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Non-Banking Financial company

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Abstract: *NBFC stands for Non-Banking Financial Corporations. As per Section 451(c) of the RBI Act, a Non-Banking Company that carries the business of a financial institution is called a Non-Banking Financial Corporation or NBFC.*

Keywords: NBFC

I. INTRODUCTION

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 instalments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

A major driver of growth in an emerging economy such as India is sustained investment by the private sector. For triggering as well as sustaining investments, a critical factor is stable availability of credit. Historically in the Indian economy, credit has grown faster than gross domestic product (GDP). The ratio between the growth of bank credit and the growth of nominal GDP ranged from 1 to 2 and averaged 1.42 from 1962 to 2019. For most of this period, banks constituted the predominant source of credit in the formal economy whereas bond markets and nonbank lenders accounted for a relatively smaller share of credit.

NBFCs can offer services such as loans and credit facilities, currency exchange, retirement planning, money markets, underwriting, and merger activities.

There are typically two models of providing credit: (i) intermediated credit that flows through the balance sheet of financial institutions such as banks and NBFCs, and (ii) market credit that flows through the bond market (sometimes through risk pass-through vehicles such as mutual funds).

Abstract

In late 2018, the default by a major nonbanking financial company (NBFC) in India led to a credit crunch in the Indian economy. The crisis raises questions about the business model of NBFCs in India, and the role they play alongside banks in the economy. This paper analyses the evolution of the NBFC sector in India over time and its importance in extending credit, and it discusses the factors that may have contributed to the 2018 crisis. The paper attempts to understand the advantages and disadvantages of the business model of NBFCs, and the drivers of their rapid rise and subsequent challenges. The paper also briefly discusses the potential impact of the coronavirus pandemic on the NBFC sector. Drawing on lessons from the past, NBFCs need to be strengthened to play an important role in India's financial landscape.

NBFCs supplement the role of the banking sector in meeting the increasing financial needs of the corporate sector. The Reserve Bank's regulatory perimeter is applicable to companies conducting non-banking financial activity. On the basis of their liability structures, the type of activities they undertake and their systemic importance NBFCs are classified in to twelve types. This paper aims to present a performance NBFCs in India. It includes assets quality, profitability, exposure to sensitive sector and capital adequacy of NBFCs. The study found that there has been some deterioration in asset quality of NBFCs in recent years, but it is better than that of banks. NBFCs also reported better profitability and

capital positions. The RBI is constantly striving to bring necessary regulatory changes in the NBFC to ensure financial stability in the long run.

India's financial sector structure has changed over the last few decades. Banks still dominate, especially public sector banks (PSBs), but private sector banks as well as nonbanking financial companies (NBFCs) are playing an increasingly prominent role. Private banks have generally stronger balance sheets with lower nonperforming loan ratios, although some private banks have faced stresses in recent years as well.

NBFC Registration

NBFC registration refers to the process by which a non-banking financial company (NBFC) obtains authorization and approval from the regulatory authority, typically the Reserve Bank of India (RBI) in India, to operate as a financial institution and provide certain financial services to the public. The registration process involves fulfilling specific criteria, submitting required documents, meeting regulatory guidelines, and complying with financial and operational norms set by the regulatory authority. Once registered, an NBFC can legally engage in financial activities such as lending, investment, and other financial services, subject to the regulations and guidelines provided by the regulatory authority.

NBFC Regulations

NBFC regulations are a set of rules, guidelines, and norms established by regulatory authorities, such as the Reserve Bank of India (RBI) in India, to govern the functioning and operations of non-banking financial companies (NBFCs).

Regulatory Authority: NBFC regulations are overseen by regulatory bodies like the Reserve Bank of India (RBI) in India.

Licensing and Registration: NBFCs need to obtain proper licenses and registration from the regulatory authority to operate legally.

Capital Adequacy: NBFCs are required to maintain a certain level of capital to ensure financial stability and solvency.

Asset Classification: Regulations dictate how NBFCs categorize their assets and loans, ensuring transparency and risk assessment.

Risk Management: NBFCs must have adequate risk management strategies in place to mitigate financial risks.

Corporate Governance: Regulations focus on good governance practices, including board composition, transparency, and accountability.

Features of NBFC

The NBFCs are allowed to accept/renew public deposits for a minimum period of 12 months and maximum period of 60 months. They cannot accept deposits repayable on demand.

NBFCs cannot offer interest rates higher than the ceiling rate prescribed by RBI from time to time. The present ceiling is 12.5 per cent per annum. The interest may be paid or compounded at rests not shorter than monthly rests.

NBFCs cannot offer gifts/incentives or any other additional benefit to the depositors.

NBFCs (except certain AFCs) should have minimum investment grade credit rating.

The deposits with NBFCs are not insured.

The repayment of deposits by NBFCs is not guaranteed by RBI.

There are certain mandatory disclosures about the company in the Application Form issued by the company soliciting deposits.

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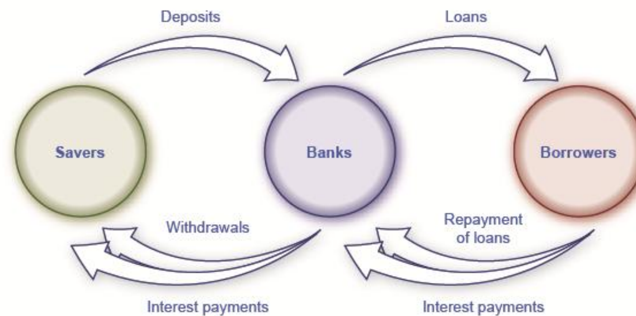

Types of NBFC

Asset Finance Company (AFC)

An AFC is an organisation that conducts the financing of tangible assets as its primary business.

For the purposes of this definition, a company's principal business is any operation that generates at least 60% of its total assets and income from financing tangible assets that support economic activity.

Investment Company (IC)

Any business that engages in the acquisition of securities as its primary business and is a financial institution is referred to as an IC.

Loan Company (LC)

LC refers to any company that is a financial institution and conducts the provision of finance as its primary business. This includes making loans, advances, and other types of financial commitments for activities other than its own.

Infrastructure Finance Company (IFC)

IFC is a non-banking finance business that:

invests at least 75% of its total assets in infrastructure loans;

has a minimum of Rs 300 crore in net owned funds;

has a minimum credit rating of "A" or similar;

has a CRAR of 15%.

Systemically Important Core Investment Company (CIC-ND-SI)

A Core Investment Company (CIC) is a Non-Banking Financial Company (NBFC) that engages in the acquisition of shares and securities and invests at least 90% of its net assets.

Functions of NBFC

NBFCs play a significant role in diversifying the financial landscape by offering a wide range of services that complement traditional banking services. Here are the functions of Non-Banking Financial Companies (NBFCs):

Financial Intermediation: NBFCs act as intermediaries between borrowers and lenders, providing various financial services without being full-fledged banks.

Credit Provision: They offer loans and credit facilities to individuals, businesses, and sectors that might have limited access to traditional banking services.

Investment Activities: NBFCs invest in various financial assets such as stocks, bonds, mutual funds, and other securities.

Leasing and Hire-Purchase: They offer services like leasing and hire-purchase, allowing individuals and businesses to acquire assets without the immediate need for large upfront payments.

Factoring and Bill Discounting: NBFCs provide factoring services where they purchase accounts receivable from businesses and provide immediate funds, helping with cash flow management.

Insurance Services: Some NBFCs offer insurance-related services, especially in rural areas, to provide coverage to those who are underserved by traditional insurance companies.

Foreign Exchange Services: Certain NBFCs offer forex services for individuals and businesses needing currency exchange and remittance facilities.
Microfinance: NBFCs provide microfinance services to financially underserved sections of society, particularly in rural areas, by offering small loans and financial products.
Advisory Services: Some NBFCs offer financial advisory services, helping clients with investment decisions, financial planning, and portfolio management.
Mortgage Services: They provide mortgage loans, allowing individuals to buy or improve real estate properties.
Vehicle Finance: NBFCs offer loans for purchasing vehicles, both for personal use and commercial purposes.
Retail Financing: They provide financing for consumer goods, electronics, and other retail products through partnerships with retailers.

Regulations of NBFC

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Regulatory Authority: NBFC regulations are overseen by regulatory bodies like the Reserve Bank of India (RBI) in India.
Licensing and Registration: NBFCs need to obtain proper licenses and registration from the regulatory authority to operate legally.
Capital Adequacy: NBFCs are required to maintain a certain level of capital to ensure financial stability and solvency.
Asset Classification: Regulations dictate how NBFCs categorize their assets and loans, ensuring transparency and risk assessment.
Risk Management: NBFCs must have adequate risk management strategies in place to mitigate financial risks.
Corporate Governance: Regulations focus on good governance practices, including board composition, transparency, and accountability.
Prudential Norms: NBFCs have to follow specific norms related to lending practices, income recognition, and provisioning.
Disclosure Requirements: NBFCs are required to disclose financial information regularly to provide transparency to investors and stakeholders.
Interest Rates: Regulations often guide NBFCs on the maximum interest rates they can charge on loans.

Role of NBFCs in the Financial System

Non-banking financial companies (NBFCs) in India play a crucial role in the financial sector. They provide a wide range of financial services and contribute to the overall economy in the following ways:
Financial Inclusion:
NBFCs help promote financial inclusion by extending credit and financial services to underserved population segments.
Credit Access:
NBFCs complement the banking sector by providing access to credit for individuals and businesses who may not meet the stringent requirements of traditional banks.
Sector-Specific Financing:
It specializes in catering to specific sectors such as vehicle financing and housing finance.
Rural and Agriculture Development:
NBFCs play a significant role in supporting rural and agricultural development.
Employment Generation:
NBFCs contribute to job creation by facilitating financing for small and medium enterprises (SMEs) and supporting entrepreneurship.
Innovation and Flexibility:
NBFCs often demonstrate greater flexibility and innovation in their products and services, adapting to evolving market demands and customer needs.

II. CONCLUSION

Banks have been the main providers of credit within India's financial system, accounting for around 60 percent of credit to the private sector. Since the 1970s, PSBs have played a pivotal role in India's development strategy by extending credit to sectors prioritized by the government. Although private banks are playing a more important role, NBFCs in particular have grown in recent years as alternative intermediaries of finance. NBFCs have provided an alternative source of credit for businesses and households, now accounting for about one-fifth of the credit of banks.

However, NBFCs also receive a significant share of their funding from banks, increasing the risk that stress in NBFCs can spill over to the banking system. During 2015–18, NBFCs expanded credit at around twice the pace of banks, partly prompted by constrained credit growth by the PSBs and accompanied by higher systemic risk. Subsequently, a high-profile NBFC default in 2018 significantly tightened funding conditions for NBFCs and reduced the flow of credit.

The change in the NBFC regulatory framework has increased the ability of the sector to withstand adverse shocks, but vulnerabilities remain. The introduction of a scale-based framework and the adoption of guidelines for liquidity management represent significant steps toward strengthening NBFCs and reducing the regulatory gap between them and banks. This progressive alignment in regulation could favor consolidation between banks and NBFCs, potentially generating efficiency gains and improving governance. At the same time, the increased inter-connectedness between banks and NBFCs implies that shocks hitting either of these sectors would have immediate and direct spillover on the other. Regulation aimed at limiting bank borrowing by NBFCs, and in general favoring diversification in funding sources, would contribute to weakening interlinkages and preventing a diabolic loop from emerging in the future. Further strengthening the liquidity requirements for NBFCs would contribute to reducing the risk of adverse liquidity shocks leading to insolvency and sectoral stress, as it happened in the past. Closing macroprudential policy gaps, for instance by requiring NBFCs to maintain a net stable funding ratio, as has been the case for banks since 2021, would represent an important step.

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