Volume : 2 | Issue : 8 | Aug 2013 • ISSN No 2277 - 8160

Research Paper | Management

Non Banking Finance Companies: Role & Future Prospects

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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 of NBFCs in India, its significance, the funding sources of NBFCs and its future prospects. Finally the paper concludes that NBFCs have to focus more on their core strengths and must constantly endeavour to search for new products and services in order to survive and grow constantly.*

KEYWORDS: NBFCs, Debentures, Non-performing assets

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 as the definition of NBFC inherently incorporates the fact that it is a company incorporated under the Companies Act, 1956. NBFC is a company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934 which should have a minimum net owned fund of Rs 200 lakh w.e.f April 21, 1999.

Role of NBFCs

By now it is well established, with the experience, that the robust growth and effective functioning of a financial system is vital for economic development. There is universal agreement that a well functioning financial system is necessary for a thriving modern economy (Kroszner, 2010). In all advanced economies, for example, sophisticated financial systems efficiently deliver a broad range of financial services and act as a critical pillar in contributing to macroeconomic stability and sustained economic growth and prosperity (World Bank, 2003). Moreover, the well developed financial markets facilitate mobilization of savings, by offering savers and investors wider choice of instruments. Further, with NBFCs coming up on the financial system, investors could place their funds at more attractive returns in comparison to the bank deposits. This is the single most important reason to explain as to why the NBFCs are popular among lower and middle class population including India. This development paradigm is increasingly recognized around the world, especially in the aftermath of repeated emerging market crises in countries with bank-dominated financial systems. According to a report from the World Bank (2003), developed financial markets also have enhanced access to finance for more firms and individuals at reasonable cost, reduced volatility and distortions, by operating in an environment that is transparent, competitive, and characterised by the presence of a diverse array of products and services, including instruments for effective risk management. All these were made possible because of widening the financial system with effective participation of NBFIs.

Indeed it is evident in India that with the development of NBFCs segment within the overall financial system, it challenged the other segments, 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 jewelleries 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 Funding, Initial Public Offering (IPO) Financing, Promoter Funding, etc. These customized credit products have added liquidity and encouraged retail participation in public issues in particular and equity markets in general, 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).

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).

It is therefore, necessary to view NBFIs segment of financial system as a catalyst for economic growth and to provide proactive regulatory policy support for their contribution towards economic development.

Significance of NBFCs in India:

According to the Economic Survey 2010-11, it has been reported that NBFCs as a whole account for 11.2 per cent of assets of the total financial system. 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. In the multi-tier financial system of India, importance of NBFCs in the Indian financial system is much discussed by various committees appointed by RBI in the past and RBI has been modifying its regulatory and supervising policies from time to time to keep pace with the changes in the system.

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.

Funding source of NBFC sector

Funding source of NBFCs comprises debentures, borrowings from banks and FIs, public deposits, commercial papers, and inter-corporate loans. In FY12, borrowings from banks and FIs, followed by debentures, constituted an important source of funds for NBFCs-D. Borrowings from banks and FIs accounted for 50% and debentures accounted for 29% of the total borrowings of NBFCs-D in FY12. Debentures form an important source of funds for NBFCs-ND-SI. In FY12, debentures accounted for 46% and borrowings from banks and FIs accounted for 32% of the total borrowings of NBFCs-ND-SI.

Figure1

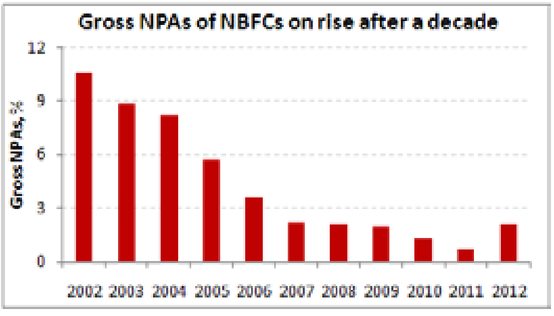

Figure 1 clears that there is a huge decrease in the gross Non- performing Assets (NPAs) of NBFCs from 2007- 2011. In year 2012 there comes again a rise in the percentage of gross NPAs.

Figure 2:

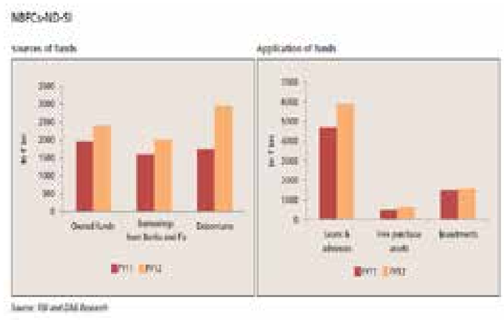

Figure 2 indicates that the balance sheet size of NBFCs-ND-SI as at end-FY12 stood at Rs 9,213 bn, as against Rs 7,613 bn, indicating 21% growth. This rise is mainly due to a sharp increase in borrowings from banks and FIs, and debentures. Secured borrowing constitutes a major source of borrowings and grew 29.3% during FY12. The leverage ratio of the entire NBFCs-ND-SI sector remains unchanged at 2.83% during FY12. On the deployment side, loans and advances continue to constitute the largest share, followed by Investments and hire purchase assets. During FY12, loans and advances grew 25.3% on account of 31.7% growth in secured loans and advances, hire purchase assets grew 26.5%, and investments grew by 5.9% .

Future of NBFCs in India

The passage of the Banking Laws Amendment Bill 2011, has put NBFC stocks in the spotlight. This is true especially of those companies who are actively seeking a banking license. One more factor that has added to the enthusiasm are the recent recommendations by the RBI for the NBFC sector. A panel headed by the former deputy governor of RBI, Usha Thorat has made certain recommendations which will tighten the ropes on the NBFC sector as a whole but ensure a better and safer functional environment. Here are some recommendations which will help in strengthening the NBFC sector going forward:

- Tier -1, or core capital of NBFCs, has been pegged at 12% from 7.5% now.
- The new provisioning rules will be 90 days instead of 180 days.
- The risk weights for NBFCs not sponsored by banks could be raised to 150% for capital market exposures and 125% for commercial real estate (CRE) exposures.
- A minimum asset size of over Rs 50 crore is required for registering a new NBFC.
- The panel has stipulated the maintenance of a statutory liquidity ratio of 15% of aggregate deposits for deposit accepting NBFCs, besides, making applicable ALM guidelines to those holding deposit of Rs 20 crore and above.
- Existing NBFCs will be given a period of 2 years with milestones for achieving the minimum threshold of Rs 25 crore of financial assets.
- All registered NBFCs, both deposit taking and non-deposit taking, should maintain high quality liquid assets in cash, bank deposits available within 30 days, money market instruments maturing within 30 days, investment in actively traded debt

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 framework 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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