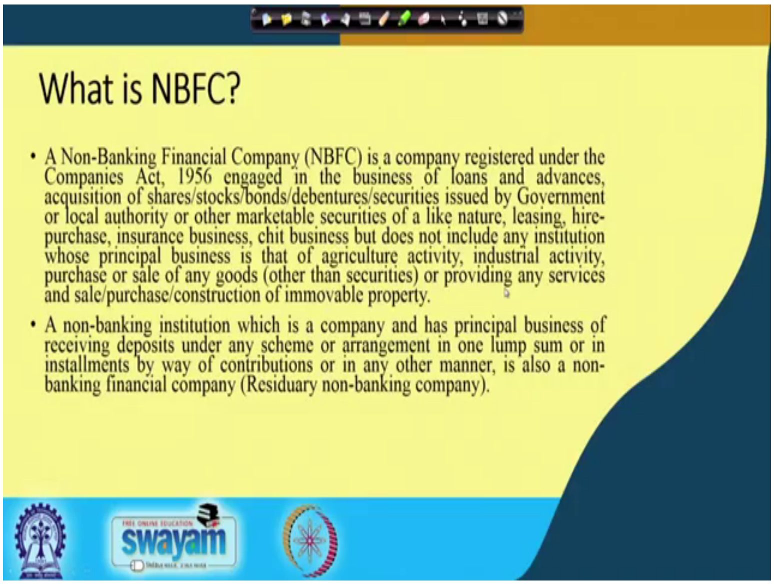
Financial Institutions and Markets
Prof. Jitendra Mahakud
Department of Humanities and Social Sciences
Indian Institute of Technology, Kharagpur

Lecture – 30
Non–Banking Financial Companies (NBFCs) – I

So, what we are discussing about the different kind of Non-Banking Finance Companies, there we discussed about the pension fund, then the provident fund, then we move towards the discussion on the mutual fund and all. So, today we can start the discussion some other non-banking financial companies, which are operating in the Indian financial system. And how those particular companies are providing the services, and what kind of services they provide, and who are the regulators of those particular companies, and as well as what is the benefits of having those kind of organizations in the financial system.

(Refer Slide Time: 01:01)



So, let us start the discussion. Whenever we talk about the NBFC, NBFC is basically a company which is registered under the companies act. To provides the loans and advances to the different kind of entities, to provide certain kind of services. And what are those kind of services we are talking about, those services deals with the is services like leasing, hire-purchasing, insurance, chit business. All kind of services what basically always, we want to get from the financial system. Those services are given by the different kind of NBFCs.

So, they do not provide these services, what the banks generally provide, but they provide the services in terms of the different kind of further activities. Although, some of the activities are similar with the banks, but exactly the services of the activities are not equal to the banks. Most of the cases, also it is observed.

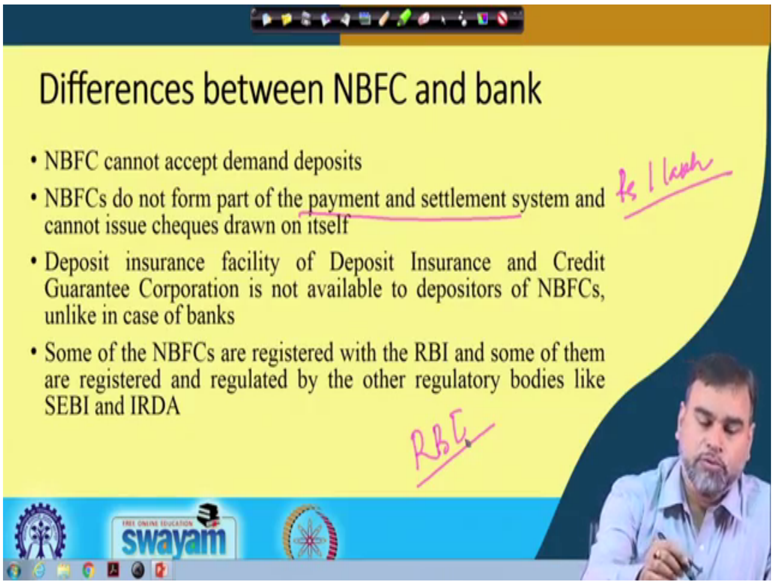
Those services are typically provided from some specific reasons. Either the services or the particular activities can be confined for the agricultural activity; it may be only confined to the industrial activity or to provide certain kind of services in terms of purchasing, and selling of any kind of goods. Particularly, the physical goods we are referring, then also the services can also be provided to create certain kind of fixed assets.

So, the basic nature or basic job of NBFC is basically to provide the services, although the services are also given by the banks, but the services are basically very much specialized in nature. And for specific purpose, these organizations exist in the financial system. So, here we have a concept called principal business, you see whenever the particular financial companies or non-banking financial companies work in the system, they can provide the different type of services or various kind of activities, they can perform in the system, but they most of some kind of principal business.

Principal businessman means in the sense, that those kind of companies this non-banking companies provide certain services in a larger way that means, around 60 percent of the total income or 60 percent of the total profit of that particular companies should arise from that particular type of business. So, here basically we are talk about that is why what we can say, it is a company and has a principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or any other manner. And there are some non-banking companies they are called also residuary non-banking company. So, this residuary non-banking company has some kind of specific business that will be discussing in this particular session.

So, overall if you want to conclude, the conclusion is the non-banking companies are registered under the Companies Act 1956 in India. And those existence or the basic objective of those companies are basically providing the services in terms of some specialized activities. So, this is the way the NBFCs are defined.

(Refer Slide Time: 04:42)



And let us see that how this NBFCs are categorized, and who are basically the regulator of this NBFC, and how it is different from the banks. So, whenever we talk about NBFC, the major operation of the bank always works that the bank always accept the deposits, the demand deposits. Some of the NBFCs also accept the deposits, but mostly if you see the deposits are not basically the demand deposits or we cannot save our money, and get the interest from that kind of institutions or those kind of organizations, which is the major job or major function of the commercial bank that is basically number-1.

And NBFC is also do not be a part of the payment and settlement system and cannot issue any kind of cheque. Because, whenever you are depositing the money in the bank, you see that what do you mean by the payment and settlement, because any kind of transactions always whenever we do in the market, particularly in the financial market or any other market. The transactions and the settlement everything are carried out through a commercial bank.

But, whenever you talk about the NBFCs, the NBFCs are not a part of the payment and settlement system that particular job is only done by the commercial banks or the banks as a whole. And bank against your deposit bank can issue the cheque to you, and the cheque can be used for withdrawal of the money or for the depositing the money etcetera.

But, whenever you talk about the NBFC, NBFC is not allowed or NBFC cannot issue the cheque, on particular deposits whatever the customers have, so that is why, there are some specific kind of services for the NBFCs can provide or NBFC can always contribute to the system, but not like the banks whatever way we always operate or we get the services from the commercial bank.

And another thing the deposit insurance and the deposit insurance means what, the deposit insurance means whenever you have the deposit in the commercial bank, that deposits are basically insured. Insured in the sense, if there is any kind of failure of the bank or the bank is going to be liquidated, the then in that particular point of time, if you have the deposit in that bank, you can get certain amount of money or your deposits are basically insured. But, the question here is in India, the deposit insurance is not very strong. And the maximum amount of money what you can draw, against the deposit insurance is 1 lakh rupees.

So, if there is any failure, even if you are deposit one is more than 1 lakh, you cannot get more than 1 lakh rupees from the bank against your deposit whatever you have. So, the deposit insurance market in the context of India is not very robust, but still some amount of deposit insurance always we get, if you have the money or you have the deposit with the commercial bank, but those kind of services are not available for the NBFCs.

And another thing is the credit guarantee corporation, the credit guarantee corporation is basically what, they provide the guarantee against these kinds of credits or whatever loans we take. But, those kind of services are also not applicable to the NBFCs or NBFCs do not get this kind of services, in terms of the credit guarantee or in terms of the deposit insurance that already we have discussed.

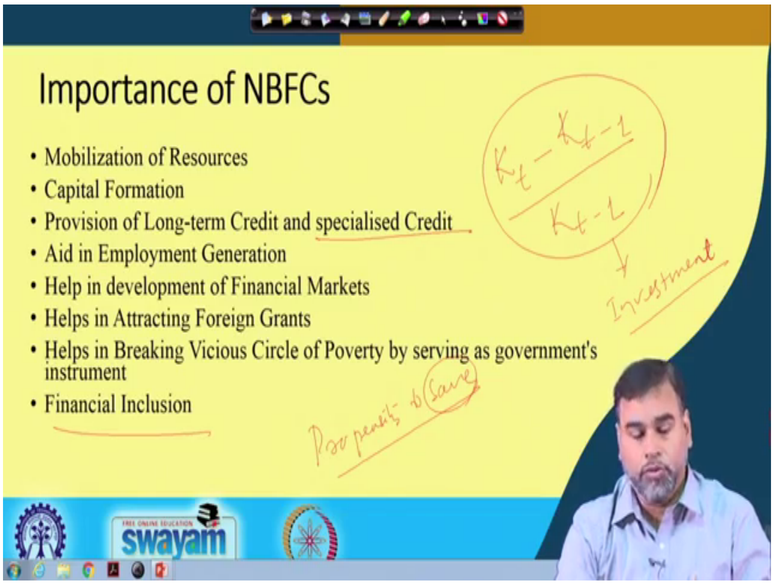
And another thing already you know that the commercial banks are basically regulated by the Reserve Bank of India. The regulatory body for the commercial bank is the central bank of the county, which is for our case it is the reserve bank of India. But, whenever you talk about NBFCs, the NBFCs are not only controlled by or only regulated by the Reserve Bank of India.

So, there are some NBFCs, they are regulated by the Reserve Bank of India. There are some NBFCs which are controlled by or regulated by the Securities Exchange Board of India. There are some regulatory some NBFCs which are basically regulated by the insurance or the IRDA insurance regulatory body that is Insurance Regulated Development Authority. And there are some kind of NBFCs, which are also regulated by (Refer Time: 09:04) other kind of agencies like NSB and all.

So, therefore on the basis of the functions, on the basis of the services they provide, the regulatory bodies are different. But, whenever you talk about the commercial banks, the commercial banks are only regulated by the Reserve Bank of India or the central bank of that particular country, so that is basically the another difference what we can observe between a non-banking financial company and a bank.

So, in this context what we have observed, more or less the services we get it, whatever way the banks provides. Some amount of services its similar with the commercial bank, but in the true sense or in the complete sense we cannot say the services what the NBFCs provide, and the services of what the commercial banks provide they are same, because NBFC services are confined to some for some specific purpose. So, this is basically the basic difference between the NBFC and the bank.

(Refer Slide Time: 10:03)



Then you see why there is a existence of NBFC, what is the importance. First of all you see our financial system is a very diverse system. And if you talk about the whole country, it is not possible only by the commercial banks to cover of all kind of savings, what the people have and as well as, they also have not that kind of expertise or that kind of kind of ability. To go for mobilizing all the resources, whatever we have or whatever the people can accommodate.

So, in that context and because there is a diversified business also available in the market. So, for specific reasons, the banks are may not be able to provide all kind of incentives or all kind of loans for the investment in the particular sector or particular purpose. So, in that context what is happening the role of NBFCs are quite large. So, the mobilization of the resources or financial resources is one of the basic reason for having the NBFC in a financial system.

Second thing is because the NBFCs provide the long term financing the NBFCs provide the long term financing, they play significant role for the capital formation. You know that basically the investment is created through the capital formation; the investment is basically defined as the change in the capital. So, if your k is the capital of the time t, then k t minus K t minus 1. This is basically change in capital. If you want to go for the growth, then you can take a t minus 1.

Then this one basically what, this one basically tells you that the how much investment or what is the growth of investment takes place in that particular segment or particular sector or for that particular company. So, in that sense the capital formation is important for the growth process. And the capital formation can be made or the physical capital formation what you can say that can be made whenever you have enough kind of financial capital available with you. And who can provide this financial capital, only banks may not be able to provide that financial capital, so because of that the role of NBFC is also quite important in that particular context.

And already I told you, because they are the specialized organization. They and also they provide the long term credit, and that is why the NBFCs role is very much important, because they provide the specialized credit either you want to invest it in the physical asset or you can go for investment for buying any kind of commodities, which is very very much long term in nature. So, because of that the NBFC is only able to provide that kind of finances for that particular kind of activities in the system.

It also created the employment generation, because if the capital formation will be there or the investment will be there, it also plays a significant role for the employment generation. Overall, it helps in developing the financial market, and also it helps in attracting the foreign brands. The foreign brands in the sense the foreign aids FDI and FDI's also can come to this particular sector, ah because this particular financing or particular thing which are created in this particular segment that is basically for the long term region. And the physical set ups are created in this particular method or this particular way.

So, as the physical infrastructure is created in this through this particular financing, may be the foreign investors may be interested or the foreign brands maybe will coming will be easy to always arrive in this particular part or particular sector for the development of the economy. It helps in breaking the vicious cycle of the poverty by serving as the government's instrument, you know what do mean by the visual cycle of the poverty, because we are poor that is why we are poor. The country is poor, because it is poor.

In that particular concept means, we are providing certain services, we are heavily dependent on particular some particular entities to get the finance for the investment. So, in that context what is happening to get that particular loan, again we have gone for another loan. So, in that process it becomes vicious cycle, so that vicious circle can be can be broken or it can be destroyed by the use of the alternative sources of financing, where alternative instruments for the financing. So, to create that kind of situation in the market, always we take the help from the NBFCs. And NBFC basically cater to that particular demand in the larger way, by providing the alternative financing or the long term financing to the system.

Then last one is quite important that is basically what we called the financial inclusion. To some extent NBFC, there are some NBFCs which basically play the role for the financial inclusion. What do you mean by the financial inclusion, the financial inclusion is nothing but providing the financial services to everybody in the country, so that means, everybody should have the bank account or everybody should provide this loan services, so get this deposit services. And all kinds of things can be possible, whenever you have more type of financial inclusions exist in the system. Only commercial banks may not be able to provide or cater the demand for a large country like India.

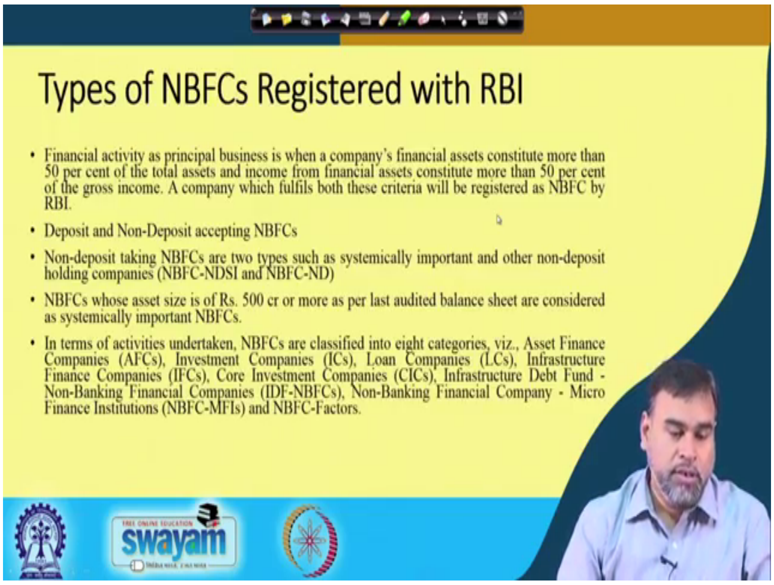
So, in that context, if you want to make this or increase this financial inclusion in this particular country, then always we need the help from the different kind of financial inclusions which exist, because they for some specific purpose, whenever we are providing the loan. Then in these context the NBFCs provide or cater that particular services into the system, and because of that the financial inclusion may take place or the financial inclusion may increase.

So, the in those process the financial inclusion also can happen in the system, you know why we are considering the financial inclusion is important. But, if you go by the Keynesian theory, there is a concept called if you remember that is called the propensity to save or propensity to consume. So, whenever you talk about the propensity to save, so whenever you have you can gather this, and whose propensity to save is more. The propensity to save is always more for the retail household household sector.

So, once this you can cater the demand for the household sector, and the services can reach to all the household sector. Even if because the propensity to save is more for household sector, then there is a possibility that the total amount of savings in the economy can increase. If the total amount of savings in the economy can increase, then what will happen whatever money the household sector saves, then what will what basically that money is basically where it goes, it goes to the business sector for the investment. So, once the money which is collected from the household sector goes to the business sector, then that money can be utilized for the investment. And finally, the output can increase number-1.

Number-2, because it provides certain specific kind of services and if that particular kind of organization exist in their particular system, then it is very reasonably easier for those kind of customers, who wants that particular loan or particular kind of financial services to increase their business or maybe increase their kind of activities, what they want to do. So, because of that it is quite important that we should have a proper development in terms of the NBFCs in the financial system as a whole. So, this is about your importance or why we need the NBFC in the financial system altogether.

(Refer Slide Time: 18:11)



Then we will see that how those NBFCs are categorized, what are those different kind of NBFCs which exist in the system. So, whenever you talk about the types of NBFCs, so there are different type of NBFCs already told you. If you categorize the NBFCs in terms of the registration, some NBFCs are registered with RBI, and some of the NBFCs are registered with other financial, other regulatory bodies like SEBI and IRDA and other bodies.

So, there we will talk about the other kind of entities further, like the venture capitals capitalist, then you have the merchant banks, you have the credit rating agencies, you have also the kind of organizations like a other specialized organizations like NABARD and all. So, those things as separate all together in terms of the common NBFCs. So, those merchant bank, venture capitals, and all these things are basically regulated by SEBI, so that we will discuss later. So, what basically here we are going to discuss, it is basically the NBFCs which are registered with Reserve Bank of India.

So, if you see according to Reserve Bank of India, the financial activity of a principal business, whenever you talk about there we have they have to satisfy certain conditions. What are those conditions, the condition is this the 50 percent of the total asset. The company's financial asset constitute more than 50 percent of the total assets, and the income from financial assets constitutes more than 50 percent of the gross income, whatever business the companies doing.

And when they both criteria are fulfilled by the company, they are basically registered as NBFC by RBI. And this some of the NBFCs are deposit taking, some NBFCs are the non-deposit taking. And again the non-deposit taking NBFCs are two types. One is your systematically important, and other is basically the other is non-deposit holding companies like your NBFC-NDSI and NBFC-ND, and which is called the systematically important.

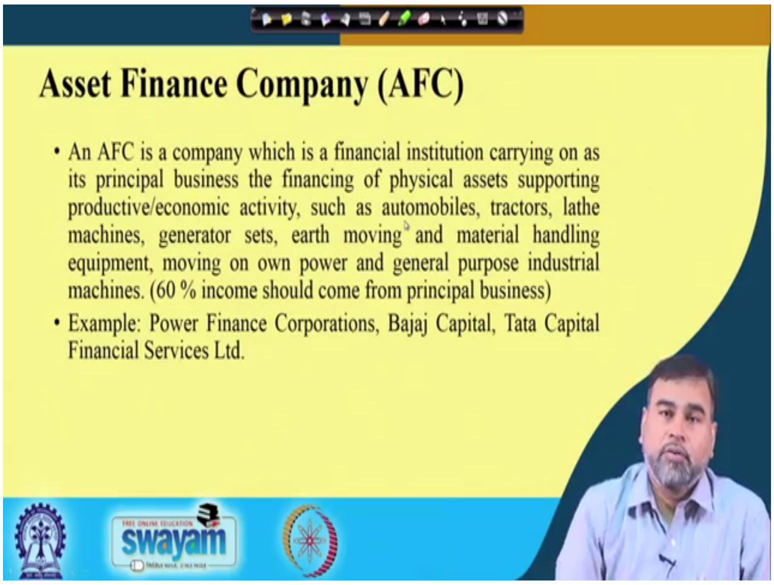
The particular NBFC, which asset size is more than 500 crore, according to the last edited balance, these are basically called the systematically important NBFC in this particular system. And you can also categorize those NBFCs in terms of activities or services they provide, what kind of services the NBFCs provide on that basis also the NBFCs can be categorized.

So, they can be asset finance companies, they can be investment companies, they can be loan companies, then can be infrastructure finance companies, they can be core investment companies, they can be in infrastructure debt fund non-banking financial companies, then they can be also the microfinance institutions, they can be NBFC factors. So, there are different kind of NBFCs which exist, and they are all registered with reserve bank of India.

And already we have discuss that some of the NBFCs are deposit takers and some of the NBFCs are not allowed to take the deposits, so that means they call the non-deposit accepting NBFCs, but generally the NBFCs are more discussed in terms of the activities. So, we have to be more concerned that what kind of services the NBFCs provide, and those services basically how we can define it.

So, in that context, we have to more concerned about the NBFCs, which are providing the different kind of specific kind of services to the financial system like your asset financing invest companies, loan companies, etcetera, etcetera. So, we will be discussing more about this classification than the other classification, because within that classification, they also provide the same kind of services in the financial system as a whole.

(Refer Slide Time: 22:28)

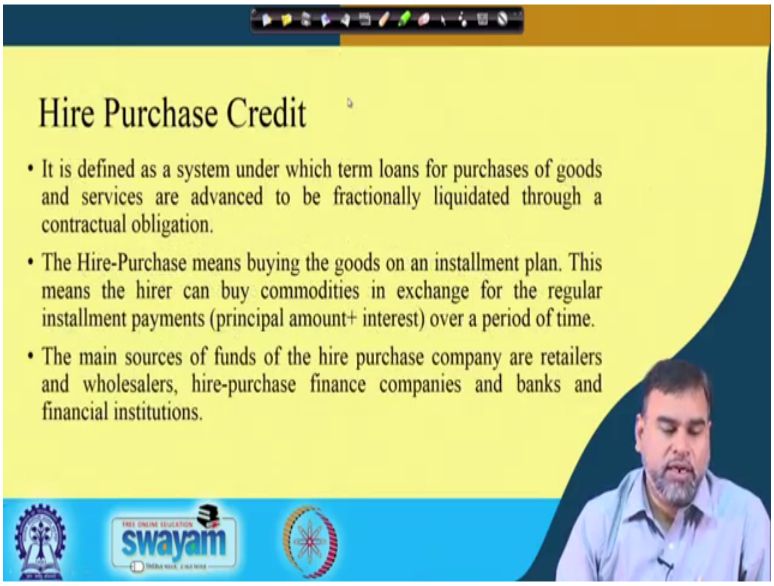


Then you can start with there is a asset finance company. So, what do you mean by asset finance company, the basic job of asset finance company is which principal business is financing of the physical assets, which support the economic activity, productive economic activity. And mostly the companies finance to the automobiles, tractors, machines, generator sets, earth moving machines, material handling equipment, moving on power and general purpose industrial machines.

And the 60 percent of the income of those companies are coming from this business that means, these companies are basically exist in the system to provide the credit, to provide the loan for those kind of companies, who are related or those kind of individuals or those kind of entities, who want to invest their money in this kind of activities. So, mostly those companies provide the services for creation of the physical assets or the fixed assets in the system. If you see the example, we have the power finance corporations, Bajaj Capital, Tata capital, financial services. So, those kind of companies provide the money for buying the different kind of assets on which asset basically contribute for the economic activity.

So, they are basically used to create certain kind of value addition to the economic activity, and this kind of asset finance companies major business is to provide the capital or loan to them. The financing activities are basically carried out, through this asset finance companies. It can be also done by the commercial banks, but mostly you can the specific purpose of asset finance company is to provide the finance for this activities. So, this is about your asset finance company.

(Refer Slide Time: 24:40)

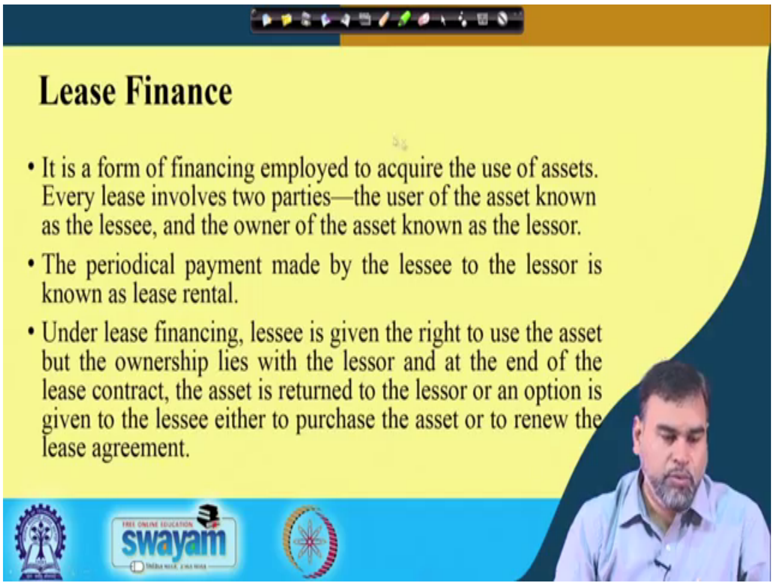


Then if you see that, there is another company called the hire purchase credit. What this hire purchase credit company does or what kind of NBFC, it is what do you mean by the hire purchase, the hire purchase is basically a system under which the term loans particularly the long term loans are given for purchase of the goods and services in advance. And they are fractionally liquidated through a contractual obligation that means, what you if you want to buy any kind of vehicle or you want to buy any kind of asset, which for that we need more money.

So, in that context, what we do the you can go for this kind of entities or this kind of companies, who provide this particular finance to go for this kind of buying this kind of goods. And fractionally you can pay that money over the period of time that is why, the hire purchase means buying the good on an installment plan. This means the hirer can buy the commodities in exchange for the regular installment payments; it may be principal amount or the interest over a period of time.

So, this is basically we called the hire purchase credit, which is given by the NBFCs. And some NBFCs are specializing in that, and they provide this kind of services to the consumers. The major the main source of funds for the hire purchase company are retailers, wholesalers, hire-purchase finance companies, banks and financial institutions. They provide this kind of services to the economic system.

(Refer Slide Time: 26:31)

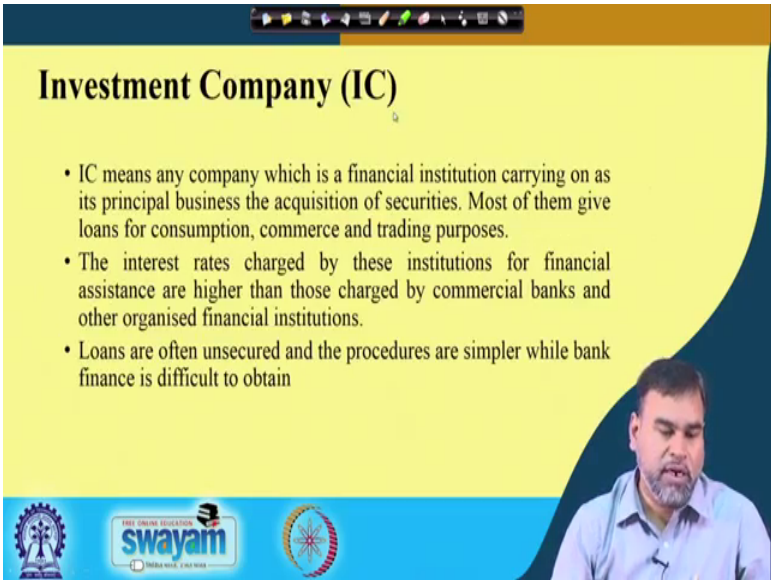


Then we have lease financing. What do you mean by the lease financing, it is basically a form of financing employed to acquire the use of the assets that means you are not going to own that asset, but you are taking that asset as a lease. And then this process every lease involves two parties the user of the assets which is known as the lessee, and the owner of the asset which is known as the lessor.

So, the periodical payment made by the lessee to the lessor is known as the lease rental. For example, there is a warehouse incorporation. So, they have taken the warehouse on the lease, and they pay the rent periodical basis to use that particular warehouse or to get that services what the warehouse can provide.

So, therefore under this lease licensing or lease financing, the lease lessee is given the right to use asset, but not the ownership. And the ownership lies with the lessor. And at the end of the lease contract, the asset is return to the lessor or an option is given to the lessee either to purchase the asset or to renew the asset agreement. So, this is basically for a specific period. And once the period is over, then the option will be given to him, you can own that asset, you can buy that asset or if you want you can renew that particular contract for the another period that is basically we call it the lease financing.

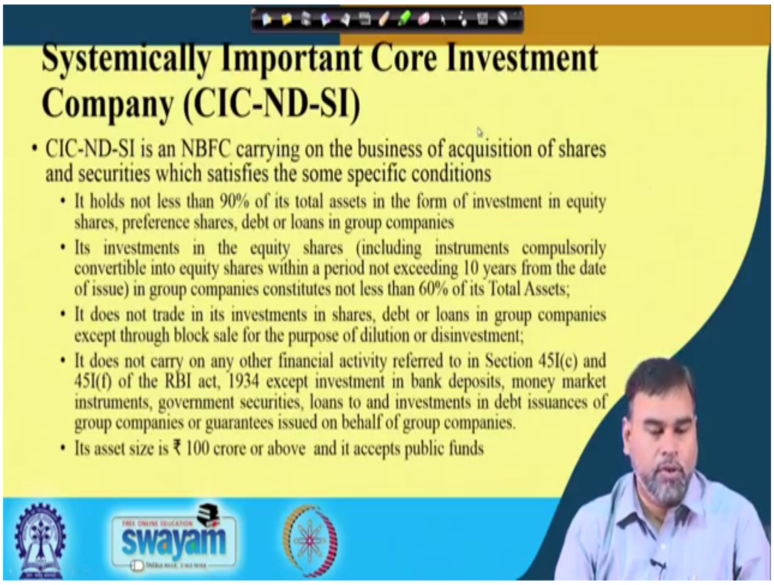
(Refer Slide Time: 28:10)



Then we have another entity call the investment company. What is Investment Company, it is basically company which basically the principal business of this particular company is to provide the finance for the acquisition of the securities. So, most of the these companies provide the loans for consumption, commerce, and trading purpose in the market.

So, the interest basically what they charge, these are basically the financial assistant which are higher than the charge of the commercial banks. And the other organized financial institutions, investment companies interested is little bit higher. Whenever we are not able to generate the capital or generate the financial capital from the commercial banks or other organized financial institutions, then we can go to the investment company to less than money and loans are unsecured, but procedures are very simpler in comparison to the commercial banks, so that is why the importance or the dependency on investment company is also there, whenever anybody wants to do the business or anybody wants to buy something for the commerce or the consumption.

(Refer Slide Time: 29:24)



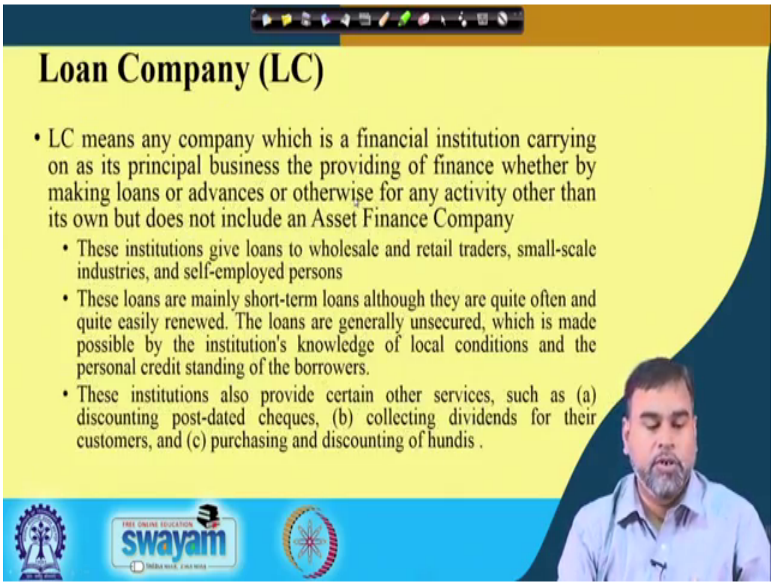
Then we have another company called systematically important core investment company. These are the company, which basically carrying on the business of acquisition of the shares and securities, which satisfies the some specific conditions. What are those conditions, these conditions basically what, it holds not less than 90 percent of its total assets, in the form of investment, in equity shares, preference shares dept, or the loan in the group companies.

Its investment in equity shares including instruments, which are can be converted into equity shares within a period not exceeding 10-years from the date of issue in a group companies constitutes not less than 60 percent of its total assets. It does not trade in its investment in shares, dept or loans in group companies, except through the block cell of the purpose of dilution or the disinvestment.

It does not carry on any other financial activity, except the investment in bank deposits money market instruments, government securities, loans to and investment in dept issuances of the group companies or guarantees issued on behalf of the group companies. And it asset size is crore or above, and it accepts the public funds, so that they deposit taking NBFC, which exist in the system. These are the condition has to be satisfied to make that particular or to define that company a systematically important core investment company in the financial system, so that is basically the another kind of

NBFC, which exist in the system. Then we have the other NBFCs which basically provide the other type of specialize services to the system.

(Refer Slide Time: 31:23)



We have the loan company, they provide the loan to wholesale and retailers, small-scale industries, and the self-employed person. The loans are mainly short term, and these are unsecured. And these are basically provide the other services like discounting the post-dated cheques, collecting dividends for the customers, and purchasing the discounting of the Hindis. So, these are the services which is given by the loan companies.

(Refer Slide Time: 31:55)

Please go through these particular references for this particular system. So, these are some of the companies what we have discussed, then we have the other companies like microfinance institutions factors, and all these things that will be discussing in the next class.

Thank you.