Non-Banking Finance Companies in India – Regulatory Challenges and Concern

"Banks get in trouble for one reason: They make bad loans."

-- Carl Webb, co-managing member of Ford Financial Fund

That's elementary, isn't it? Now what if there was a way to navigate around the "*bad loan*". Nationalized banks have been trying to tone down the losses incurred due to such loans for quite some time now, have been successful a few times and a few times not. To alleviate the condition the idea of NBFCs was born. Understanding NBFCs require some awareness about evolution of banking, let's explore:

The idea of banks began as long ago as 1,800 BC in Babylon. Banks were supposed to be a haven meant for safekeeping of people's properties. Greece and Rome saw banks make loans, change money and accept deposits. However with the collapse of the Roman Empire trade slumped and banks temporarily vanished. Banking began to revive again in the 12^{th} and 13^{th} centuries in the Italian towns of Florence and Genoa.

The banking system started in India with the foundation of Bank of Hindustan in the then capital, Calcutta in 1770.The pre-independence phase oversaw the presence of a nearly 600 banks in India. After Independence, in the year 1949, the Reserve Bank of India was nationalized. In two decades, fourteen commercial banks were nationalized in July 1969 during the reign of Smt. Indira Gandhi. Nationalization was a significant step in the banking sector, and it helped improve people's confidence in the system. Post 1991, the government opened up the economy and invited foreign and private investors to invest in India. This move marked the entry of private players in the banking sector, and the rest is history.

For any country to function without major anomalies a fully-fledged banking industry is a necessity. The banking industry handles finances in the country including cash and credit. With the apparent influence of the banking industry on the economy of any country, which is quite visibly substantial, its regulation too, becomes an issue of serious consideration. In India, the Reserve Bank of India

(RBI) is that apex banking institution, which regulates overall monetary policy in the country. In all economic systems, banks have the leading role in planning and implementing financial policy. The difference lies with prioritizing goals and their way of achievement. Banks in the present times influence transactions all around us to such an extent that their absence will surely put society in a standstill.

RBI is the giant on whose shoulders the whole weight of the Indian Economy rests.

Our country being a developing one, clearly no walls of ambiguity about the stature of our financial system, compared to first-world countries. Factors such as overpopulation, years of poor economic reforms, among others- all imply a rather **low per capita income**, and consequently low standards of living. Moreover, with the economy being cyclic, nationalized banks do tend to hike interest rates throughout different periods. Although the scenario has improved considerably, lot of the population still face hitches, owing to unaffordable interest rates, absence of viable collaterals, lack of flexibility, and the like.

All these reasons culminated into the birth of NBFCs in India.

"A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property. A non-banking institution which is a company and has principal business of receiving deposits under any scheme of arrangement in one lump sum or in instalments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company)" (RBI website)

NBFCs are classified into various branches: Loan Company, Investment Company, Asset Finance Company, Infrastructure Finance Company, and Mutual Benefit Financial Company. The RBI looks at the NBFC in question and has the final say on the category it falls under and whether the company is a financial institute or not. These decisions are taken on the basis of principal business of a specific company and other relevant factors. Moreover, NBFCs can be further sub-classified under four headings, viz. Deposit Taking NBFCs, Non- Deposit taking NBFCs, NBFCs with assets size of 100 crores or more and Core Investment Non-Deposit NBFCs.

It seems that NBFCs are the key to better and more accessible means of financial exchanges. In practice, however it's evident that this is far from the case, as numerous challenges and concerns come into light upon closer study of these institutions. The issue which takes centre stage is the credibility of the NBFC.

With RBI having to direct and inspect the working of NBFCs, the possibility of such an institution engaging in unlawful activities of hiding assets and exploiting the public is a major concern. History has its fair share of chit fund scams, cases of companies carrying out NBFC-esque operations without an RBI license, etc. which only end up negatively impacting the Indian economy. As per reports by **The Ministry of Corporate Affairs**, an estimated 34,000 firms had allegedly been running businesses on the lines of non-banks without proper authorization from the banking sector regulator as recently as in 2014. It was found that the people behind such firms had been taking advantages of various norms, bending around legislation set by the RBI.

Credibility isn't the only issue; the RBI also has to worry about the NBFCs suffering what is called a **liquidity crunch**. Monetary support for NBFCs is essential for smoother working. Absence of such support can lead to these institutions committing serious defaults. NBFCs usually make use of money from banks; sell industrial papers to mutual funds to raise funds. These funds are then lent to small and medium enterprises, retail customers and the like. When such funds cease to exist, the credit flow to the economy decreases, consequently affecting economic growth. Since the RBI aims at enabling the businesses of big nationalized players as well as small time investors, keeping the interests of NBFCs in check is an obvious challenge. Back in 2018, IL&FS had defaulted the Small Industries Development Bank of India on payments, which caused the financials of NBFCs across the country to become a subject of great discussion. It's fair to say that the people at the helm of these non-banking finance corporations had to dedicate a substantial amount of time in convincing and assuring managers, treasury heads, etc about the safety of their money.

Continuing on the subject matter of safeguarding the interest of NBFCs, the RBI can introduce some degree of flexibility when it comes to the fulfilment of criteria necessary for licensing of an NBFC. A minimum NOF of Rs. 200 lakhs had been made mandatory by the authorities back in 2017. Smaller non-banking businesses tend to suffer as a direct consequence of the minimum NOF. Flexibility in licensing of NBFCs however, can't be the only goal for RBI; it also has to spot legitimate companies while keeping fraudulent companies off the market.

Defaulters in the NBFCs scene cause considerable problems, both for the companies in question as well as the economy. The very ease of acquiring a loan, or engaging in business with the non-banks itself, can sometimes become a source of concern in case the loaned party fails to or wilfully decides against repaying.

Quite obviously, the public entrusts lesser faith on NBFCs in comparison to the banks but on the flipside, depositors enjoy higher return from the non-banks. The RBI has laid down numerous guidelines for NBFCs, some might even say rigorous ones, but in the case of bankruptcy, there is no assurance that the depositors will get repaid. Insurance companies henceforth, abstain from insuring such depositors, which is pretty problematic.

More recently, NBFCs have been witnessing stronger competition in their native fields of financial lending from banks and other institutions. With the inherent advantage of diminished funds cost, banks have been increasing their shares in retail financing, giving NBFCs a tough time. These non-banks have been facing some pressure to reduce costs and synthesize a marketing approach focused on specific customer segments by presenting customizable services. The advent of bigger NBFCs in the field of insurance and banking has been a key and welcome development in this sector. All these put together, it's fair to say the concept and prospects of NBFCs remain debateable in the present economic environment.

"Every great and deep difficulty bears in itself its own solution. It forces us to change our thinking in order to find"

-- Neils Bohr (Nuclear Physicist)

There seems to be a need for measures from the policy making and administrative units so as to enable the nation to further broaden the range of products on financial investment; both on microscopic and macroscopic degrees. Talking on a micro scale, typical awareness campaigns on aspects such as accessibility and benefits of NBFC deposits can go a long way. This measure can be pictured being highly viable in urban areas where awareness isn't entirely low but methodological knowledge about the product is an issue. The rural areas can also be subject to such awareness programs but that implies the need for a lot more infrastructure, and that's a tough issue to counter. Moreover, with most of the country's population being in the 25-45 yrs age demographic, high engagement in stock markets and mutual funds can encouraged so as to boost participation in numerous NBFC schemes, which are quite similar to direct equity investments considering fundamental assets.

On the larger scale, the recommendations being on a policy level are roughly on the terms of liberalising regulations and easing off oppressive ones. History has seen little to no attention put to the issues of corporate governance of NBFCs in economical reforms in India, changing this thus is a expected choice in future reforms. There is an urgent need to refashion the present style of authority over NBFCs in India. The existing practices have led to a scenario without equity, and therefore a better degree of transparency with respect to revealing information and subsequent action isn't totally uncalled for. There also exists the need to reconsider the composition on ample board-level representation. The enforced regulations can also be made inert to political events so as to ensure continuity and stability. Proper representation of private NBFCs and entrusting them with greater power in forums discussing economic strategy can do great wonders in the long run. Conclusively, an overhaul in the legislative and organizational arrangement in the environment of NBFCs should be considered keeping the greater philosophy of economic reforms satisfied.

An easier means of accessing credit significantly helps the Indian economy, which indicates the vitality of NBFCs in the business environment. With public and private sector banks mostly failing to appeal to parties looking for credit, there is a greater good if the RBI and Government look past the actions of a few dishonest institutions and address the problems faced by NBFCs, with an aim to not only regulate but also boost the credit scene of the country. As with the non-banks, they can try to better their outreach, all the while working within the norms, and not bending around it. It's no rocket science that maximum economic growth and stability can come about only when all concerned parties work in unison through dialogue and diplomacy.

"It's futile to pick flaws in the books and operations of NBFCs. The truth is, they do what bankers don't. A banker's skill lies in analysing balance-sheets and evaluating collaterals. NBFCs deal with borrowers who neither have a balance-sheet nor solid security — even trusting borrowers who deal in cash and hide their true income. The Budget accepts it."

(The Economic Times)