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Non Banking Finance Companies: Role & Challenges

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Abstract
Section 45I of the Reserve Bank of India Act, 1934 defines a "nonbanking 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 ofshares/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).
Keywords: NBFC, RBI, financial sector.

Introduction

Non-banking financial companies (NBFCs) engaged in varied financial activities are part of the Indian financial system providing a range of financial services. Although the terms Non Banking Financial Institution (NBFI) and Non Banking Financial Company (NBFC) is generally used interchangeably in India and when referring to each the meaning implied is the same, however technically there lies a difference in the as the terms have been defined in specific terms in the Reserve Bank of India Act (RBI Act) 1934 and hence the necessity for a separate chapter on the subject.

A Non Banking Financial Institution/ Non Banking Financial Intermediary (NBFI) is prevalent in most countries and may have different forms and different definitions in different countries. NBFI will thus serve the purpose of description of a more universal class while we will use the term NBFC as more suited to India.

Objectives

- To study the role of N.B.F.Cs.
- Significance & Challenges faced by it.
- Products offered by N.B.F.Cs.

Role of NBFCs

It is evident in India that with the development of NBFCs segment within the overall financial system, it challenged the other segment's, viz., banks to innovate, to improve quality and efficiency, and deliver at flexible timings and at competitive prices. In fact, in a number of un-treaded paths, NBFCs were the ones to enter first to try the market and develop before banks entered the field. In India, for instance, the loans against gold jewelries were introduced by the NBFCs much before the nationalised banks entered this market. Similarly, lending to small traders and small transport operators, used-commercial vehicle financing, in particular, were initiated by the NBFCs. Practically, many specialised financial services, such as the factoring, lease finance, venture capital finance, financing road transport, etc., were pioneered by the NBFCs. NBFCs have also played a leading role in the business of securities-based lending such as Loan against Shares (LAS), Margin Fund-ing, Initial Public Offering (IPO) Financing, Promoter Funding, etc. These customized credit products have added

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liquidity and encouraged retail participation in public issues in particular and equity markets in gener-al, resulting in better price discovery according to a report by the Task Force appointed by FICCI. Even housing finance was taken to newer heights by the NBFCs. In the recent years, NBFCs also played important role in wider reach of microfinance. Moreover, development of such alternative financing vehicles adds to the liquidity and diversity of the financial system, thereby increasing its effectiveness as an engine for economic growth and enhancing the financial system's capacity to absorb shocks (Carmichael et al, 2002).

Both banks and non-bank financial intermediaries are key prerequisites of sound and stable financial system and development of both sectors offer important synergies. It is interesting to note that the growth in the non–bank financial services industry in many countries has been more rapid than the deposit / lending activities of commercial banks. As a result, banking institutions have sought to diversify away from the traditional commercial banking business i.e., accepting deposits and providing loans to non-traditional banking activities, viz., investment banking, IPO financing and other capital market related activities besides the lease finance etc. NBFIs thus, in general tend to offer enhanced equity and risk-based products...' (RBI, 2005).

It is therefore, necessary to view NBFIs segment of financial system as a catalyst for economic growth and to provide proactive regulatory

Significance of NBFCs in India

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 being 22% only. NBFCs have been pioneering at retail asset backed lending, lending against securities, microfinance etc and have been extending credit to retail customers in under-served areas and to unbanked customers

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.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.

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- **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

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

Conclusion

NBFCs have been playing a crucial role in terms of the macroeconomic perspective as well as strengthening the structure of the Indian financial system. Consolidation in the sector and better regulatory frame-work for NBFCs has helped them become more focused. However, in the real world of competition, NBFCs have to focus more on their core strengths and must constantly endeavor to search for new products and services in order to survive and grow constantly.

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