Non-Banking Financial Companies-A Critical Review

Sachin Singh* Sanjay Kumar**

Assistant Professor* C.S.N. PG College, Hardoi India
Assistant Professor** Bareilly College, Bareilly India

Abstract

A Sound and robust financial system is essential for channelising the savings for the capital formation. NBFCs, do not hold the banking licence but involved in proper financial system. They are performing a better alternative to the traditional banking system. This is a review paper which focuses on the evolution, financial areas and regulatory framework of NBFCs. This study has inculcated various studies related with NBFCs which are presented on the basis of relevancy and time-period is stretched over a long period of 1968 to 2020. This paper presents an extended literature review inculcating various studies related with NBFCs and for selection of relevant research works, some criteria have been used i.e. language, access, sources and nature of research paper. These literatures pertaining to various methodologies that is helping to reduce the risk involved. Some of the studies are concerned with remarking NBFCs as 'backbone of our economy'. Some other studies talks about evolution of NBFCs with time as well as inherent potential of these companies to attain high growth trajectory in future. A few studies analyse the effect of emergence of COVID-19 on the financial position of such companies. Several studies recognise the contributions and role of NBFCs in capital formation after mobilising savings of households. Other relevant studies are showing organisation structure and domains of operations of these institutions. Most importantly, some studies analyse the impact of financial performance of such companies on our Indian economy.

Keywords: NBFC, Financial performance, Ratios, Banking system, Economic development

Introduction

Our Indian financial system has been highly influenced by banking system but Non-Banking Financial Companies (NBFCs) plays contributing a lot and playing a complimentary as well as rival role for banks. Non-Banking Financial Institutions are incorporated to perform various financial activities and render a broad range of financial services. Section 45I of the Reserve Bank of India Act, 1934 defines ''non-banking financial company'' on following points- (i) a company form of financial institution, (ii) a non-banking institution which is a company and which has as its principal business that either receiving of deposits, under any scheme or arrangement or in any other manner or lending in any manner, (iii) such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify. In simple words, NBFC is a company which is mainly engaged in non-financial type of businesses like real estate, agriculture, transport etc. along with other secondary activities which may be financial as well as non-financial in nature. There is lack of any specific definition of the "principal business" that is why, with the change in business profile in time, the principal business may also change. However, the criteria specified by the RBI Act, 1934 for identification of principal business of a NBFC is on the basis of asset-income to issue certificate of registration (CoR). In April 1999, RBI released a press note to determination of principal function of a NBFC. According to this press release, principal business cab be identified by a numerical expression i.e. if the financial assets of a company comprises above the 50 per cent of its total assets (deducted by intangible assets) and income generated by using financial assets is also more than 50 per cent of its gross income, then such company will be considered as a NBFC.

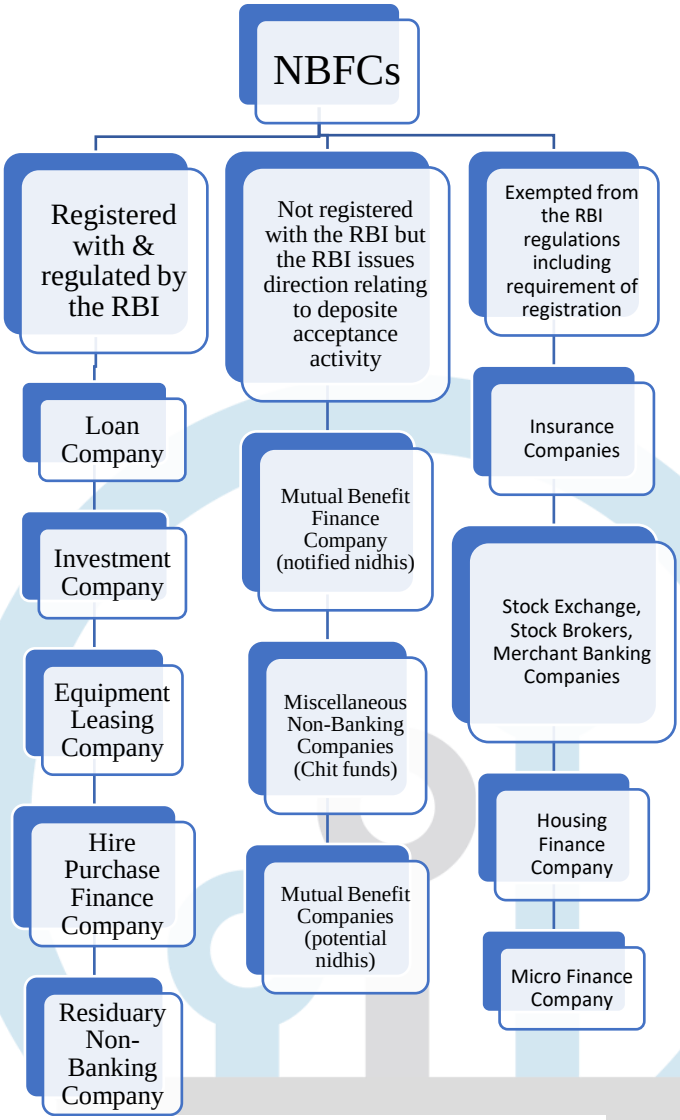

Fig.1 Types of NBFCs (Registered under Companies Act, 2013)

These institutions are incorporated under the Companies Act, 1956 or the Companies Act, 2013 and these perform various functions e.g. providing loans, hire-purchase and instalment payment, leasing business, insurance business, accepting deposits in a few cases, chit funds, investment function etc. NBFCs are classified into two wide categories on the basis of deposits i.e. firstly, NBFCs holding public deposit (NBFCs-D) and secondly, NBFCs not holding public deposit (NBFCs-ND). On the other hand, nature of activities various companies like Investment Company, Asset and Infrastructure Financing Company, Housing Loan Company, Chit Fund and Nidhi Company, Venture Capital Company, Mutual Fund Company etc. The Companies Act, 1956 defines an investment company in Section 372A, as a company which is principally engaged in business of seeking investment in equity shares, preference shares, debentures or any other form securities. The functions of the NBFCs are mainly regulated by the Ministry of Corporate Affairs (MCA) as well as the Reserve Bank of India (RBI) but on the basis of nature of functions, SEBI (in case of Mutual Funds, Investment Company, Merchant Banks, and Venture Capital), IRDA (in case of Insurance), NHB (in case of Housing Finance), State Governments (Chit Fund) etc.

Objectives of the Study

This study is related with aggregating relevant studies with following objectives:

- To identify the role of NBFCs in our Indian economy.
- To study the evolution of NBFCs along with the factors contributing in growth of such institutions in India.
- To look into the structure and financial performance of NBFCs working in India.

Literature Review

Afroze Nazneen and Sanjiv Dhawan (2018) in their paper, "A Review of the role and challenges of NBFCs in economic development in India," explain the specific role of NBFCs in the Indian financial system, i.e. financial stability, economic development, enhancing financial inclusion, prospering the capital market, increasing saving mobilization, and infrastructure financing. It created an environment to provide credit facilities to retail customers in unbanked areas. This ability to create products that meet the needs of customers NBFCs have played a key role in road transport and infrastructure, which are the backbone of the economy. Rakesh Mohan (2004) examines in the paper "The Indian financial system since independence, and

after the post-reform period", he emphasises the role of competition in increasing efficiency in terms of capital education and government ownership institutional innovation for recovery management in his paper. Globalization and the Rule of Institution Building in the Financial Sector, the Indian Case. Financial sector, non-banking financial companies RBI ownership in financial institutions' capital market Insurance and debt market reforms have reaped greater benefits from technology, while the Indian banking sector has undergone numerous reforms. Honey Jain, Tanmayee Parbat, and Rohan Benhal (2021) in the "Analysis of the growth prospects of NBFCs in India". This paper focuses on NBFCs' evolution, growth, and development, as well as regulatory agencies and supervision. The research was exploratory, diagnostic, and relied on secondary data. The diagnostic method was used to determine the causes and problems, as well as how to improve the performance of NBFCs. It is needed to change the study and improve their portfolio (positioning and pricing), procedures (internal and external), and end-to-end customer experience.Shail Shakya (2014) offers some visions and revisions in his working paper titled "Regulation of NBFCs in India." NBFCs are pioneers in their cash development, accessibility to the market, and money organisation; they are also known for their higher risk-taking capacity than the banks. NBFCs have an attraction for investors. It is found to be very attractive for specialised services such as factoring, venture capital finance, and financing road transport. In recent years, there have been several financial crises that have brought to light some critical issues that require attention and regulation in order to maintain an efficient monetary system. Bank credit has been increased for NBFCs; as a result, the risk has increased, which is regularly regulated.

Harsimran Kaur and Bhawdeep Singh Tanghi (2013), "NBFCS: Role and Future Prospects," NBFCs are financial organisations that do not hold banking licences but nonetheless offer services to the banking sector. In certain nations, commercial activities extend beyond the typical banking system, which consists of accepting deposits and disbursing loans for non-banking services like investment banking, IPO financing, and other capital market activity. Commercial papers, public deposits, bank loans, borrowing from them, debentures, etc. are some of the NBFCs' funding options. NBFCs represented 11.2 percent of the total assets of the financial sector in 2010–2011.Dr. Deepak Kumar (2020) noted that NBFCs fulfil a range of tasks and are a significant component of the Indian financial system in his study, "NBFCs in India: A Review of Literature." It was discovered that regulation is activity-based, which causes the cost of compliance to be rationalised to create a model that works for both regulation and the activities that regulate regulation. The prohibited uses of NBFCs' financial resources are debenture funding, loss in the priority sector, securitization, and on-lending. Due to regulatory restrictions and an extremely stagnant growth environment, banks have become aware of direct and indirect lending to priority sector customers. It has been noted that this is anticipated to reverse once the requirement for project financing and large-scale investment begins. Here, banks operate differently and have changed their cost structures to fit a distinct clientele. According to this perspective, in order to increase their profitability in the priority borrower group, NBFCs have concentrated their efforts on marketing to customers. By making a greater range of products available as market penetration increases, the segmented approach to licencing the finance sector for the various types of banks can create the correct dynamic and open the door for the development of NBFCs. Larger market companies may find this difficult because transitioning from banking to nonbanking businesses without an effective regulatory framework can be risky.

Dr. M. Somasundram (2020) in his article "The Merits and Demerits of Moratorium Offered by Banks and NBFCs in India," identifies how moratorium provides a facility to customers and how it is managed by them without profit. A moratorium means a temporary prohibition of a specific activity. COVID has had a negative impact on every industry. All employers, whether government or non-government, received their pay checks after deductions. On March 27, 2020, the government announced that companies would receive a three-month moratorium on their respective equated monthly instalments. This moratorium has been used by approximately 32% of borrowers in the banking and financial industry. Kshetrimayum (2014) the role of non-banking financial companies (NBFCs) in supplementing the organised banking system by providing credit needs to the unorganised sector and small local borrowers was the focus of Ranjan Singh's paper on the growth and development of non-banking financial companies in India. This is because NBFCs enjoy more flexibility compared to banks. This paper also analyses the evolution of NBFCs in India from 1980 to 2001. Between 1996 and 1999, the failure of NBFCs was attributed to the CRB capital market. The number of NBFCs is increasing rapidly due to fewer regulations, which provide a range of activities like hire-purchase and investments. Shariq Nisar and Mohsin Aziz (2004) "Islamic Non-Banking Financial Institutions in India: Special Focus on Regulation" seeks to shed light on how Indian Muslims have attempted to conduct their economic affairs in accordance with shariah. A changing regulatory environment resulted from the expansion of NBFCs in India between 1980 and 1990, as well as their subsequent collapses. Due to restrictions caused by religion, it was not particularly effective. It wasn't a business endeavour; NBFC preferred to put its money into hazardous ventures in commercial banks. On the other hand, a paternalistic and complacent attitude toward the regulation, a lack of money, and a lack of capital availability were the causes.

R.J. Mody (1994) in his paper, "Reforms in Non-Banking Financial Intermediaries," they focus on reforms in the area of NBFIs. Reforms in this context imply changes in financial institutions and financial markets. This paper deals with reforms with respect to the regulatory and legal framework of NBFIs. It means norms regarding adequacy of capital, debt ratio, income recognition, and provision against doubtful debts. Practising sound and transparent asset valuation and uniform disclosure requirements. RBI issues directions to NBFCs under the legal framework to regulate deposit acceptance, loan investment, hire purchase finance, mutual benefit finance, and housing finance. Mangilal Meena in his paper "Economic Growth Trends in India," analyses the impact of NBFCs on the unorganised sector of India. in examining the determinants of microfinance, banking, and financial sectors. It was found that the profitability and financial health of these institutions were remarkably good, but they needed to improve earnings by increasing their fee-based business because NBFIs acted as an intermediary between savers and investors. These instruments allocated risk and reallocated capital to make better use of it. Dr. Vinay Kumar (2020) "non-banking finance firms (as a supplementary to the banking industry)" This study has taken place to evaluate the structure and financial position of NBFCs. Selected ratios and figures have analysed and various statistical techniques have been used to determine the current financial performance of NBFCs and banks. NBFCs have a pivotal role in the Indian economy, which accompanies the banking

system simultaneously. A banking system accepts public deposits and makes credit available to borrowers. It channels the savings into capital formation. NBFCs are more helpful for those borrowers who are unable to get loans through banks due to strict norms. NBFCs manage to contribute financial services worth up to 24 percent of the GDP, whereas banks contribute 21 percent.

Dr. H.R. Kaushal (2016) "Impact of Non-Banking Financial Companies in Indian Economic Growth," notes that while NBFCs cannot directly accept deposits from the general public, they do offer lease financing, housing loans, share trading, advance for share trading, and hire purchase for automobiles. They examine how NBFCs affect India's unorganised economy and the factors that affect microfinance, the financial industry, and banking services. It was observed that NBFCs' profitability and financial stability have grown over time. Large deposits at NBFCS are expanding their public popularity, which is attributable to a simple sanctioning procedure, a good rate of return on deposits, and the prompt availability of credit in particular industries like equipment leasing and hire purchase of autos. Dr. S. Shankarii (2020), in his study on the "growth and performance of non-banking financial companies in India," assessed the nature of income sources and fund utilisation practises of NBFCS and checked the financial health of the sixteen NBFCs. The nature of the data is secondary. It was discovered that in order to increase income and services, NBFCs should form an association similar to banks in order to manage interest rates for both lending and deposits. NBFCs cannot accept demand deposits directly from the public, which suggests enhancing their income from other sources. Khaleel Ahmad (2011) examines the factors that affect NBFCs' financial success when they invest in advice, investment financing, and asset management during a two-year period in his study, "Financial performance of non-banking financial firms in Pakistan." Secondary data sources were used to draw the conclusion that, while commercial banks offered the same services and goods, the performance of NBFCs in 2008 was better than in 2009 due to an increase in the discount rate, the worst capital market situation, high borrowing from other institutions, and losses due to TFC revaluation. For making investing decisions and improving knowledge of the market, this study was really helpful.

Anuj Pratap Singh, Sharad Tiwari, and Shweta Singh (2016) "The rule and regulation of non-banking financial companies in India: the structure and status profile" emphasised the rules and laws governing NBFCs in India as well as the funding sources, importance, composition, functional area, present status, and upcoming requirements. It examines how the financial system and economic growth are related and makes recommendations for different credit policies to reduce interest rates, which directly aids small sector units in meeting their diverse financial needs. Sarojit M. Mondal (2015) in his paper titled "Comparison of Growth between NBFCs and Banks and Their Contribution in the Indian Economy," has attempted to compare the performance and growth of NBFCs with banks and their contributions to the GDP of India. The period of the study was 2006–2013, using secondary sources of data. It was discovered that NBFCs provided 58 percent of infrastructure loans. NBFC balance sheets are growing faster than bank balance sheets. The rate of return is higher in NBFCs as compared to banks. Dr. Jakku Srikanth's (2020) study, "The Role of Non-Banking Financial Companies in the Indian Economy," concentrated on the importance of NBFCs in the Indian monetary system, where they compete with banks to improve efficiency and diversity in financial operations, heterogeneity, asset quality, profitability, and regulatory architecture. The RBI has announced new regulations for the NBFCs to have higher capital adequacy norms and also better fund management because of the various roles that NBFCs play in the development of the economy, including financial stability, financial inclusion, the capital market, factoring services, and infrastructure financing.

Dr. Rosy Kalra (2016) explained in her study, "Performance Analysis of Non-Banking Financial Institutions," that NBFCs have developed as an alternative option for commercial banking. It is an important part of the Indian economic system, and it has assisted the government in increasing money inclusion. They studied twenty NBFCs (asset financing companies and core investment companies) for the period of 2006–2015. A secondary source of data was used to analyse the profitability and financial structure of NBFCs. Ratio analysis, correlation, and regression through SPSS were used. To ascertain the growth of different NBFCs, a graphical method is used to find that the selected companies increase positively by improving total equity and operating efficiency. N Geetha (2016) investigated recent trends in NBFIs, such as regulatory changes and complexity, in his study titled "Performance of NBFIs in India." Digitalization and technology development have brought about changes in the global talent and skill competition, as well as changes in investment and capital sources and returns. Since 1980, there have been a substantial number of NBFCs. The number of NBFCs increased from 24009 in 1990 to 55995 in 1995. This is because NBFCs' high deposit rates tempt investors to place their money there.

Research Methodology

This research is descriptive and quantitative in nature. Various studies related with NBFCs are presented in form of extended literature review collecting works from thesis, Scopus listed journals, and UGC-Care listed journals, peer-reviewed journals, chapters of edited book and other authentic sources. After analysing various sources, total 19 articles are cited along with their detailed explanation which are relevant for this study. Other research works are mentioned according to needs of this study. The following table tells about the criteria for inclusion and exclusion of relevant studies in order to get a meaningful outcomes.

Table 1: Basis for inclusion and exclusion of research works

Criterion	Inclusion	Exclusion
language	English and Hindi	Other language
Access	Complete paper access	Limited access of a paper

Sources	Thesis, Scopus and UGC care listed journals, Peer reviewed journals, Chapters of edited book and other authentic sources	Unauthentic source
Nature of research papers	All authentic papers	No exclusion

Conclusion

NBFCs are playing a very crucial role in channelling the savings into capital formation. In comparison to banks, NBFCs provide distinct services. i.e., do not accept demand deposits directly from the public. Long-term financing of any project needs a proper cash flow situation, liquidity in the firm, and a calculation of the risk involved. To measure its financial health, various techniques have been used to analyse it, like the Altman Z score and CAMEL analysis, standard deviation, profitability ratios, and ANNOVA. Investors are very interested in NBFCs for specialised services such as factoring venture capital finance, hire purchase and asset financing and road transportation projects. These projects involve a huge amount of risk, so the regulatory framework is quite important to maintain the debt ratio, income recognition, adequacy of capital, and provision for doubtful debts. RBI always issues notifications to NBFCs under such a framework to regulate deposit acceptance, loan investment, hire purchase finance, mutual benefit finance, and housing finance. After going through various studies done in arena of NBFCs we can conclude that these institutions form the backbone of our economy. This sector has evolved in a long stretch of time as well as having great potential to attain exponential growth in future. However, unexpected challenges like emergence of COVID-19 can negatively affect the financial position of such companies. Several studies recognise the contributions and role of NBFCs in capital formations. Some relevant studies are concerned with their organisation structure and domains of operations. In last, these companies are one of the driving wheels of our Indian economy with their efficient and impactful functioning.

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