

# Non-Banking Financial Companies in India – A Conceptual Framework

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## ABSTRACT

This study focus on the non-banking financial companies in India – a conceptual framework It should be noted that during the 36-month period from April 1997 to March 2000, Crisis downgraded 149 NBFCs due to their deteriorating business and financial risk profiles and credit fundamentals. The stringent regulations, refusals for registration and the notifications regarding the cancellation of the permissions to raise deposits have gradually reduced the fly-by-night operators. NBFCs are now struggling hard to find reasons for continued existence, strategies for such existence and business areas for growth and earnings.

**KEYWORDS:** NBFC's, Customer, CRM, Digital Marketing, RBI

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## INTRODUCTION

Non-Banking Financial Companies (NBFCs) in India were having golden days during 1990s. Their hay days were fuelled with the rapid industrial growth due to liberalization in 1991, simple resource-raising regulations and eager and greedy investors ready to put their savings into any finance company. As has been said, when you have a sample amount of something with you, you do not care for it, NBFCs too have invested heavily but unwisely. Growth-at- any-cost was the strategy of some of the NBFCs. Moreover, due to many of these weaknesses NBFCs could not pay the hefty interest during the industrial showdown during 1997 bringing to an end the golden period (or otherwise) of NBFCs. The rating agencies downgraded many companies which were followed by the RBI tightening the resource-raising and prudential norms in January 1998.

### The Task Force on Non-Banking Finance Companies

The Task Force on Non-Banking Finance Companies (NBFCs) submitted its report on October 28th, 1998. The major recommendations are as under: - The rising number of defaulting NBFCs and the need for a quick redressal system call for change in the existing legislative and regulatory framework for NBFCs. Extension of the period for attaining minimum Net Owned Funds (NOF) beyond three years (January 2000) should be made conditional and adequate steps having been taken by the concerned NBFCs. Also, the minimum prescribed NOF of Rs. 25 lakh be considered for

upward revision. The Reserve Bank of India should draw up a time bound programme for disposal of applications for registration of NBFCs and keep States informed of registration granted/rejected in respect of NBFCs in the respective states. Higher CRAR of 15 percent for NBFCs seeking public deposits without credit rating be prescribed by RBI, as against existing 12 percent for rated NBFCs. Ceilings for exposures to real estate sector and investment in capital market, especially unquoted shares, are prescribed by the Reserve Bank of India. The Reserve Bank of India may stipulate 25 percent of reserves of NBFCs to be invested in marketable securities in addition to Statutory Liquidity Ratio (SLR) securities already held by them. The following ceilings may be prescribed for public deposits in respect of different categories of NBFCs.

NBFC with NOF less than Rs. 25 lakh deposits credit rating Loan/Investment Companies are eligible for registering the firm in RBI. Also, some statutory provisions are made to provide to unsecured depositors first charge on liquid assets. Depositors' grievance redressal authority with specified territorial jurisdiction is appointed by the RBI with the help of the office of the Banking Ombudsman available in several states. Separate instrumentality for regulation and supervision of NBFCs be set up under the aegis of the RBI and entrusted under one Executive Director, supervised by a Deputy Governor. To strengthen the off-site surveillance

mechanism to identify/control NPAs; sensitive market intelligence system be developed to trigger on site inspection, to be followed by appropriate regulatory response. Deposit-taking by unregistered NBFCs be made a cognizable offence; State Governments should set up special investigation wings for enforcing this provision. Unauthorized deposit taking by unincorporated financial intermediaries should also be made a cognizable offence. They should attain the minimum CRAR of 15 percent on or before March 31st, 2000 as per their audited balance sheet, failing which they should regularize their position by repayment or otherwise by December 31st, 2001.

### Non-Banking Financial Company

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by the government or local authority or other securities of marketable nature, leasing, hire purchase, insurance business, chit business, but does not include any institution whose principal business is that of agricultural activity, industrial activity, sale/purchase/construction of immovable property. A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement or any other manner, or lending in any manner is also a non-banking financial company (residuary non-banking company).

### NBFC and Bank

NBFCs are doing functions akin to that of banks; however there are a few differences:

1. A NBFC cannot accept demand deposits that are payable on demand immediately or within a very short period like current or savings accounts.
2. It is not a part of payment and settlement system and cannot issue cheques to its customers; and
3. Deposit insurance facility of Deposit Insurance Credit Guarantee Corporation (DICGC) is not available for NBFC depositors unlike in the case of banks.

### NBFC and Registration

In terms of Section 45-IA of the RBI Act, 1934, it is mandatory that every NBFC should be registered with the RBI to commence or carry on any business of non-banking financial institution as defined in clause (a) of Section 45-IA of the RBI Act, 1934. However, to obviate dual regulation, certain category of NBFCs which are regulated by other regulators are exempted from the requirement of registration with the RBI viz. venture capital fund/merchant banking companies/stock broking companies registered with Securities Exchange Board of India (SEBI), insurance company holding a valid certificate of registration issued by Insurance Regulatory Development Authority (IRDA), nidhi companies as notified under Section 620A of the Companies Act, 1956, chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982 or housing finance companies regulated by National Housing Bank.

### Types of Non-Banking Finance Companies

The NBFCs that are registered with the RBI are: (i) Equipment Leasing Company; (ii) Hire-Purchase Company; (iii) Loan Company; and (iv) Investment Company.

However with effect from December 6, 2006 the above NBFCs registered with RBI have been reclassified as (i) Asset Finance Company (AFC), (ii) Investment Company (IC) and (iii) Loan Company (LC).

- I. Asset Finance Company (AFC)** would be defined as any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising there from is not less than 60 percent of its total assets and total income respectively.
- II. Investment Company (IC)** would be defined as a company whose main business is holding securities of other companies purely for investment purposes. The investment company invests money on behalf of its shareholders who in turn share in the profits and losses. There are at least three types of investment companies:
  - A. Open-End Management Investment Companies (Mutual Fund)
  - B. Closed-End Management Investment Companies (Closed End Fund)
  - C. UITs (Unit Investment Trust)
- III. Loan Company (LC)** means any company which is a financial institution carrying on as its principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an equipment leasing company or a hire-purchase finance company.

### The Rules and Regulations

The Indian economy is going through a period of rapid 'financialisation\*'. Today, the 'intermediation\*' is being conducted by a wide range of financial institutions through a plethora of customer-friendly financial products. The segment consisting of Non-Banking Financial Companies (NBFCs), such as equipment leasing/hire purchase finance companies have made great strides in recent years and are meeting the diverse financial needs of the economy. In this process, they have influenced the direction of savings and investment. The resultant capital formation is important for our economic growth and development. Thus, from both the macroeconomic perspective and the structure of the Indian financial system, the role of NBFCs has become increasingly important. It is interesting to note that as at the end of March 1996 the regulated deposits (deposits which RBI regulates) of 10,194 NBFCs amounted to Rs.45, 439 crore. The borrowing of these companies stood at Rs.62, 995 crore. One of the most important components of these deposits/borrowings is deposits from public in which the RBI is more concerned. Such deposits stood at Rs.17, 883 crore excluding Housing Finance Corporations (HFCs) which comes out to 4.25 percent of the total deposits of scheduled commercial banks.

The momentum of recent developments in non-banking financial sector has evinced considerable debate. While there is a class in the industry strongly opposing the strengthening of regulatory framework and focusing closer supervisory attention, ostensibly in support of principle of free market,

the other is urging the Reserve Bank to intervene and enhance the image quotient of the industry so that a moderate level of sustainable growth is assured of. To appreciate and understand the present predicament, it is better to look back to the history of the regulation of NBFCs. To briefly recapitulate, the scheme of regulation of NBFCs originated in mid-sixties when sudden upsurge in deposit mobilization by Non Banking Companies was noticed.

However, the focus of regulation was mainly intended to ensure that it serves as an adjunct to monetary and credit policy and also provides an indirect protection to the depositors. The focus continued to be the same till early 90s. Over a period of time, especially during late 80s and early 90s, NBFCs have penetrated into the main stream of financial sector and have established themselves as complements of banking industry.

### Requirements for Registration

A company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 IA of the RBI Act, 1934 should have a minimum net owned fund of Rs 25 lakh (raised to Rs 2 crore from April 21, 1999). The company is required to submit its application for registration in the prescribed format along with necessary documents for bank's consideration. The bank issues certificate of registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

### List of registered NBFCs and instructions

The list of registered NBFCs is available on the web site of the Reserve Bank of India and can be viewed at [www.rbi.org.in](http://www.rbi.org.in). The instructions issued to NBFCs from time to time are also hosted at the above site. Besides, instructions are also issued through Official Gazette notifications. Press releases are also issued to draw attention of the public/NBFCs.

### Requirements for accepting public deposits

All NBFCs are not entitled to accept public deposits. Only those NBFCs holding a valid certificate of registration with authorization to accept public deposits can accept/hold public deposits. The NBFCs accepting public deposits should have minimum stipulated net owned fund and comply with the directions issued by the bank.

An NBFC maintaining required NOF/CRAR and complying with the prudential norms can accept public deposits as follows:

- A. Category of NBFC
- B. Ceiling on public deposits
- C. AFCs maintaining CRAR of 15 percent without credit rating
- D. AFCs with CRAR of 12 percent and having minimum investment grade credit rating 1.5 times of NOF or Rs 10 crore whichever is less
- E. Four times of NOF
- F. LC/IC with CRAR of 15 percent and having minimum investment grade credit rating 1.5 times of NOF

Presently, the maximum rate of interest a NBFC is 11 percent. The interest may be paid on compounded rates. 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.

### Responsibilities of Non-Banking Finance Companies

The NBFCs accepting public deposits should furnish to the RBI:

- A. Audited balance sheet of each financial year and an audited profit and loss account in respect of that year as passed in the general meeting together with a copy of the report of the Board of Directors and a copy of the report and the notes on accounts furnished by its Auditors;
- B. Statutory Annual Return on deposits
- C. Certificate from the Auditors that the company is in a position to repay the deposits as and when the claims arise
- D. Quarterly Return on liquid assets;
- E. Half-yearly Return on prudential norms;
- F. Half-yearly Asset Liability Management (ALM) Returns by companies having public deposits of Rs. 20 crore and above or with assets of Rs.100 crore and above irrespective of the size of deposits
- G. Monthly return on exposure to capital market by companies having public deposits of Rs 50 crore and above and
- H. A copy of the Credit Rating obtained once a year along with one of the Half-yearly Returns on prudential norms as at (e) above.

The NBFCs having assets over Rs. 100 crore but not accepting public deposits are required to submit a Monthly Return on important financial parameters of the company. All companies' not accepting public deposits have to pass a board resolution to the effect that they have neither accepted public deposit nor would accept any public deposit during the year. However, all the NBFCs (other than those exempted) are required to be registered with the RBI and make sure that they continue to be eligible to remain Registered. Further, all NBFCs (including non-deposit taking) should submit a certificate from their Statutory Auditors every year to the effect that they continue to undertake the business of NBFI requiring holding of Certificate of Registration under Section 45-IA of the RBI Act, 1934. The RBI has powers to cause inspection of the books of any company and call for any other information about its business activities. For this purpose, the NBFC is required to furnish the Information in respect of any change in the composition of its Board of Directors, address of the company and its directors and the name/s and official designations of its principal officers and the name and office address of its auditors. With effect from April 1st, 2007 non-deposit taking NBFCs with assets size of Rs.100 crore and above have been advised to maintain minimum CRAR of 10 percent and shall also be subject to single/group exposure norms.

An NBFC accepts deposits under a mutual contract with its depositors. In case a depositor requests for pre-mature payment, the Reserve Bank of India has prescribed Regulations for such an eventuality in the Non Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 wherein it is specified that NBFC can not grant any loan against a public deposit or make premature repayment of a public deposit within a period of three months (lock-in period) from the date of its

acceptance, however in the event of death of a depositor, the company may, even within the lock-in period, repay the deposit at the request of the joint holders with survivor clause / nominee / legal heir only against submission of relevant proof, to the satisfaction of the company. An NBFC subject to satisfied the above provisions, without any problem, may permit after the lock-in period premature repayment of a public deposit at its sole discretion, at the rate of interest prescribed by the Bank. The prohibition shall not. However, apply in the case of death of depositor or repayment of tiny deposits i.e. up to Rs. 10,000 subject to lock-in period of 3 months in the latter case.

### Conclusion

The Indian economy is going through a period of rapid 'financialisation'. Today, the 'intermediation' is being conducted by a wide range of financial institutions through a plethora of customer friendly financial products. The segment consisting of Non-Banking Financial Companies (NBFCs), such as equipment leasing/hire purchase finance companies have made great strides in recent years and are meeting the diverse financial needs of the economy. In this process, they have influenced the direction of savings and investments. The resultant capital formation is important for our economic growth and development. Thus, from both the macroeconomic perspective and the structure of the Indian financial system, the role of NBFCs has become increasingly important. Further, a direct linkage with the SHGs can ever attract the interest of commercial banks for prolonged periods. It is more likely that most of the commercial banks may rely on indirect linkages through NGOs or SHG federations. At last, for sourcing international funds for Micro Finance Institutions (MFIs), Reserve Bank of India internal panel recommended to the government to consider reducing the threshold limit for Foreign Direct Investment (FDI) for Non-Banking Finance Companies (NBFC)-Micro Finance Institutions (MFIs).

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