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Role of Nbfc's in the Economic System

* Dr. Amardeep

* H.O.D. Faculty of Commerce, S.K.D. Degree College, Baghra (Muzaffarnagar)

ABSTRACT

A robust banking and financial sector is critical for activating the economy and facilitating higher economic growth. Financial intermediaries like NBFCs have a definite and very important role in the financial sector, particularly in a developing economy like ours. They are a vital link in the system. The role of NBFCs in creation of productive national assets can hardly be undermined. This is more than evident from the fact that most of the developed economies in the world have relied heavily on lease finance route in their developmental process.

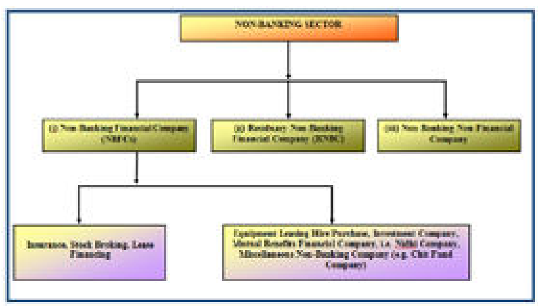
INTRODUCTION

The Non-Banking Finance Companies (NBFCs), spread all over the country, and registered with Reserve Bank of India and authorised to accept public deposits, have joined hands and formed a Self Regulatory Organization (SRO) under the name of Finance Industry Development Council (FIDC). FIDC is registered as a Company u/s 25 of Companies Act, 1956. The main objective of the regulator body is to work towards bringing discipline amongst our members by enforcing a model code of conduct, besides presenting a unified face of this sector.

A robust banking and financial sector is critical for activating the economy and facilitating higher economic growth. Financial intermediaries like NBFCs have a definite and very important role in the financial sector, particularly in a developing economy like ours. They are a vital link in the system. After the proliferation phase of 1980s and early 90s, the NBFCs witnessed consolidation and now the number of NBFCs eligible to accept deposits is around 600, down from 40000 in early 1990s. The number of asset financing NBFCs would be even lower, around 350, the rest are investment and loan companies. Almost 90% of the asset financing NBFCs are engaged in financing transportation equipments and the balance are in financing equipments for infrastructure projects. Therefore, the role of non-banking sector in both manufacturing and services sector is significant and they play the role of an intermediary by facilitating the flow of credit to end consumers particularly in transportation, SMEs and other unorganised sectors. NBFCs due to their inherent strengths in the areas of fast and easy access to market information for credit appraisal, well-trained collection machinery, close monitoring of individual borrowers and personalized attention to each client as well as minimum overhead costs, are in a better position to cater to these segments. Now, unlike in the past, NBFCs are very well regulated and supervised. RBI has classified the non-banking sector in the following manner:

(i) Non-Banking Financial Company – The Principal business is receiving deposits from the public under any scheme and lending in any manner.
(ii) Residuary Non-Banking Company – Receives deposits from the public under any scheme but it does not belong to any of the categories mentioned above under NBFC.
(iii) Non-Banking Non-Financial Company – Refers to an industrial company as defined in the IDBI Act, 1964 or a company whose principal activity is agriculture, trading, etc. which cannot be called as financial activity.
(iv) Residuary Non-Banking Company – Receives deposits from the public under any scheme but it does not belong to any of the categories mentioned above under NBFC.
(v) Non-Banking Non-Financial Company – Refers to an industrial company as defined in the IDBI Act, 1964 or a company whose principal activity is agriculture, trading, etc. which cannot be called as financial activity.

DIAGRAM : 1.
CLASSIFICATION OF NON-BANKING SECTOR



The role of NBFCs in creation of productive national assets can hardly be undermined. This is more than evident from the fact that most of the developed economies in the world have relied heavily on lease finance route in their developmental process, e.g., lease penetration for asset creation in the US is as high as 30% as against 3-4% in India.[1]

A conducive and enabling environment has been created for the NBFC industry globally, which has helped it grow and become an essential part of the financial sector for accelerated economic growth of the countries. This is not the case in our country. It is, therefore, obvious that the development process of the Indian economy shall have to include NBFCs as one of its major constituents with a very significant role to play. NBFCs, as an entity, play a very useful role in channelising funds towards acquisition of commercial vehicles and consequently, aid in the development of the road transport industry.

Needless to mention, the road transport sector accounts for nearly 70% of goods movement and 80% of passenger movement across the length and breadth of the country and the role of NBFCs in the growth and development of this sector has been historically acknowledged by several committees set up by the Government and RBI, over the years. In fact, RBI's latest report titled "Report on trends on progress of banking in India 2007-2008" observes.

"Notwithstanding their diversity, NBFCs are characterised by their ability to provide niche financial services in the Indian economy. Because of their relative organisational flexibility leading to a better response mechanism, they are often able to provide tailor-made services relatively faster than banks and financial institutions. This enables them to build up a clientele that ranges from small borrowers to an established corporate. While NBFCs have often been leaders in financial innovations, which are capable of enhancing the functional efficiency of the financial system, instances of unsustainability, often on account of high rates of interest on their deposits and periodic bankruptcies, underscore the need for reinforcing their financial viability."[2]

For foreign investment purposes, the government has specifically listed certain categories of NBFCs that are eligible to receive foreign investments. Non-banking financial companies (NBFCs) have become an integral part of India's financial system. In recent times, NBFCs have emerged as lenders to both companies and individuals. When it comes to lending, NBFCs are generally regarded to be complementary to banks and are often able to offer better services and products to their customers.

NBFCs have been working under a complex web of directives and guidelines formulated from time to time. Inevitably, some of the directives are viewed by NBFCs as being formulated in arbitrary manner, and at odds with practical realities.

SUGGESTIONS:

(1). Speeding Up The Certification of Registration –The Reserve Bank of India receives applications for Certification of Registration (CoR) and then allows them to accept deposits. The process of CoR is lengthy which should be made expeditious. The RBI should take steps to speed up the reform process in the functioning of NBFC sector along prudent lines. For further development of this sector, emphasis should be placed on formation of a Self Regulatory Organisation (SRO), particularly for the benefit of smaller NBFCs.

(2). Submission of Returns – NBFCs are required to submit periodic control returns to RBI. In order to inculcate a sense of discipline in this sector, action should be taken against NBFCs for non-submission of returns. RBI should impose penalties as provided for in the Reserve Bank of India Act, 1934 as also launch court proceedings, besides considering cancellation of the CoR of NBFCs having public deposits of Rs.50 crore and above, in case of default in the submission of returns. The above stipulation in respect of the size of NBFCs (i.e., Rs.50 crore and above) should be progressively reduced over time to ensure that as far as possible, all NBFCs submit periodic returns on a timely basis.

(3). Provision of Cheaper Finance – The Reserve Bank of India (RBI) should consider options to make cheaper finance available to the non-banking finance companies (NBFCs) including a separate line of credit for bank finance backed by government securities or AAA-rated Commercial Paper (CP).

(4). Relaxation in Prudential Norms- The Central Bank should review the various restrictions on placing bank funds with NBFCs and should also relax prudential ceilings.

(5). Reduction in Systemic Risk – The fund requirement is acute for three or four large NBFCs that have grown rapidly in recent times and accumulated large exposures in the stock market, real estate, commodities and retail financing. The only reason such entities need assistance is that they pose a systemic risk. The problem is acute not because there is a dearth of liquidity but because banks are unwilling to lend to NBFCs. They feel that these institutions lend to the real estate sector and for stock market transactions, both of which may face a downturn. Therefore, the loans may turn bad at a time when liquidity is an issue.

(6). Grant of Bridge Loans – At present, a bank's exposure to a single NBFC is currently capped at 10 per cent of banks' capital funds and 15 per cent for an NBFC engaged in asset financing companies. NBFC's should also be allowed to make bridge loans. Shares and debentures should be accepted as collateral for secured loans granted to NBFCs.

(7). Increase in CAR – NBFCs in the category of equipment and hire purchase companies should endeavour to increase their CAR to 15 per cent as early as possible.

(8). NBFCs to be covered under SRFAESI Act, 2002 – It is highly unfortunate that there is no law/regulation prevailing in the country today which facilitates recovery of our dues from our borrowers. Prudence tells us that timely recovery of our dues will ensure timely payment of all our liabilities including public deposits.

It is recommended that the provisions of SRFAESI Act, 2002 should also be made applicable to NBFCs also. NPAs are a problem common to all the lenders in the financial sector whether they are Banks, Financial Institutions or NBFCs. Moreover, prudential norms for asset classification, income recognition, Provisions etc. are applicable to NBFCs at par with those for Banks and FIs. Under these circumstances, it is suggested that the benefits of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SRFAESI), 2002 should also be extended to NBFCs.