

Non-Banking Financial Companies

[UPSC Notes]

What are NBFCs?

NBFCs are known as the non-banking financial companies that offer financial services and products but they are not officially recognized as a bank with a banking license.

- The activities of NBFCs include lending and other financial services like providing loans & advances, credit facilities, trading in the money market, savings and investment products, managing stock portfolios, money transfers, etc.
- Additionally, their activities also include leasing, hiring, venture capital finance, infrastructure finance, and so on.
- Before beginning the NBFC activities, NBFC registration is required.
- Some of the popular examples of NBFCs include- ICICI Ventures, SBI Factors Kotak Mahindra Finance, and Sundaram Finance.

Latest Updates on Non-banking Finance Companies

Recently the RBI has proposed a strict regulatory framework for the NBFCs by creating a four-tier structure with a progressive increase in the regulation intensity.

- In 2020 RBI announced a host of measures to offer liquidity aid to NBFCs
- RBI has also proposed the classification of non-performing assets of base layer NBFCs from 180 days to 90 days overdue.

Proposed Classification of NBFCs (Four-Tier Structure)

The supervisory and regulatory framework of NBFCs must be based on 4- a layered structure.

Base layer

- NBFCs in the lower layer would be known as the NBFC-Baselayer
- Here least regulatory intervention is warranted

Middle Layer

- The NBFCs in the middle layer would be known as NBFC-ML or NBFC- Middle Layer
- Here the regulatory regime is strict compared to the base layer

Upper Layer

- NBFCs in the upper layer would be known as NBFC- UL or NBFC-Upper Layer
- This layer would be crowded by the NBFCs that have great potential of systemic spill-over of risks, and the ability to influence the financial stability

Top Layer

- This layer is supposed to be empty.
- This top layer of the pyramid would be empty unless supervisors take a view on specific NBFCs

Criteria for NBFCs License

To get an NBFC license the company must meet the following criteria

- The company should be registered as per the Companies Act
- The corporation must be either a Private Limited Company or Limited Company
- The company must have at least Rs. 2 crores of Net Owned Fund

Following NBFCs are spared from the requirement of registration with the Reserve Bank of India:

- Merchant Banking Companies/ Venture Capital Fund/ Stockbroking companies registered with SEBI
- Chit companies as defined in clause (b) of section 2 of the Chit Funds Act, 1982
- Nidhi companies that are notified under section 620A of the Companies Act, 1956
- Insurance companies holding a Registration certificate issued by IRDA
- Stock exchange company
- Housing finance companies that are regulated by NHB (National Housing Banks)

Types of NBFCs

There are three broad heads under which the NBFCs can be categorized

- On the basis of deposits
- On the Nature of their activity
- On the basis of the size of their assets

On the basis of deposits

- Deposit-taking non-banking finance companies
- Non-Deposit taking non-banking finance companies

On the Nature of their activity

- Asset Finance Company (AFC)
- Non-Banking Financial Company-Factors (NBFC-Factors)
- Investment Company (IC)
- Systematically Important Core Investment Company (CIC-ND-SI)
- Non-Banking Financial Company: Micro Finance Institutions (NBFC-MFI)(IDF-NBFC)
- NBFC-Non-Operative Financial Holding Company (NOFHC)
- Loan Company (LC)
- Infrastructure Debt Fund: Non-Banking Financial Company
- Infrastructure Finance Company (IFC)
- Mortgage Guarantee Company (MGC)

On the basis of the size of their assets

- Non-systematically Important NBFCs
- Systematically Important NBFCs

Different Between NBFCs and Banks

A few activities of NBFCs are akin to that of banks, for example, NBFCs lend and make investments. However, there are a few differences that set them apart.

- NBFCs are types of financial institutions in India, that offer banking services without a banking license but on the other hand, Bank is a government-authorized financial intermediary which aims to provide banking services.
- NBFCs can't accept demand deposits
- They don't form part of the payment and settlement system. Also, they can't issue cheques drawn on themselves.
- Credit Guarantee Corporation and the deposit insurance facility of Deposit Insurance are not available to the depositors of NBFCs.

Significance of NBFCs

Below we have pointed out some importance of NBFCs

- In a country like India, where access to bank finance remains a challenge for a large population, NBFCs play a crucial role.
- NBFCs are the types of financial institutions that offer services to the market segments that the commercial banks don't due to high risk and low returns
- non-banking finance companies are an essential part of the economy's financial sector because of their inherent characteristics.

Challenges with NBFCs

The criticism faced by NBFCs is as follows:

- NBFCs are not heavily regulated just like banks. Due to this, a huge risk was highlighted during the 2008 Global Financial Crisis, where the lending practices of the companies were unchecked. In the end, it resulted in a disastrous outcome.
- The IL&FS default and turbulence in the Indian Credit Market in 2018 pointed out some fundamental, and critical questions about the role of NBFCs and their business model