenecks due to lack of liquid funds can be avoided and

(iv) Undue credit expansion arising our of credit creating power of bank deposit is avoided.

**GROWTH AND DEVELOPMENT OF NBFCs**

In the last two decades, the capital market in India has witnessed significant developments. The volume of capital market transactions has increased sharply; its functioning has been diversified. New financial institutions such as merchant banks, mutual funds and venture capital companies have come up and are quite active. New financial instruments, such as fully and partly convertible debentures (FCDs and PCDs), commercial papers, CDs etc., have appeared. These reflect the growing diversification and measure of sophistication of the financial services sector catering to the needs of growing capital and money markets. The volume of new issues is presently between Rs. 15,000 crores and Rs.20,000 crores. The number of shareholders runs into several millions, indicating the growth of the cult of equity. Commercial banks which deal in the money market are entering the capital market through their merchant banks and mutual funds subsidiaries. They are going to leasing and venture finance also.

**HIRE PURCHASE FINANCE INSTITUTIONS**

Hire-purchase finance companies help small transport operators, farmers and professionals to buy equipments on the basis of hire-purchase. The goods themselves serve as security until the loan is fully cleared.' At present, the hire-purchase form of credit is provided by private hire purchase finance institutions, commercial banks and State Financial Corporation’s (SFCs). The last two mentioned institutions have entered this field only recently. The bulk of the hire purchase credit goes to the road transport industry. According to a number of studies on the subject, there is considerable demand for hire purchase credit and there is good scope both for the organised banking system and private hire-purchase agencies to enter the field. Important features of the hire purchase financial institutions in India are:

- They are better developed and organised in the southern region than in other areas.
- There are a large number of individuals and partnerships in this field.

- Many small hire purchase agencies indulge in such undesirable practices as charging exorbitant rates of interest, forcible repossession of the vehicles financed.

- The demand for hire purchase credit exceeds considerably the supply of funds for the same.

The private hire purchase companies are organizationally weak. A large number of them are too small in size and are financially weak. It is necessary to strengthen them, by setting up through amalgamations and mergers, large and strong units. Towards this end, the Banking Commission has made the following recommendations:

(a) All hire purchase finance units should compulsorily be licensed and the licensing authority should be given the power to revoke the licence in case of unsatisfactory functioning and unhealthy practices.

(b) The government should prescribe permissible equity-debt ratio and liquidity ratio for hire purchase companies and they should be higher for smaller units and lower for bigger units. This will induce small units to become large through expansion or through merger.

(c) The hire purchase finance agencies should be classified into approved and non-approved categories and the approved agencies should be entitled to refinance facilities from the banking system and their lending operations should be covered under the Credit Guarantee Scheme.

(d) The lending commercial banks may form new hire purchase finance companies or they may promote subsidiary hire purchase finance companies. The Banking Commission particularly favored the idea of local commercial and urban co-operative banks to take more interest in the field of hire purchase, since they are specially suited to extend hire-purchase credit which demands personalized service because of their intimate knowledge of local conditions.

**LOAN AND FINANCE COMPANIES**

Loan and Finance Companies in certain States like Gujarat and Karnataka, a type of non-banking financial intermediaries called as "finance corporation", "finance company" or "Loan Company", has been making rapid progress. In almost all cases, the finance companies or corporations, as they are most commonly called, have very little capital less than Rs.1 lakhand their main source of funds is deposits from the public, for which they offer attractive rates of interest and other incentives. They make loans to wholesale traders and retailers, small scale industries and employed persons. Bulk of their loans is given to parties which do not either approach commercial banks or which are denied credit facilities by the latter. The finance companies give loans which are generally unsecured. The rate of interest charged by them is said to be about 18 percent but generally ranges between 24 and 36 per cent. Besides giving advances, the finance companies run chit funds, purchase and discount hundis and discount post-dated cheques.

Essentially, these finance corporations are banks since they perform the basic twin functions of banks, viz., attracting deposits and making loans. However, they are not regarded as banking companies. Hence, there is no minimum liquidity or cash ratio, no specific ratio between their owned funds and deposits. That depositors of these corporations are subject to extreme insecurity is clear from the following

a) Bulk of their loans are unsecured and are given to very risky enterprises and hence, they are charging high rates of interest;
b) The loans, though given for short periods, are renewed frequently and thus, become long-term loans;
c) As there is no exchange of communication between different corporations, it is possible for a person to borrow from more than one finance company; and
d) The deposits of the public with the finance companies are not protected by the Deposit Insurance Corporation.

Apart from these inherent defects, the working of the finance companies has also not been in the interest of the economy. For, it is generally believed that the finance companies are behind hoarders and speculators. They encourage the tax-evaders. Accordingly, there is general consensus that their activities should be controlled and regulated. As these finance corporations are parabanking, institutions, it is necessary to regular their activities on the same lines as in the case of commercial banks. The Banking Commission has, therefore, recommended that:

a) No finance corporation should be allowed to function without a license from the RBI;
b) A specified ratio should be prescribed between their owned funds and their deposit liabilities; and
c) A liquidity ratio should be prescribed for them, but the ratio may be lower than that applicable for commercial banks.

**SUMMARY OF FINDINGS AND SUGGESTIONS**

From the analysis of NBFCs functioning it was clear that despite large scale expansion of commercial banks in India, the NBFCs continue to play a predominant role in the development of agriculture, industry and commerce. It would be good, if their creativities are regulated by RBI, so that they could be developed on a solid and sound basis.

## METHODS OF PROTECTING DEPOSITORS' INTEREST

Another way of protecting the deposits accepted by the NBFCs is to have them guaranteed by their bankers. Companies which operate without any borrowings from the banking system are very few these days. Banks do take into account the public deposits accepted by a company before fixing the credit limits. The increase in the cost of borrowing in the shape of guarantee commission can easily be absorbed by the companies.

To give a measure of protection is to ensure that only sound companies go in for public deposits. This can be done by prescribing certain financial ratios to be satisfied at the time of acceptance of public deposits are sought. The provision that deposits should not be accepted for a period of more than 36 months is a welcome regulation in protecting the interests of depositors wholly.

At present, companies are required to maintain liquid assets equal to a sum which shall not be less than 10 per cent of the amount of deposits maturing during a financial year in the form of bank deposits, unencumbered securities of State and Central Governments or unencumbered approved securities.

Though there is a mushroom growth of NBFCs in the past decades, the information given by the investing public about their fund development on various types of investment is not adequate. NBFCs in their advertisement in the newspapers and magazines, there will be minimum information for attracting the savers to make deposits with them. Thus the unrestricted advertisement permitted by the government gives freedom to some of the NBFCs to cheat the innocent investing public. That is why a strictly regulatory measure becomes essential for making a fair and adequate disclosure of information by NBFCs.

## BANKS' DIVERSIFICATION INTO CHIT FUNDS

Banks are facing competition in deposit mobilization and credit deployment due to disintermediation, liberalization and exodus of bank deposits to capital market. Profitability aspect is compelling the bankers to search for fee based business. Financial services have acquired the status of an industry now.

On the other hand, there is vast potential for chit funding, a fee based financial service, where banks can enter. Since no credit creation or increase in money supply is involved, banks will not be required to maintain either "SLR" or "CRR". The marginal cost for entering into this field will be very much less, because banks already have good branch network, staff and other infrastructural facilities.

At present banks are not permitted under Banking Regulation Act to do chit fund business. The government and RBI can consider allowing banks to play a role in chit funding by making suitable amendments in the Banking Regulation Act. RBI can frame necessary guideline to commercial banks for their chit fund operations. The study on "All India savings and deposits tend patterns" conducted by N.I.B.M. gives the following suggestion to tap the savings of URBAN savers.

"It is found that consumer durables, business assets and house property account for major portion of the savings of (Urban) households. By developing some deposit linked credit schemes at least the amount to be spent on such items may remain with the banks as deposits till such purchases are made."

Chit funds satisfy the requirement of "deposit linked credit scheme" for banks, if they enter into chit-funding. The present emphasis on the fee-based services also goes out with the concept chit-funding. Chit funds offer certain privileges to the depositors to borrow and hence will be superior to any other deposits linked credit plan.

The various study groups have done a very commendable job in a short period. It has rightly taken a pragmatic stand on all issues. Without advocating strict compulsions for registration, it has managed to build certain positive benefits to make it desirable. Of course there is always room for modifications.

The NBFCs are earning more than 18% of rate of return on wned funds. It shows a satisfactory level of performance of NBFCs.

- NBFCs are mobilising large amount of funds through various attractive schemes of deposits. The present study reveals that in the past 10 years, the deposits with NBFCs have grown tenfold.

- The NBFCs are giving credit at cheaper rates and at the same time returns to the depositors are higher because of the elimination of financial intermediaries.

- Timely and easy credit on reasonable terms and conditions is made available from the NBFCs.

- Production bottle-necks due to lack of liquid funds can be avoided through projected cash flow statements.

- Undue credit expansion arising out of credit creating power of bank deposits is avoided.

## SUGGESTIONS

1. All NBFCs can be brought under the full supervision and control of the RBI.

2. To protect the depositors completely, insurance coverage to the deposits with NBFCs has to be extended as in the case of commercial banks.

3. Since the deposits are made for longer periods i.e. up to 3 years fast growing NBFCs are preferred by the investors.

4. NBFCs which give better service are always to be preferred. Good service is possible only if the companies have invested in infrastructure like computerization, better communication, intensive branch network and training of staff.

5. The NBFCs should be encouraged to convert into corporate bodies.

6. The existing investment companies should be identified and they should be regulated through a special legislation.

7. There should be uniform chit fund legislation as applicable to the whole country.

8. NBFCs accepting deposits from the public and making loans and advances should be regulated on the same lines as commercial banks.

9. It. is advisable to check the market price of the shares of these companies. This is because share markets are the real barometers of safety and inherent health of a company.

10. It is a welcome sign that the RBI is seized of the matter and is forming regulations for insisting all the NBFCs to get a credit rating for each of the financial year. This credit rating should be made precondition for inviting deposits from the public.

## CONCLUSION

The whole spirit of the report has been very positive keeping in view the general environment of openness and transparency. The NBFCs have come of age and it has muted the enactments of separate legislation for them, placing them on par with commercial banks. A.C.Shah study group of NBFCs, tried to provide the status of banks for NBFCs. It would be wiser to restrict their activities to only financial services. Property development and marine exports should not be allowed to fall within the ambit of finance companies.

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