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Non-Banking Financial Institutions

Jyotica Singh

Abstract: To understand what are Non-Banking Financial Institutions, know what all functions they perform and discuss what role RBI plays in controlling and regulating these institutions. A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency. NBFIs facilitate bank-related financial services, such as investment, risk pooling, contractual savings, and market brokering. NBFIs supplement banks by providing the infrastructure to allocate surplus resources to individuals and companies with deficits.

Key words: NBFCs, RBI, Deposits, Investment, Leasing, Institutions, Lending, Commercial Banks.

1.1 What are Non-Banking Financial Institutions' ?

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 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. They are increasingly being recognised as Complementary to the Banking system capable of absorbing shocks and spreading risk mitigation at the time of financial distress.

NBFCs do offer all sorts of banking services, such as loans and credit facilities, retirement planning, money markets, underwriting, and merger activities. The number of non-banking financial companies has expanded greatly in the last several years as venture capital companies, retail and industrial companies have entered the lending business.

1.2 Classification of Non-Banking Financial Institutions:

The major types of NBFC's registered with RBI are:

1. **Equipment leasing company: -** is any financial institution whose principal business is that of leasing equipments or financing of such an activity.

2. **Hire-purchase company:-** is any financial intermediary whose principal business relates to hire purchase transactions or financing of such transactions.

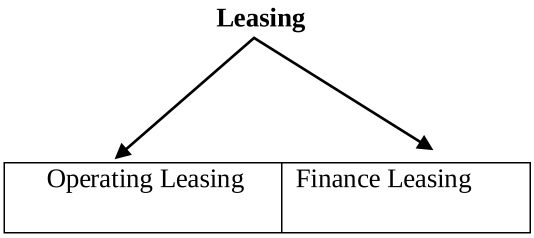
3. **Loan company:-** means any financial institution whose principal business is that of providing finance, whether by making loans or advances or otherwise for any activity other than its own (excluding any equipment leasing or hire-purchase finance activity).

4. Investment company:- is any financial intermediary whose principal business is that of buying and selling of securities.

1) Equipment Leasing Company

It is a company which is carrying on as its principal business, the activity of leasing of equipment or the financing of such an activity.

The Leasing business arises out of a contract between the ***lessor (i.e. leasing company)*** and the ***lessee (i.e. borrower)*** whereby the lessee is permitted to use specified capital equipment, as a hire against the payment of a monthly rental fee. Thus the lessee does not make an outright purchase of the capital equipment, but he buys the rights to use it.



***A)* Operating Leasing:** In operating leasing the producer of capital equipment offers his product directly to the lessee on a lease basis. There is no middle man in operating leasing.

It is a lease whose term is short compared to the useful life of the asset or piece of equipment (an airliner, a ship, etc.) being leased. An operating lease is commonly used to acquire equipment on a relatively short-term basis. Thus, for example, an aircraft which has an economic life of 25 years may be leased to an airline for 5 years on an operating lease.

The lessor leases the equipment to the lessee which pays periodically a rent. Operating lease is the smartest way for the outsourcing of industrial equipment. It allows the company not to use its equity in an investment that produces no direct added value, but to dedicate it to its core business and valuation.

B) Finance Leasing: In finance leasing the producer or capital equipment sells the equipment holder sells the equipment to a leasing company who in turn leases it out to the ultimate user of that equipment. Thus there are three parties in finance leasing i.e. ***producer, leasing company, lessee*** and the leasing company acts as a middle man between the producer and user.

Finance lease is one in which risk and rewards incidental to the ownership of the leased asset are transferred to lessee but not the actual ownership. Thus only the notional ownership is passed to the lessee.

2) Hire Purchase Company: These Companies help small transport operators, professionals and the middle income group to buy equipment on the basis of hire purchase. It is a less risky business since the goods purchased on hire purchase basis themselves serve as securities till the last instalment of the loan is paid.

During the repayment period, ownership (title) of the item does not pass to the buyer. Upon the full payment of the loan, the title passes to the buyer. If the purchaser makes default in the payment of an instalment, the seller can take back the possession of the goods.

Top Companies which provide **Hire Purchase** facility are:

1) Bajaj Finance
2) Mannapuram Finance
3) Cholamandalam
4) M&M Finance
5) Magma Fincorp

3) Loan Company: Loan Company means any company which is a financial institution carrying on as its principal business of providing finance whether by making loans or advances. It does not include an equipment leasing company or a hire purchase finance company or a housing finance company.

Generally these companies extend loans to wholesalers, retailers, small-scale industries and the self-employed .Most of their loans are unsecured and risky and hence they charge high rates of interest. Though loans are given for short periods, they can be renewed and thereby become long-term loans.

There are some regulations which these companies have to follow:

a) Every Loan Company must obtain a license from the RBI without which it should not be allowed to function.
b) A certain liquidity ratio and owned funds to deposits ratio must be prescribed , through at a lesser rate than that of commercial banks
c) There should be a ceiling on the interest rates offered on deposits

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4) Investment Company: Investment Company is any financial intermediary whose principal business is that of buying and selling securities. The principal aim of an investment company is to protect the small investors by collecting their small savings and investing them on diversified securities so that the risk may be spread. As individuals cannot do this. But, the investment company has been formed for the collective investment of money subscribed by many investors' particularly small investors. Besides, it gives its investors the benefit of trained, experienced and specialized management.

Apart from Investment Company, there are *Investment Counsels*. An investment counsel engages itself purely in the business of giving investment advice to investors. It helps investors to select a sound and liquid security.

In India, investment trust companies are popular. They channelize the savings of the people into productive venture. Small investors are protected by providing the much needed diversification of investments. They render expert investment advice and manage the investment portfolio of their clients. Some of them undertake underwriting, promoting and holding company business besides financing. These investment trusts promote business stability in the economy by keeping the capital market active and busy.

2.1 Functions of Non-Banking Companies/Institutions

1. Receiving of Deposits: The primary function of non-banking financial institutions is to receive deposits from the public in various ways such as issue of debentures, unit certificates, savings certificates, subscriptions etc. Hence, deposits of non-banking companies comprise of money received from the public by way of deposit or a loan or in any other form.

Types of Deposits

Regulated Deposit   Exempted Deposit

a) Regulated Deposit: A regulated deposit is one which is subject to certain regulations by the controlling authority. Generally, the RBI regulates some of the deposits of these companies by prescribing certain ceilings or by putting certain restrictions. Those deposits which come under this category are called regulated deposits.
b) Exempted Deposit: Those deposits which are completely free from the regulations of the regulations of the controlling authority are known as exempted deposits, Like: Intercompany borrowings, money received from the Government, borrowings from banks and other financial institutions. The exempted deposits occupy major share in the total deposits of non-banking companies.

2. Lending of Money: Non-Banking companies provides financial assistance in various forms-hire purchase, leasing finance, finance for social activities etc. Easy and timely finance is available and generally those customers who have been denied of bank finance approach these companies and enjoy the credit facilities extended by them.

3. **Investment of Money:** These companies also invest their surplus money on various outlets. In case of investment companies, their main function is to invest on principal securities and pass on the benefits to small investors.

3. Commercial Banks Vs Non-Banking Companies

Commercial Banks and non-banking companies are both financial intermediaries receiving deposits from public and lending them or investing them as the case may be. But there are some vital differences between the two:

1. Cheques can be issued against bank deposits whereas no such facility is available in the case of NBFCs.
2. The commercial banks can manufacture credit out of raw material of deposits by creating claims against themselves. But, NBFCs cannot create credit as commercial banks do. They can lend only out the resources on hand. So, they have limited capacity to create credit.
3. Commercial banks are able to enjoy certain facilities like rediscounting, deposit insurance coverage facilities, refinancing facilities etc. These facilities are not extended to NBFCs.
4. The commercial banks offer lesser rate of interest and also charge lesser rate of interest than that of NBFCs.
5. A variety of assets in the form of loans of various types, cash credits, overdrafts, bills discounting etc are held by commercial banks whereas the assets of NBFCs are more or less specialized in nature.

4. RBI's Control over NBFCs

In the interest of the economy as a whole and in order to pursue an effective monetary policy, it is desirable that the NBFC's should be brought under the control of the RBI in the same way as the commercial banks are controlled. It is so because, whenever the RBI increases its bank rate charges or the lending rate or deposit rates they will have no impact on the rates charged by these non-banking intermediaries. Again, when the RBI follows a policy of credit squeeze, the industrial houses can escape from this policy by restoring to the system of financing through public deposits. Besides any person with any type of security can approach NBFCs at any time to obtain a loan. Some of the NBFCs have been found to be issuing misleading advertisements for attracting deposits .In these circumstances, RBI cannot function effectively and implement its fiscal and monetary policies unless the NBFCs are brought under its control. Hence, the RBI has been taking several steps in this direction .Some of them are as follows:

1) Issue of Directions

2) Restrictions on Deposits

3) Regulation of Brokerage

4) Regulation of Liquidity

5) Compulsory Registration

6) Submission of Returns

Conclusion

The NBFCs are fastly competing with the commercial banks in tapping the savings of the public in the form of deposits, providing easy lending facilities, wide investment options which have now gained confidence in the eyes if customers. NBFCs sector in the past few years has seen tremendous growth, but when compared to the commercial banks, the volume of business done by these institutions is quite small in front of them. With the regularisation of RBI, these companies are equally monitored by RBI as like the Banks. The Benefits and ease which these companies have provided to customers suggests that NBFCs foresee bright future in the growing Indian Economy.