

NON-BANKING FINANCIAL INSTITUTIONS AND THEIR CONTRIBUTION TO THE INDIAN FINANCIAL SYSTEM

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ABSTRACT

The financial sector in any economy consists of several intermediaries. Apart from banking entities, there are investment intermediaries (such as mutual funds, hedge funds, pension funds, and so on), risk transfer entities, information and analysis providers, investment banks, portfolio managers and so on. All such entities that offer financial services other than banking, may be broadly called non-banking financial institutions. The Non-Banking Financial Companies (NBFC's) have emerged as substantial contributors to the Indian economic growth by having access to certain deposit segments and catering to the specialized credit requirements of certain classes of borrowers. A non -banking institution which is a company and which has its principal business of receiving deposits under any scheme of arrangement of any other manner, or lending in any manner is also a non-banking financial company. While NBFCs have been rendering many useful services, several adverse, unhealthy features of their working also have been observed. The protection of savers from malpractices has been one of the important issues. The authorities have evolved an appropriate regulatory/statutory framework to oversee the operations of NBFCs. The current study looks at the significance of non-banking financial companies (NBFCs) in India's economic development, as well as the issues they face.

Key words : Financial Sector, Non-Banking Financial Companies,

INTRODUCTION

NBFC is a Financial Institution that is into Lending or Investment or collecting cash under any plan or arrangement but does not include any institutions which operate on its major business-like agricultural activity, industrial activity, trade and acquisition or sale of immovable assets. A firm that engages on the business of receiving deposits as its core activity is likewise an NBFC.

India has a varied financial industry experiencing fast development, both in terms of the robust growth of current financial services organisations and new entities joining the market. The sector contains commercial banks, insurance firms, non-banking financial businesses, co-operatives, pension funds, mutual funds, and other smaller financial enterprises. The banking regulator has enabled new organisations such as payments banks to be founded lately so adding to the kinds of businesses functioning in the industry.

Non-Banking Financial Companies (NBFC) in India had a modest starting far back in the 1960's to fulfil the demand of the savour and investor whose financial needs were not adequately covered by the existing banking system in India. The NBFCs started to request fixed deposit from investor and work out

lease contract for major industrial enterprises. Initially, they functioned on a small scale and could not have a substantial influence on the financial system. However, during 1980's and 1990's, NBFCs gained solid footing and began to inveigle a big number of investors due to their consumer-friendly reputation. Non-Banking Financial Firms or NBFCs in India are registered companies doing commercial operations similar to normal banks. Their banking activities involve making loans and advances accessible to individuals and companies, acquisition of marketable securities, leasing of hard assets such as autos, hire-purchase and insurance business. Though they are comparable to banks, they vary in handful key aspects.

NBFCs cannot take demand deposits, cannot issue checks to consumers and the deposits with them are not protected by DICGC (Deposit Insurance and Credit Guarantee Corporation) (Deposit Insurance and Credit Guarantee Corporation). Either the RBI (Reserve Bank of India) or SEBI (Securities and Exchange Board of India) or both regulate NBFCs. The NBFC industry in India has undergone substantial vicissitude over the last several years and has grown to be regarded as a fundamentally crucial aspect of the financial system. The NBFC market has undergone consolidation throughout the recent past, notably in the NBFCND-SI category. Indeed, it is obvious in India that with the expansion of NBFCs sector within the broader financial system, it forced the other segments, i.e. banks to innovate, to increase quality and competence, and provide at flexible timings and at competitive pricing. In reality, in a lot of un-treaded paths, NBFCs were the ones to venture first to study the industry and expand before banks joined the space. NBFCs are widely categorized into two groups depending on whether they take public deposits, i.e. NBFC-Deposit taking (NBFC-D) and NBFCs-Non-Deposit taking (NBFC-ND) (NBFC-ND). Besides, there are only two residuary non-banking financing companies (RNBCs) which are also deposit taking firms of distinct character. In the recent years, infrastructure financing has gathered momentum, and NBFCs involved in infrastructure finance are designated 'Core Investment Companies'.

The financial sector in each economy consists of numerous intermediaries. Apart from banking entities, there are investment intermediaries (such as mutual funds, hedge funds, pension funds, and so on), risk transfer entities (such as insurance companies), information and analysis providers (such as rating agencies, financial advisers, etc), investment banks, portfolio managers and so on. All such businesses that provide financial services other than banking, may be roughly dubbed non-banking financial institutions.

NON-BANKING FINANCIAL COMPANY

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition 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 installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary nonbanking company).

REVIEW OF LITERATURE

Raj (1999) claims that the Indian government's involvement in controlling resource allocation in the financial sector was warranted prior to the 1980s due to popular concern about potential market inefficiencies. The majority of the initial 85-year plans overlooked the role of the financial sector in driving growth (Patra and Roy, 2002). Despite its size, the Indian financial sector has been recognized for providing a limited contribution to a locative efficiency due to a system that impeded optimal pricing (Joshi and Little, 1996).

Shollapur (2005) underlines NBFCs' significant contribution to India's financial sector, stating that they enhance the services provided by commercial banks. Their capacity to provide adaptable and effective financial services has allowed them to expand their customer base to encompass both large corporate entities and small-scale borrowers. Amita (1997) analyzed the financial performance of non-banking financial organizations (NBFCs) in India from 1985 to 1986 and 1994 to 1995. This investigation discovered that some Non-Banking Financial Companies (NBFC) groups display distinct patterns of behavior.

Balachandran (2006) in his study on NBFCs has revealed that in the financial market, different financial products are available which provide on effective payment and credit system and thereby facilitate the channelizing of funds from savers to investors in the economy and thus the NBFCs play an important role in Indian financial system. The researcher has also traced the growth of NBFCs from 7000 in 1981 to 40,000 in 1995. Deposits in these NBFCs have been growing at a much higher rate than with commercial banks. Dubey and Shubhashish (2007) analysed that NBFC's in India had a great revolution after 1991 liberalization which led to simple regulatory mechanisms and allowance to greedy investors to park their money with NBFC's. With more customers' base and unwise investments started rising to have large profitability. This in turn leads to weak not compatible with strong players and fading of golden era for NBFC's. Jafor (2009) stated that the NBFCs have been playing a very significant role in the present day rigorous money-market conditions. They are serving the nation by supporting the economic reconstruction and giving a booster to industrial production. They are engaged into the business of providing loans and advances of small amounts for a short-period to small borrowers. The NBFCs play an important role in channelizing these savings into investment. They have supplemented the role played by the banks. Sundaram (2010) has analyzed the growth, profitability and Financial Performance of NBFCs. The researcher suggested that the RBI must exercise full control over the NBFCs like that of its control over commercial banks, since these companies are growing very fast as that of banks.

Khalil (2011) analyzed the financial performance of those non-bank finance companies which are providing the services of investment advisory, asset management, leasing and investment finance for 2 years from 2008 to 2009. Ratio analysis method has been used to analyze the. The study concluded that the financial performance of NBFCs was better in 2008 as compared to the overall decline in 2009 caused by many factors. Suresh (2011) investigated the performance of NBFCs in India (other than banking, insurance, and chit fund companies) during the year April 2008–March 2009. Study highlighted that Financial and Investment Companies' growth in income, main as well as other, decelerated during the period and growth of total expenditure also decelerated but it was higher than the income growth. Sornaganesh et al. (2013) investigated the fundamental analysis of NBFC in India to analyze the profitability position of 5 sample NBFC companies, like STF, SF, BF, and M and MF for the period from April 2008 to March 2012, using Ratio Analysis. The study revealed that SF has performed better in terms

of Earnings Per Share but STF and M&MF are far better than other in NPM. Perumal and Satheskumar (2013) studied on the topic “NBFCs” analyzing the Balance Sheets and income statements of two sample companies, viz., Sundaram Finance Limited and Lakshmi General Finance Limited for the period 2007–2012 using primary and secondary data. The study was performed using various statistical techniques such as average, standard deviation, co-efficient of variation, trend analysis, index number, etc. and concluded that the contribution of NBFCs to economic development is highly significant.

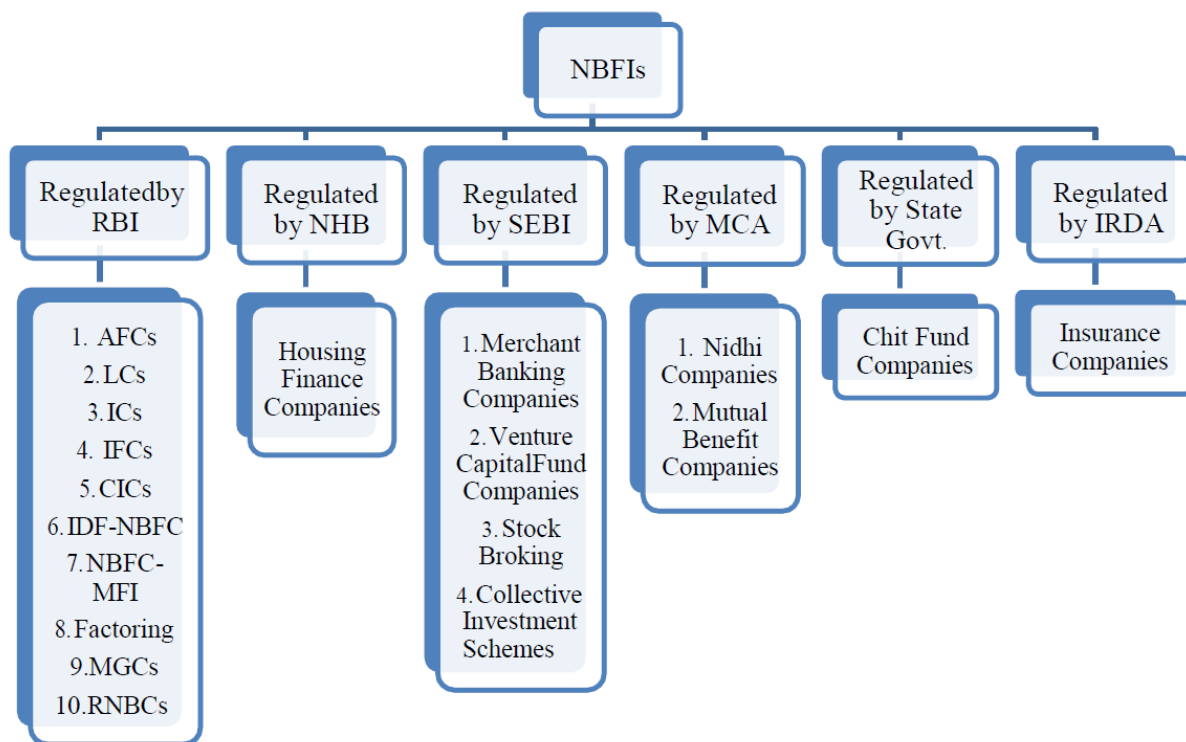
Kumar and Naresh (2011) conducted a study using CAMEL ranking approach to assess relative performance of Indian public sector banks. The study observed that there is significant difference between the mean values of CAMEL ratios of public sector banks. It is found that the top two performing banks are Bank of Baroda and Andhra Bank because of high capital adequacy and asset quality. The study recommends that banks has to improve its management efficiency, asset, earning quality and liquidity position. Kumar and Kumar (2012) highlighted that though ranking of ratios is different for different banks in State Bank group. But there is no statistically significant difference between the CAMEL ratios. It signifies that the overall performance of State Bank group is same; this may be because of adoption of modern technology, banking reforms and recovery mechanism. SBI needs to improve its position with regard to asset quality and capital adequacy, SBBJ should improve its management efficiency and SBP should improve its earning quality. Kumar and Afroze (2013) revealed that Loans, Management Efficiency, Liquidity and Sensitivity have statistically significant influence on the capital adequacy of private sector banks. However, the independent variable asset quality has negligible influence on capital adequacy of Indian private sector banks. Moreover, the study reveals that the Indian private sector banks maintain a higher level of capital requirement than prescribed by Reserve Bank of India. Kumar and Sanjeev (2013) applied capital adequacy, assets quality, management, earning, liquidity, systems and controls (CAMELS) model on the secondary data Indian old private sector banks the period from 2007 to 2012. The study reveal that 6 banks out of 13 selected banks have shown good and excellent financial performance. Tamil Nadu Mercantile Bank secured first position in terms of overall composite ranking followed by Federal Bank. On the basis of CAMELS criteria Tamil Nadu Mercantile Bank, Federal Bank and Nainital Bank have shown excellent financial performance. On the contrary Catholic Siyrian Bank, ING Vysya Bank and Dhanalakshmi Bank Kumar (2012) expressed that Reserve Bank of India recommended two supervisory rating models named as CAMELS and capital adequacy, assets quality, compliance, systems and controls for rating of Indian commercial, private and foreign banks operating in India.

Mohan 2013 highlighted that traditionally, India has had a bank-dominated financial sector. Even so, there have always been NBFCs. These were in early times that small family used to run businesses for deposits acceptance and lending activities. Even today, the sector may be „small“ as compared to banking sector with a total asset size of just around 14 percent of that of scheduled commercial banks (other than RRBs) but there is no denying that the sector has grown tremendously over the years in size, form and complexity, with some of the NBFCs operating as conglomerates having business interests spread to sectors like insurance, broking, mutual fund and real estate. Concomitant with the above, interconnectedness and systemic importance of the NBFC sector also have increased. Financial Inclusion has been the main focus of the RBI since its inception. Financial inclusion has been defined as the “provision of affordable financial services” to those who have been left unattended or under-attended by formal agencies of the financial system. The current paper analyses the need of NBFCs in Indian economy, their importance in the Financial Inclusion, what challenges do they face and what measures must be taken to enhance their effectiveness.

In the light of the above review of literature the main objective of the study is to provide theoretical knowledge about the role and challenges face by NBFCs in India. The nature of present study is mainly qualitative and does not make use of any statistical technique for analysis. The present study has been done mainly on the basis of literature review and secondary information available from various journals, conference proceedings and reports of professional bodies.

NBFI UNIVERSE

Non-banking Financial Institutions carry out financing activities but their resources are not directly obtained from the savers as debt. Instead, these Institutions mobilize the public savings for rendering other financial services including investment. All such Institutions are financial intermediaries and when they lend, they are known as Non-Banking Financial Intermediaries (NBFI) or Investment Institutions.



LEGAL REGULATIONS

Banks in India are regulated and supervised by the Reserve Bank of India (RBI) under the RBI Act of 1934, Banking Regulation Act, Regional Rural Banks Act, and the Cooperative Societies Acts of the respective state governments for cooperative banks.

NBFCs are registered under the Companies Act, 1956 and are governed under the RBI Act. There is no specific law catering to NGOs although they can be registered under the Societies Registration Act, 1860,

the Indian Trust Act, 1882, or the relevant state acts. There has been a strong reliance on self-regulation for NGO MFIs and as this applies to NGO MFIs mobilizing deposits from clients who also borrow. This tendency is a concern due to enforcement problems that tend to arise with self-regulatory organizations. In January 2000, the RBI essentially created a new legal form for providing microfinance services for NBFCs registered under the Companies Act so that they are not subject to any capital or liquidity requirements if they do not go into the deposit taking business.

DIFFERENCE BETWEEN BANKS AND NBFC

Sr. No.	Parameter	Banks	NBFCs
1.	Acceptance of Demand and Term Deposits	Demand Deposits- Permitted Term Deposits- Permitted, subject to term restrictions	Demand Deposits-Not permitted Term Deposits- Permitted subject to limitations, but the term of deposit is at least one year
2.	Payment and Settlement Systems	Banks are a part of Payment and Settlement Systems also controlled by RBI	NBFCs cannot take part in Payment and Settlement Systems i.e. it cannot issue cheques drawn on itself
3.	Need for a license	Licensing norms are tightly controlled and generally, it is perceived to be quite difficult to get a license for a bank	It is comparatively much easier to get registration as an NBFC. Besides, there are NBFCs currently registered, many of which may be available for sale
4.	Deposit insurance facility of DICGC	Available for Banks	Not available for NBFC
5.	Establishment Act	Established under Banking Regulation Act 1949	Established under Companies Act 1956
6.	Foreign Investment	Upto 74% capital in banking companies may be acquired for foreign owners.	100% capital may be held by foreign owners subject of minimum capitalization requirements under FDI

RECENT TRENDS IN NON BANKING FINANCIAL INSTITUTION

- 1. Regulatory changes and complexity :** Since the financial crisis, regulatory pressures have increased the cost of capital, prompted banks to divest themselves of 'risky' or capital intensive businesses or departments, shaped bank attitude towards risk and redrawn the boundary between retail and wholesale banking. Banks have withdrawn from lending to certain constituents, such as SMEs and infrastructure, whilst investing and recruiting heavily in compliance to meet new regulatory requirements. Amidst this regulatory pressure, non-banking financial institutions,

especially FinTech firms that are not subject to the same financial pressures, are offering competing services to bank clients, establishing specific funds or investing in new challengers.

2 Digitalisation and technological advances : Technological advancement is changing financial institutions and the ways people interact. It has created opportunities for new challengers to disrupt traditional business models and penetrate new markets. The ubiquity of technology across the globe, such as the World Wide Web, mobile phones and Apps, has created FinTech companies who offer lower cost services for traditional services, such as e-payments and online trading. Technology is changing the way that customers interact with financial institutions. Although investment in IT infrastructure has increased massively over the last few years, many traditional banks remain behind the curve. Social media companies such as Facebook, Twitter and Google have a huge user base and are moving into the financial sector, bringing new sources of capital and investment.

3 Changes in investment and capital sources and returns : Regulatory capital requirements are causing a drag on returns and taking significant management time. Banks are complying with stress tests, responding to regulatory investigations or managing increasingly punitive regulatory fines. Some non-bank financial institutions are more profitable than banks and are as large and significant in terms of global stability. Entrants with lighter regulatory burdens are moving into areas (insurance, lending, ownership of hard assets) traditionally undertaken by banks, in a search for yield, and are creating or exploiting opportunities. Non-bank financial institutions are investing in new challengers to banks. New FinTech firms, providing financial solutions, are investing heavily and online only banking ventures, or other platforms, are attracting investment and gaining traction.

4 Demographic and behavioural changes : There is a new generation of young people (millennials) with different expectations and ways of interacting with financial institutions: through online and social media based platforms. They are using social media to connect, communicate or complain and do not have traditional customer loyalties. Mature customers and retirees are demanding improved returns from investments and moving against intermediaries due to a perception of a lack of transparency. There is government and regulatory pressure upon pension funds and asset managers to reduce management fees yet maximise returns for the 'grey market'. High net worth and ultra high net worth individuals and families are growing outside of the UK/US/Europe, in new regions, such as LatAm, the Middle East and parts of Asia. This is in concert with improved education, skills and a rising middle class in these areas creating a new 'mass affluent' class, potential client base and work force.

5 Global talent and skills race : Regulatory pressures, risk management and technological advances are creating a new and challenging environment which risks driving out some of today's leaders. Financial institutions will need new leaders who can identify, understand and manage new and emerging risks. New leaders will be sought by traditional banks, NBFIs, FinTech firms and regulators. Competition will become fierce as the talent pool decreases but demand increases for those who can keep pace with the changing financial landscape. Emerging markets such as LatAm and Asia will offer new consumers and a highly skilled labour force, creating new outsourcing hubs in regions outside the UK/ US and Europe. Technology will diminish the geographical divide but only new leaders will bridge the cultural differences. There will be a renewed focus on risk management but, as regulators improve their understanding of risk and compliance, there will be a skills gap as firms try to recruit new staff, up-skill existing teams and rely on specialist risk advisors.

6 Business operating model pressures : Traditional business operating structures are under pressure from regulators demanding transparency over fees and greater competition for consumers. There is pressure on the efficacy/profitability of the universal bank model and a return to the wholesale/retail banking division, driving down returns and potentially stifling innovation. The financial sector is becoming increasingly segmented. Regulatory pressures and the cost of capital is pushing financial institutions to focus on core consumers, creating opportunities for specialist service providers, such as infrastructure or SME focused funds or through online platforms. There is a rise of specialist retail and wholesale competitors, or successful regional banks in the US or Multilatinas. These pressures are also driving disintermediation as intermediaries are displaced and/or specialist providers cater to specific sectors and take market share from traditional FIs. New challengers are obtaining market share through innovative uses of technology, such as P2P lending, crowd funding and mobile payment.

CONCLUSION

These non-bank financial institutions (NBFCs) have recently come to be recognized as a critical component of our financial system. From the perspective of traditional financial institutions, these companies service a "undeserved" clientele: retail clients who cannot qualify for a loan owing to their low credit score and inadequate or nonexistent documents. Through the process of functional specialization, the operations of NBFCs in India have experienced qualitative shifts throughout time. Since NBFCs can make decisions more quickly, take on more risk, and tailor their services and fees to each individual customer, they are widely acknowledged as efficient financial intermediaries. It's no secret that non-bank financial companies (NBFCs) in India have risen to prominence in a variety of industries, from hire purchase financing and equipment leasing to loans and even investing. Fee-based business is growing faster than fund-based business for NBFCs. They are currently concentrating on the retail sector, particularly in the areas of mortgage lending, unsecured consumer loans, and insurance distribution. The robust NBFCs have quickly been established as "financial institutions," and they are now transforming into "financial supermarkets," or one-stop financial shops.

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