Financial Institutions and Markets
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Lecture - 31
Non - Banking Financial Companies (NBFCs) – II

So, in the previous class we discussed about the importance of NBFCs and there are different type of what are the different type of NBFCs work in the Indian financial system. And, there are some NBFCs which are regulated by the Reserve Bank of India, a registered with RBI and there are some NBFCs which are basically registered with the SEBI and other kind of regulatory bodies which exist in the Indian financial system.

Then we were discussing about those NBFCs which are basically exist in the or which are registered with Reserve Bank of India now. And, there are many kind of NBFCs which provide their services and those NBFCs are categorized on the basis of their activities. So, we discussed about certain NBFCs like you have the asset finance company, you have the loan companies, you have some of the NBFCs systematically important NBFCs and all these things. Then we can open to some other NBFCs which also play the significant role in the financial system for providing the services.

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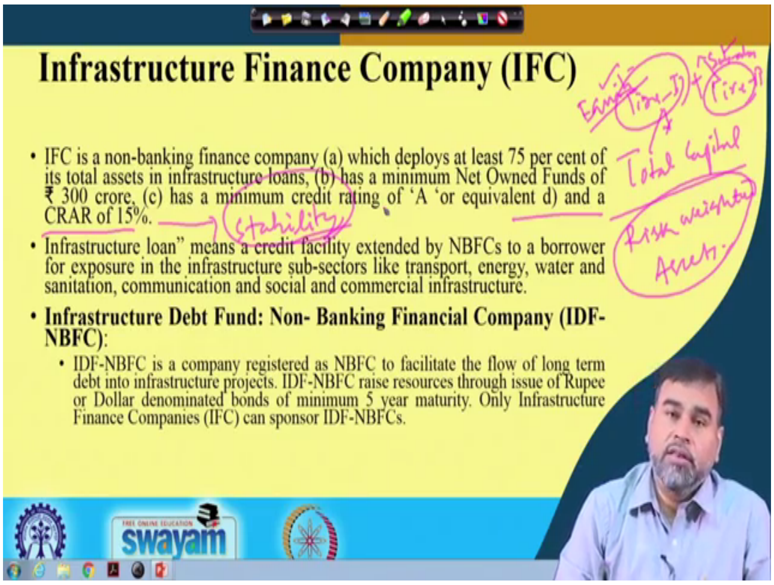

One of the company is infrastructure finance company and what do you mean by infrastructure finance company. The infrastructure finance company is NBFC or the non-banking financial company which deploys at least 75 percent of the total assets in infrastructure loans. Whatever loans the company provide out of them the 75 percent of the loans are given on the infrastructure. It has a minimum net owned funds of 300 crore and should have a minimum credit rating of A or equivalent and the capital adequacy ratio of 15 percent.

So, the IFC the Infrastructure Finance Company is basically what which deploys at least 75 percent of the total assets in infrastructure, loan has a minimum net owned funds of 300 crore, has a minimum credit rating of A or equivalent and a capital adequacy ratio of 15 percent. So, these are the required conditions or necessary conditions to consider or to define a company called the infrastructure finance company. So, what do you mean by the capital adequacy ratio? If you remember the capital adequacy ratio is nothing, but this is your total capital divided by the risk weighted assets..

The total capital includes your tier I capital and plus the tier II capital and the tier I capital is basically what; the tier I capital is your equity. And tire II capital is basically your what your subordinate debts. So, equity and the subordinate debt these are two different capitals which are available in this particular part of the tier total capital. And, the risk weighted assets are basically what, the total assets and always this particular type of weights has been given to this particular assets. And, the basis of the type of loans what this particular bank or particular NBFCs has given.

So, the minimum and that particular thing is basically measure the stability, that basically the CRAR basically measure the stability of the bank or stability of the NBFCs. So, if the CRAR or the capital adequacy ratio is 15 percent and credit rating is A, minimum net owned funds of 300 crore and 75 percent of the loans are given for the infrastructure then we can call that company the infrastructure finance company. And which is a very reputed NBFC which work in the Indian financial system..

And what do you mean by the infrastructure loan? The infrastructure loan is basically nothing, but providing the credit facility to a borrower for exposure in the infrastructure sub sectors like transport, energy, water, sanitation, communication, social and commercial infrastructure. In this particular entity or particular company or particular individual who is taking the loan for this specific sectors or for this specific industries; then and the loan is basically disbursed against that then we call that the infrastructure loan. And, another thing is already we have said that the basic job of the infrastructure company is to provide the services for creation of the assets in the system.

And, that asset may be includes the roads, buildings and all these things; it can be creating some kind of avenues to create the energy. It can be provide certain kind of for incentives to provide the better water facility, water supply and sanitation facility. Or, it can also create certain infrastructure to enhance the communication facility in the in the country or the any kind of commercial infrastructure if you have. But, in every cases we are creating certain kind of physical assets which is helping us to create some infrastructure for the development of the economy.

And the 75 percent of the total loans what the particular NBFC is giving that is basically belongs to this category loan or this category credit. Here another thing is within that we have an Infrastructure Debt Fund Non-Banking Financial Company that is it is called IDF NBFC. It is registered as NBFC to facilitate the flow of long term debt into infrastructure projects and NBFC IDF NBFC raise resources through issue of the rupee or dollar dominated bonds of the minimum 5 years maturity. And, the infrastructure finance company is the sponsor for this; mostly the loans which are given by this company is long term in nature or the minimum term to maturity is 5 years.

So, that is basically we call the infrastructure debt fund and the major sponsor of the infrastructure debt fund is basically the IFC or the Infrastructure Finance Company. That is why the basic job of the infrastructure finance company is to create the infrastructure in the economic system which overall increase the product can help to increase the productivity.

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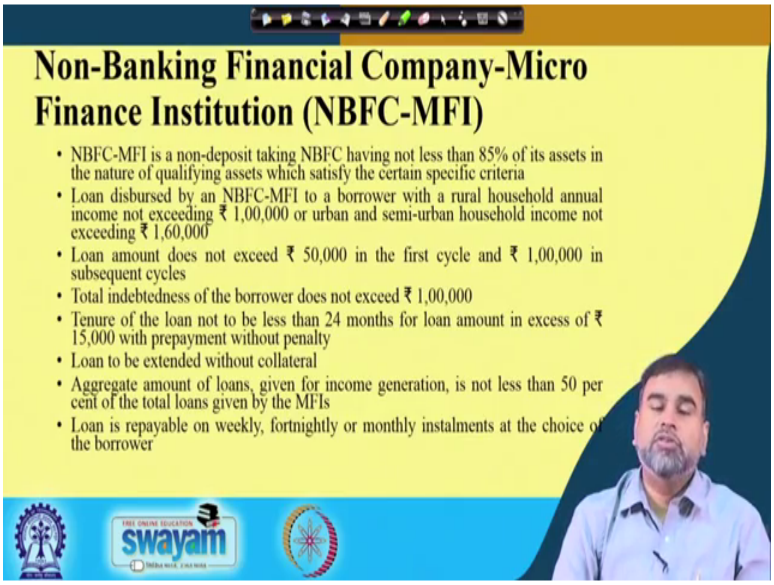

Then we can move into the other kind of NBFC which are working. Another most important type of NBFC we have that is called the NBFC microfinance institutions. All of you might have very much acquainted with this word, this microfinance institution. And, the microfinance institution is basically one NBFC and this NBFC is a non-deposit taking organization.

This NBFC does not take any kind of deposit from the public and having not less than 85 percent of its assets in the nature of qualifying assets which satisfy the certain specific criteria. And what is the basic job of this? The basic job of the kind this microfinance institution is to provide the small loans to some specific group of the people to create certain kind of business for their survival or we can say that to create certain kind of employment opportunity.

So, these organizations provide small-small loans and the small some these small loans are used to create a small business by that particular group or by that particular individual which can create certain regular cash flows in the future. So, the basic nature of this particular kind of company or basic kind of asset whatever the company has this is basically nothing, but the loans the small-small loans what they have given. So, what are those criteria they have to satisfy to be considered as a microfinance institutions? The loans disbursed by the MFI to a borrower with a rural household mostly they are confined to rural areas, the annual income not exceeding 100000.

And if it is urban areas or semi urban areas then this annual income of that household should not exceed 160000; that means, the loan should be given only to those kind of households whose income level is very low. Loan amount does not exceed 50000 in the first cycle and 100000 in the subsequent cycles; that means, the disbursement of the loans the amount of loans which are given against this microfinance institutions are quite low. Then total indebtedness of the borrower does not exceed 100000. That means whatever loans the customer is taking the MFI should ensure that the total amount of loan at a particular point of time should not exceed 100000.

Total loan indebted means whatever existing loan they have and whatever new loan they are taking all together the total at a particular point of time the total loan amount should not exceed or total debt amount of that particular person should not exceed 100000 rupees the tenure of the loan not to be less than 24 months for the loan amount in excess of 15000 with prepayment without penalty right. So, minimum 2 years the tenure of the loan, it cannot be less than that if the loan amount is exceeding 15000 rupees that actually this MFI has to ensure. Loan to be extended without collateral; whatever loans the m f is are giving they cannot take any kind of mortgage collateral against this loan. These small loans have to be given to that particular individuals or particular households without any kind of collateral.

So, the loans are basically unsecured loans. The aggregate amount of loans given for income generation is not less than 50 percent of the total loans given by the MFIs. The loans which basically they give they are given for the different kind of purpose, different kind of reasons, but the MFI has to ensure that whatever loans they are given that loan amount should not be less than 50 percent of the total loans which are given for the income generation that actually they have to ensure. Loans are repayable on weekly, fortnightly or monthly instalment are the choice of the borrower. You see generally the whenever we take the loan from the banks, the banks basically recover the loan minimum frequency is monthly.

Whenever we talk about the NBFCs like MFI they can recover the loan minimum frequency is weekly. So, they can take the money from the borrower or they can recover the loan from the borrower with interest in weekly basis or fortnightly basis or monthly basis. So, this is the loans are basically always recovered from the small borrowers who have taken the loan from the MFI. But, if you consider from the banking prospective banks do not provide even a bank provide the small loans; they do not recover the money and the weekly or fortnightly basis.

They recover the loan from on the customer or from the borrower in the minimum the monthly basis. And, another thing you see the amount of loan or the amount of interest what the MFI charges that is relatively higher than the interested charges by the commercial banks.

Because, the revenue generation or the financing of MFI are done through banks only or some kind of entities who provide the loan to cater this kind of services in the economy. It can be SIDBI or any other organization who provide the loan for this kind of activities. So, then the MFI basically pay the interest to them and from there they get the money and cater the demand for the small customers or the small borrowers. So, because of that the relatively the interest rate on this kind of loan is relatively higher than the loan rate of the same maturity which are given by the commercial banks. But still it has its own reasons because, of that the MFI importance in the Indian economy is quite large or quite important.

And they cater the also the demand for the small customers and as well as also fulfil the requirements of the financial inclusion. So, MFI plays a very significant role for the financial inclusion in the economic system in India.

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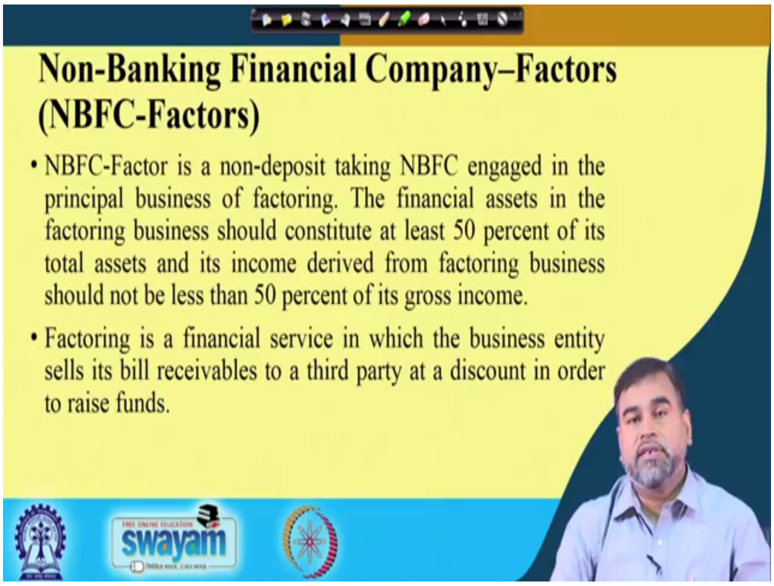

Then we have another kind of NBFC who provides the services like factoring then; that means, what NBFC factor is also is a non-deposit taking NBFC and their principal business is the factoring. And, the financial asset in the factoring business should constitute at least the 50 percent of its total assets and the income derived from the factoring business should not be less than 50 percent of the gross income. That is why we call that the principal business of this organization this kind of organization is the factoring.

So, 50 percent of the total assets is related to the factoring business and the income what they are generating from the factoring business should be minimum 50 percent of the total gross income what are the companies basically generating from the business. What is factoring? Factoring is basically a financial service in which the business entity sells its bill receivables to a third party at a discount in order to raise the funds. It is a financial service in which the business entity sells its bill receivables to a third party at a discount in order to raise the funds.

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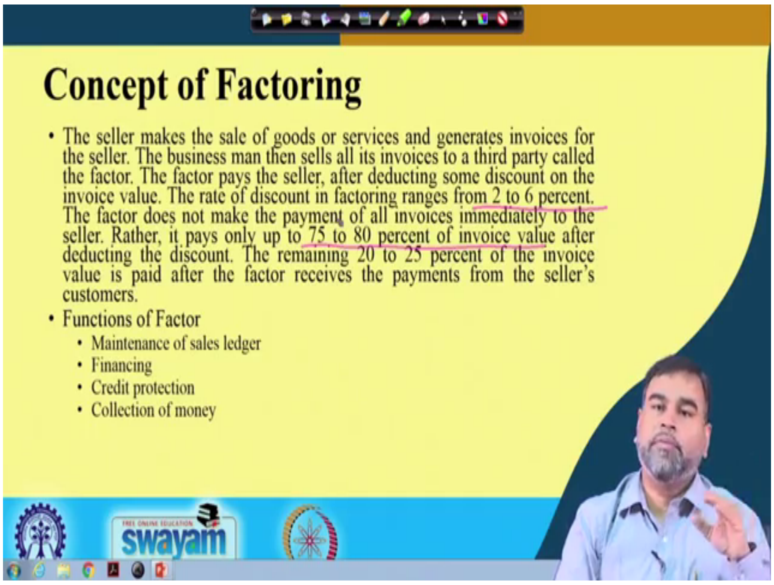

Let us explain that what did exactly means for example, the seller makes the sale of the goods and services you somebody one seller you are some buyer has buyer have gone to a seller they have bought some commodities from the seller and the seller has sold these commodities to that particular buyer. And against that the seller generates the invoices; the invoices are generated. Then what will happen that is the buyer may not make the payment to the seller immediately. In that particular point of time what happens the seller sells its invoices to a third party called the factor. The seller goes with that invoices to the third party and pays some kind of factoring piece or factoring services.

And, it is the job of the factors who basically will collect the money from the buyer. And once the invoices will be received by the factors from the seller immediately the factor pays the seller after deducting some discount on the invoice date or invoice value. The invoice value whatever let 500000 is the invoice value, the discount it may be 10 percent, 5 percent whatever it may be. They discount that and whatever remaining money will be there they try to give that money to the seller. Seller gets back is money and the discount is varies from 2 to 6 percent. Thus, you see what whenever the discount the invoices they basically charge from 2 percent to 6 percent. But, one thing is the factors may not pay all 100 percent money to the seller.

They pay 75 to 80 percent of the invoice value to the seller and another 20 to 25 percent they keep it and they will pay this whenever the buyer will pay the money to the factors. So, the remaining 20 to 25 percent of the invoice value is paid after the factor receives the payment from the seller's customers. So, it is the job of the factor who will collect the money from the buyers. So, this is the knot job of the seller to collect the money, seller gets around 75 to 80 percent of the total invoice value. And, for that they have to pay 2 to 6 percent charge to these particular factors and it is a job of the factor who will collect the money from the buyer.

And, once they will collect the money the remaining 20 to 25 percent they will pay to the sell. So, there are does it that is the way the factor ; that means, it is not the obligation; this is not the responsibility of the seller who can collect the money from the buyer if any kind of commodity has been bought on the credit. That is what basically the measure job of the factors, that is the concept of factoring what we can explain. What generally the factors do? They maintain the sales ledger account, they sometimes also less the role for the financing. They protect their credit, credit protection is done by these factors and on behalf of the sellers they also collect the money.

So, this is the job of the factors who can collect the money from the buyers. So, the responsibility of the seller is less whenever they have paid the giving that invoice and the invoices are discounted by the factors and factors pay the money. But, it is the job of the factor to collect the money from the buyers and end of the day whatever remaining money will be there they can pay to the seller in the end. So, that is where the factoring works in the system.

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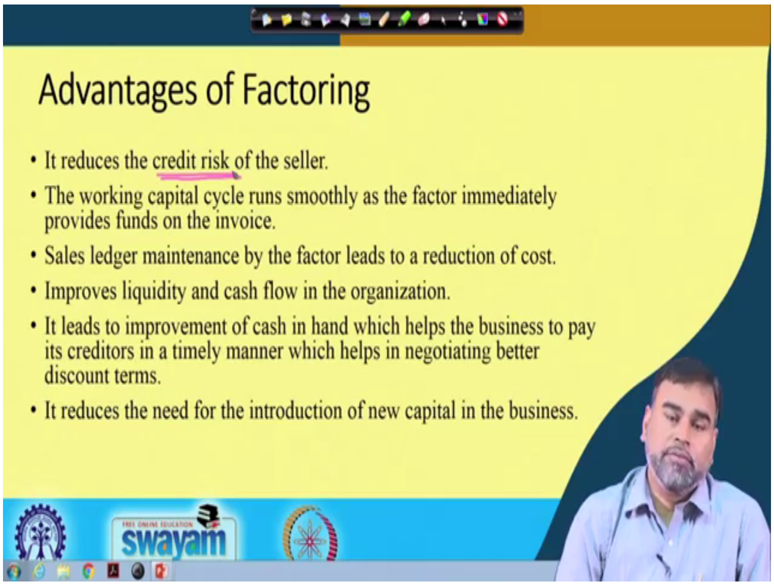

What are those advantages of the factoring? Obviously it reduces the credit risk, factoring reduces the credit risk. The working capital cycle runs smoothly as the factor immediately provides the funds on the invoice against the invoice; whenever you are submitting the invoice this seller gets back its money. So, the working capital cycle of the seller runs very smoothly. Sales ledger maintenance by the factor reduces the cost of the seller relatively the cost of maintaining that ledger account of this particular seller is less, if they are getting the factoring services.

Improves the liquidity and cash flow in the organization because, immediately getting back your money. It also leads to improvement in the cash in hand of the seller which helps the business to pay its creditors at the timely manner, which helps in negotiating also the better discount terms. It also reduces the need for the introduction of the new capital in the business because, the cashes cash is readily available and the factors are able to pay that particular thing and, factors of the expertise to collect the money and to manage that particular business in a better way because, they have the expertise to deal with this kind of business.

So, all the sellers may not have that kind of expertise to deal with this particular collection of money and discounting this invoices and all, but the factors are which are responsible for this kind of business they have the clear expertise for doing this. And because, of that it is advantageous for both factors and as well as the sellers for creation of the liquidity in the system and to make this working capital cycle smoother. So, this is basically the advantages of the factoring, but there are some disadvantage also.

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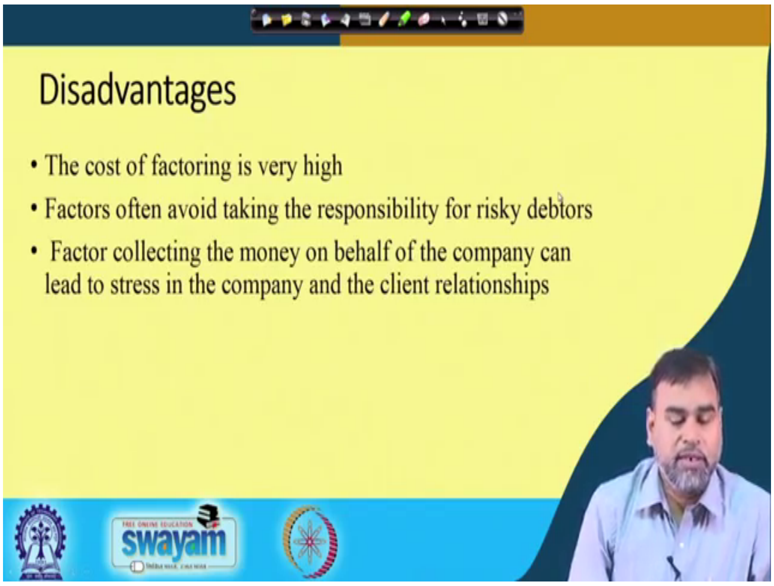

There are some disadvantages also whenever you go for the factoring. It is observed that the cost of factoring is relatively high. The discounting what the invoices they do sometimes the seller feels that the cost of factoring is very high, the service cost of the factoring is high. Factors often avoid taking the responsibility for the risky debtors and factors collecting the money on behalf of the company can lead to the stress in the company and the client relationship.

Sometimes the factors may not be that kind of way behaves with the customers whenever they collect the money, because anyway they are not the business entities; their job is only to collect the money. In that particular point of time if the relatively harsh or their approach for collecting the money is basically not that way working better, then the it can create the conflict between the buyers and sellers which may affect the business of the seller in the future. So, there are some disadvantages what we can observe whenever we are using the factoring services or the factors are coming into the picture for the business.

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But they have their unique role in that; then we have another company called mortgage guarantee companies MCG sorry MGC. So, the what is MGC? The MGC are basically a financial institutions for which at least 90 percent of the business turnover is mortgage guarantee business or at least 90 percent of the gross income is coming from the mortgage guarantee business out of the total income and net owned fund should be 100 crore and above. What do you mean by this mortgage guarantee business basically for example, what is happening you have taken a home loan.

Then your home loan home is the mortgage, the mortgage is the home and you are obliged to pay your interest and finally, your principal regularly. But what is happening for some reason if you are not able to pay the interest or you are not able to pay the principal either the person has died or the person has some kind of critical illness. Something may arise while paying the interest to that particular financial organization or financial entity at that particular point of time what happens the role of the mortgage guaranty companies comes. It is basically a insurance.

So, if your home loan is insured the companies basically provide the services for this kind of business or this kind of purpose. If it is insured then what will happen that there is if there is some kind of uneven situation arises, then it helps this financial institutions to cover the home loan. Or, they can cover the risk of default without affecting or without making any kind of arrangements for the liquidation of the home. That means, what the customer will not face any difficulty; the loan amount will be paid.

And as well as the customer who could not pay the loan because, of certain reasons the insurance company will basically is able to cater the services on behalf of the customers or that means, the loan is insured. And, this kind of services are provided to the banks and housing finance companies. The companies are the banks who provide the housing loan, the loans are basically always insured nowadays which is given by this mortgage guarantee companies. And, that is the way basically the loans can be insured and the probability of default or the risk of default declines in this particular process.

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Then we have another one is NBFC non-operative financial holding company this is a institution which promoter groups will be permitted to set up a new bank. It is only one fully one non-operative financial holding company and why we are basically half this company is to separate the several financial services carried out by the same holding company. And, the prudential norms of these companies are same with the banks. I can give example in this case for example, the Bandhan the microfinance organization who has got this license for doing the banking business. So, now this is basically what it is in Bandhan is basically known as a microfinance companies.

So now, this Bandhan bank is a separate holding company who will provide these services in terms of the banking and their operation in terms of MFI is different. That is why this financial activities will not be overlapped. Same holding company, but the services or activities are totally differentiated. There should not be any kind of overlapping for this kind of activities what they do or this kind of services what they provide. But the norms and everything would be similar in that of the banks, the regulatory norms what basically we follow for this is basically the always same with this commercial banks. So, we have this kind of setup in the Indians financial system to overcome any kind of crisis which can happen to this.

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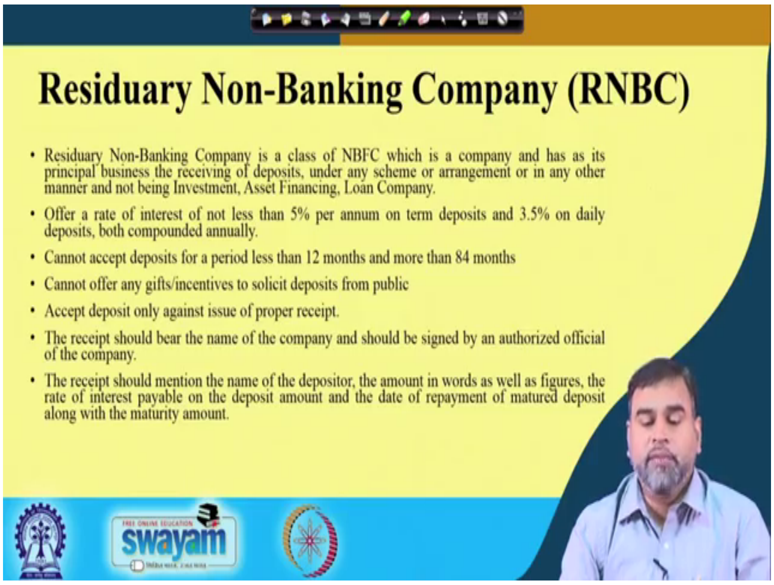

Then we have last one is the residuary non-banking company. Its principal business is the receiving of deposits under NBFC a scheme or arrangement or any other manner not being investment asset financing or the loan company. This RNBC offers or these companies offer a rate of interest of not less than 5 percent per annum on term deposits. And, 3.5 percent on daily deposits both compounded annually; cannot accept deposits for a period less than 12 months. They cannot accept the deposit for a period less than 12 months or more than 84 months cannot offer any gift or incentives to solicit deposits from the public. Accept deposit only against the issue of the proper receipt.

The receipt should bear the name of the company and should be signed by the authorized official of the company. The receipt should maintain should mentioned the name of the depositor. The amount in words are as well as figures, the rate of interest payable on the deposit amount and the date of repayment of matured deposit along with the maturity amount. So, this particular company more or less provides the all kind of NBFC services what are they supposed to provide. And, offer a interest rate not less than 5 percent on the term deposits and 3.5 percent on the daily deposits and both are compounded annually.

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Then we have a new regulatory framework of NBFC registered with RBI; there what RBI has defined the minimum net owned fund for the existing NBFCs has been increased to 20 million. In order to strengthen the deposit acceptance regulations across all deposit taking NBFCs, the credit rating has been made compulsory for all unrated asset finance companies by March 31st 2016.

Tighter prudential norms have been prescribed, minimum tier I capital requirement raised to 10 percent. Then the non-deposit taking NBFCs be categorized into two broad categories: one is NBFCs ND those with assets less than 5 billion rupees and NBFC SI Systematic Important NBFC whose asset will be more than 5 billion and above which is known as systematically important.

And, regulations will be applied accordingly; regulations for NBFC SI and NBFC ND these are relatively little bit different, but they are defined on the basis of their total assets value. So, these are time to time the regulatory things are changing, but these are the framework which is existing now for all the NBFCs registered with the Reserve Bank of India. So, this is about all the regulatory bodies which are registered in RBI. Then will be discussing other NBFCs which are basically controlled or regulated by the other regulatory bodies in the Indian financial system in the next class.

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Please go through these particular references for this particular session.

Thank you.