NBFCs – HISTORY, CHALLENGES, DIFFERENCES AND CASE STUDY

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***Abstract*: Non-Banking Financial Companies comprise a significant part of the financial area. They pioneer in their money arrangement, openness to the business sectors and others to tally. NBFCs are involved in high risk taking opportunities than the banks. NBFCs form an integral part of financial system despite being an institution of attracting the customers. Many specialized services have been championed by these institutions. Services like factoring, financing road transport, venture capital financing. NBFC's have seen major degree of consolidation, ending up into large companies with diversified institutions.**

NBFCs have played a major important role in enhancing the growth of the Indian economy. They have traditionally taken the place of banks. They have solved the needs of those borrowers who were not considered appropriate by the banks due to various failing reasons. A customer belonging to low-class and middle-class income family was not able to pass the credit worthiness test of the banks. Those customers can now enjoy the financial services provided by the NBFCs. Also banks only helps the individuals in rural and urban areas for accepting deposits. However, NBFCs have fulfilled these loopholes by coming into picture. Credit service provided by NBFCs are much faster than that of banks. In short NBFCs have reached those corners of the countries which banks were not able to approach.

The project covers the meaning of NBFCs and their functions. Further it talks about the challenges, regulatory and supervisory framework of the NBFCs. Moreover, it specifies the case study of about IL&FS liquidity crisis along with a various measure's taken by the Infrastructure leasing and financial services ltd. (IL&FS) group to overcome the situation and setting up an example for other institutions as well that we should "Never let a good crisis go to waste". Further, project includes how Non-banking financial institutions differs from Banks.

INTRODUCTION

A NBFC's (Non banking financial companies) is a company that is registered under the Companies Act , 1956 doing business of loans and advances , acquisition of stocks/bonds/ debentures/shares and securities issued by the government or local authority or any other marketable institution of a same nature , hire-purchase, leasing, insurance and chit business but does not include any business engaged in purchase or sale of any goods other than securities or is engaged in agricultural activity , industrial activity or giving any services related to purchase/sale or construction of immovable property.

Any company or a non-banking institution which is involved in a business of receiving deposits in one lump sum or in installments is also considered as a NBFC (non banking financial company).

HISTORY

In India NBFC's came into existence a way back in 1960's in order to fulfill the needs of the savers and investors whose financial requirements were not satisfied by the banking system. In beginning they started on a small scale and began inviting investors for depositing their amounts in fixed deposits and start leasing to the firms. However, they could not able to make a enormous impact on the financial system of India.

At beginning, NBFC's were regulated under the Companies Act. Due to the complex and unique nature of their functioning a need was felt that there should be a proper and separate regulatory system to access their functioning as the financial companies also started acting as a financial intermediary.

In 1934, Chapter III B was included in Reserve Bank of India Act, delegating limited authorities to Bank to regulate the deposits taking companies. Various measures taken by RBI to regulate.

RBI implemented recommendations formed by James S. Raj study Group in 1975. As per recommendation's companies are allowed to hire and lease funds to the extent of their net owned funds. The directions include that the companies are required to maintain liquid assets in the form of unencumbered government approved securities.

Between 1980's and 1990's NBFC's started to attract good investors owing to their customer relationship. NBFC's grew from 7000 in 1981 to 30,000 in 1992. This was the time when RBI felt the need to regulate the sector. In 1992, RBI formed a committee headed by A.C Shah (former chairman of Bank of Baroda) to suggests some measures for the effective and efficient working of the industry. The Shah suggested prudential norms from compulsory registration.

In January 1997 enormous changes were made in RBI Act 1934. Fundamental objectives of changes were putting of a complete supervisory and regulatory structure, for proper functioning of the NBFC's and for protecting the interest of the investors.

In the year following the amendment of the Act, the industry has grown immensely in technical sophistications, operations and customized products.

NBFC's are gaining popularity due to their customised products . In August 2016, regulated NBFC's have received nod for foreign direct investments from union cabinet.

DIFFERENCE BETWEEN BANKS AND NBFCs

Banks and NBFCs are financial intermediaries and are akin to each other. Both provide similar kind of services such as borrowing and lending of money and form an integral part of Indian economy. But due to similar activities provided by them it leads to confusion to customers to choose which one. So some of the differences between Banks and NBFCs are given below

INCORPORATING BODY

Banks are incorporated under the Banking Regulation Act 1949 WHEREAS NBFCs are incorporated under the Companies Act 2013.

LICENSE

Before providing banking services Banks are required to hold Banking License WHEREAS NBFCs are required to have Certificate Of Registration issued by RBI.

ACCEPTANCE OF DEMAND DEPOSIT

Demand Deposit means the amount that is deposited with the bank account can be withdrawn anytime as per our requirement.
Demand deposits is inseparable part of banking system WHEREAS NBFCs are not allowed to accept demand deposits.

SETTLEMENT OF PAYMENT SYSTEM OF RBI

Payment and settlement system of RBI is for the economic development. It facilitates paper based transactions as well as e-payments to en route high value transactions.

Banks are supported by RBI in facilitating e payments and money based transactions WHEREAS NBFCs are not considered eligible by RBI for settling payments.

MAINTAINING RESERVE RATIOS

Percentage of total deposits which are not allowed to lend it to customers in case there is mass withdrawals by customers.

Banks are required to maintain reserves ratios like cash reserve ratio whereas NBFCs are not required to abide by maintenance of reserve ratios.

INSURANCE DEPOSIT FACILITY

On default of RS 5 lakhs and less the Deposit Insurance and Credit Guarantee Corporation of India pays insurance amount to the one who suffered loss

Fixed deposits provided by banks are insured WHEREAS fixed deposits provided by NBFCs are not insured

TARGET CUSTOMERS

Banks target customers are corporates or retailers having good credit scores WHEREAS NBFCs main focus is towards retailers, startups or underprivileged class of society not entertained by banks

LOAN PROCESSING

Banks take 5-6 days in loan processing after document verification and do not accept low credit score WHEREAS NBFCs process loan within 6 to 12 hours. NBFCs are fast in loan processing as well as accept low credit score for loan sanctioning.

FOREIGN INVESTMENTS

Private banks have 74% foreign direct investment cap WHEREAS NBFCs are allowed for 100% foreign investments after taking authorization from RBI.

TRANSACTION SERVICES

Banks are allowed to provide transaction services to its customers such as overdraft facility , transfer of funds , travelers cheque WHEREAS NBFCs are not allowed to provide transaction services to its customers.

LOAN SANCTIONING

Banks terms and conditions are strict for sanctioning of loan as well as proper credit scores should be there WHEREAS NBFCs have lenient terms and conditions and minimum documents are required by them.

RATING OF FIXED DEPOSITS

Rating agencies do not rate fixed deposits provided by bank WHEREAS fixed deposits of NBFCs are rated by rating agencies.

CREDIT CREATION

Credit creation means increasing the supply of money within the economy whenever required.
Banks are involved in credit creation WHEREAS NBFCs are not involved in credit creation.

CHALLENGES FACED BY NBFCs CHALLENGES OF FUNDING

In India Banks and other financial ins2tu2ons have many funding op2ons. However, NBFC's are dependent on capital markets and banks for raising funds. Due to which it is quite difficult for the growth and sustainability of NBFC's.

OBTAINING AUTHORISATION

The cycle of enrollment of NBFC is quite troublesome. It involves lots of documenta2on and approval from RBI. The process has been regulated by RBI which will be followed by NBFC's.

COMPLICATED COMPLAINCES

NBFC compliances shiHs star2ng with one kind then onto the next. The test emerge when one individual is running an organiza2on of advance and advances and so forth. It turns out to be very hard to tell how the endorsed returns are to recorded and when they must be documented.

ABSENCE OF STATUTORY RECOVERY TOOLS An absence of recovery tool can be an another hounding challenge for NBFC's.

SEPARATE REPRESENTATIVE BODIES

In the current condi2on, there are different operator bodies. It must be seen that the NBFC division is s2ll in its star2ng stages. As needs be, seMng a single operator body could be an ideal thought. It is similarly major that each part is addressed enough in the culmina2on body that empowers the respectable advancement of NBFCs.

ABSENCE OF LIMIT BUILDING

It is basic that the NBFCs make an open climate for limit developing total similarly as on an individual reason. It needs present NBFCs, and the opening must be recorded as fast as 2me licenses.

DISPARATE TAX TREATMENT

There lies an incredible imbalance in the duty structures for banks versus NBFCs like Tax deriva2on at source, double tax collec2on on rent/employ buy, and so forth.

ABSENCE OF NON PAYER DATABASE

NBFCs are helpless to merit hazard because of the absence of crucial data. Also, there is a need to get the basic administra2ve altera2ons request for these organiza2ons to use the u2lity instalments informa2on base in the credit appraisal measure.

STRIPPING OF NEED SEGMENT STATUS TO BANK LOANS TO NBFCs

This is one of the significant difficul2es looked by NBFCs. The need area status to bank loaning to NBFCs ought to be re-established. Thusly the coopera2on model between the NBFCs and banks guarantees the credit stream to those areas of the general public that are underserved. It will assist NBFCs with making resources and riches in rus2c pieces of the na2on. The Reserve Bank of India can put a top to highway a fixed level of absolute bank loaning need through NBFC.

MINIMUM COMPULSORY CREDIT ASSESSMENT FOR NBFC

It is presently mandatory for a store tolera2ng NBFC's to obtain venture grade credit. It will make them qualified for tolera2ng stores. In the scenario that the assessment of the NBFC is minimized beneath the base venture grade ra2ng, it can't take public stores. Besides, it is needed to answer to the RBI with respect to its posi2on.

<u>EXAMPLE OF CHALLENGES FACED BY NBFCs</u>

INTRODUCTION

One of the largest financing companies of India Infrastructure Leasing and Financial Services ltd (IL & FS) Group made a series of announcements during September 2018.

Announcements that were made were regarding the failure of company to meet its various financial obligations such as interest payments on Non Convertible Debentures, Letter of Credit payment to IDBI and other payments which were to be made regarding bank loans, term or short term deposits. This led to intense disruptions in the capital market. All this results in the sharper fall in the share prices and most of the stocks were three fourths of their market valuation.

SERIES OF DEFAULTS

Example of one of the listed subsidiaries of IL & FS Group which is IL & FS Investment Managers ltd

*defaulted on INR 1000 crores from Small Industries Development Bank of India

*defaulted on Letter of Credit to IDBI bank

*defaulted on short term and long term borrowing of INR 12000 crores

There was a news regarding selling of commercial paper of Dewan housing finance at discount to its issue price. They were heavily dependent on commercial papers for funding long term assets and this was great problem that led to all the defaults.

Basic reason behind all the defaults were they were trying to finance their customers needs with providing them with long term loans and at the same time borrowing from various lenders were done which were short term in nature and having their maturity earlier which led to liquidity crisis.

SHORT TERM BORROWINGS WERE UTILISED TO FINIANCE LONG TERM ASSETS

The NBFC crisis were off set of asset and liability mismatch in the financial statement. As they were relying heavily on financing their customers by providing them with long term loans and when they were borrowing from lenders it was short term loans and they were having maturity dates earlier.

Short-term loans were in approaching bracket as their redemption dates were near. The amount of repayments to be made to the creditors who offered short term loans far exceeded than the debtors having long term loans. If the liquidity in the market is proper then this method could be advantageous for the firms where the companies could borrow at less rates and lend at higher rates in the market. This method could help the NBFCs in to increase their NIM (Net interest margin).

Net interest margin is basically the difference between the interest earned and interest expenses. However, such strategy mentioned above could be exposed to higher risk as their will be comprise on the part of liquidity in order to maximize the profits.

So, when the investors came through a news about IL&FS group defaults on their repayment obligations to short term lenders, the market participants find this single as a red alert for themselves and immediately became more risk averse for their portfolio's exposure issued by NBFCs.

This increased risk aversion which means investors were paying less prices as compared to the previous prices leading to increase in the short term lending rates, funds cost, and leading to impact the profitability of the Non Financial institutions.

PATH TO OVERCOME CRISIS

Due to immediate distress, NBFCs started searching for new alternatives to overcome the repayment obligations. They came up with Overseas debt which mean taking loans from the other countries as well like external commercial borrowings. They started selling stakes which mean loans or direct sale of asset to the banks and private equity funds and other institutions. The financial institutions found this an opportunity to purchase the good quality asset from the NON banking financial institutions at a good discount.

The Reserve bank of India also came into picture by easing the liquidity conditions for the NBFCs by increasing the ceiling rate from 10% to 15%.

This IL&FS crisis was an alarm for the other participants to wake up in the shadow banking. It is important for the government and SEBI (security exchange board of India) to form some reforms that can be useful for NBFCs to address their short coming in corporate governance and helps in assigning the responsibility of top management and the directors of the company for such complex infrastructure.

SCOPE OF NBFCS

NBFCs played a substantial role in the development of the Indian economy. Several benefits that NBFCs provided are capital formation, mobilization of resources, employment generation, development of financial markets, attracting foreign grants and list goes on. With keeping in view NBFCs still have great scope of expansion and can prove as game changers.

DIGITALIZATION

In the era of technology Digitalization of work is going to help NBFCs to achieve great heights. Beginning with 24*7 customer services solving their queries as soon as possible brings customer satisfaction. With the help of social media NBFCs will be able to untap large market segment as lot of information is available online regarding individual intentions or credit worthiness. For purpose of capturing data NBFCs can come in contracts with banks or other related agencies to know regarding the credit worthiness. Digital technology will help in better portfolio management and providing other services.

FINTEC MARKET

Partnership with Fintec will help NBFCs to emerge as a stronger financial institution. Because they provide customers with advance security, greater convenience, faster and cheaper services in terms of lending or borrowings. NBFCs will be more recognized and will bring boost to their value proposition.

EFFICENT RISK DETECTION

Risk detection should be done properly by NBFCs. Potential threats should be handled by mitigation mechanism so that NBFCs are able to survive market uncertainties and regular ground checks should be done to check whether lenders are well capitalized to operate and whether borrowers will be able to repay or not.

SEGEMENTATION

Proper segmentation of market should be done so that potential customers could be recognized and nurtured correctly so that they remain connected with the NBFCs for long term. Unbanked rural areas, micro small medium enterprises, startups should be given more importance because they find a great deal of difficulty in raising funds from banks due to their procedures so this could be a great opportunity for NBFCs in regard to their growth prospects.

RECOVERY

NBFCs should adopt a data driven customer focused approach so that overdue collections are done and recovery could be maximized and write offs could be minimized.

DUE DILIGENCE

NBFCs customer base are the persons who are not able to raise funds from banks due to lack of documentations or low credit rating so NBFCs need to work on their reference checks and ground inspection for verification of their financial credentials. It will lead to high operating cost but it is necessary so that they do not face losses.

HIGH INTEREST RATES

NBFCs can get some additional amount of interest as they are providing funds to those who were rejected by banks but additional interest could only be charged by following the prescribed guidelines of RBI.

CUSTOMER EDUCATION

NBFCs could expand their market share by focusing on customers who are not having any prior experience in availing financial services. They can pitch them with the benefits of raising finance from NBFCs rather than from banks. This could be one of the great opportunities to increase customer base.

INNOVATIVE PRODUCTS

NBFCs should customize products according to customer needs. Innovative products should be introduced to the customers to cater their needs specifically which lead to high customer satisfaction and will help in sustainable growth of NBFCs

CONCLUSION

NBFCs are gaining momentum in India in a short span of time and the role they played in past few years in the development of economy cannot be neglected. Regulatory bodies such as RBI and SEBI on account of financial gap should identify regulatory opportunities regarding credit discipline and great supervision. There is a need for better risk assessment policies so that there is less scope for losses. Raising of funds is a challenge for NBFCs due to which they have to face liquidity crisis so proper raising of funds should be done. The way NBFCs are focusing on their clients soon they will be at par with the banks. Development of NBFCs are necessary for maintaining the stability in financial system. NBFCs mainly focuses on the unorganized sector of the economy because they face challenge in raising loans from bank and there is large segment of market which is still unexplored and could prove as stepping stone towards their growth. Providing customized and innovative products to their customers prove as a great advantage for NBFCs. Though NBFCs are facing challenges but they have great scope of attaining tremendous growth in near future.

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