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Types and Nature of NBFCs

Significance of NBFCs in India

NBFCs have come to be regarded as important financial intermediaries particularly for the small-scale and retail sectors with the growing importance assigned to financial inclusion.

In the multi-tier financial system of India, importance of NBFCs in the Indian financial system is much discussed by various committees appointed by RBI in the past and RBI has been modifying its regulatory and supervising policies from time to time to keep pace with the changes in the system.

NBFCs are an integral part of the Indian financial system, enhancing competition and diversification in the financial sector, spreading risks specifically at times of financial distress and have been increasingly recognised as complementary of banking system at competitive prices. The Banking sector has always been highly regulated, however simplified sanction procedures, flexibility and timeliness in meeting the credit needs and low cost operations resulted in the NBFCs getting an edge over banks in providing funding.

NBFCs have been pioneering at retail asset backed lending, lending against securities, microfinance, etc. and have been extending credit to retail customers in under-served areas and to unbanked customers.

Meaning and types of NBFCs

Section 45-I of the Reserve Bank of India Act, 1934 defines ''non-banking financial company'' as–

(i) a financial institution which is a company;

(ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.

Hence, an NBFC may be defined as a company registered under the Companies Act, 1956 and also registered under the provisions of section 45-IA of the Reserve Bank of India Act, 1934 and which provides banking services without meeting the legal definition of bank such as holding a banking licence.

NBFCs are basically engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agricultural activity or any industrial activity or sale, purchase or construction of immovable property.

NBFCs vs. Conventional Banks

- It is not a part of payment and settlement system which is precisely the reason why it cannot issue cheques to its customers.
- Deposit insurance facility of DICGC is not available for NBFC depositors unlike in case of banks.
- SARFAESI Act provisions have not currently been extended to NBFCs. Besides the above, NBFCs pretty much do everything that banks do.

Classification of NBFCs based on the nature of its business

The NBFCs that are registered with RBI are basically divided into four categories depending upon its nature of business:

- hire-purchase company;
- equipment leasing company;
- loan company;
- investment company;
- infrastructure finance company

Reclassification of NBFCs w.e.f. 6th December, 2006

In terms of the NBFC Acceptance of Public Deposits (Reserve Bank) Directions, 1988 with effect from December 6, 2006 the above NBFCs registered with

RBI have been reclassified as:

Loan Company (LC)

Loan company means any company which is a financial institution carrying on as its principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

Investment Company (IC)

Investment Company is a company which is a financial institution carrying on as its principal business the acquisition of securities.

Investment Companies are further divided into following sub-categories:

Core Investment Companies:

The Reserve Bank of India *vide* its Notification No. DNBS(PD)CC.No. 197/03.10.001/2010-11 dated August 12, 2010, a new class of NBFCs by the name of 'Core Investment Companies' (CIC) was added.

Core Investment Companies in terms of RBI's Notification means

A non-banking financial company carrying on the business of acquisition of shares and securities and which satisfies the following conditions as on the date of the last audited balance sheet:-

(i) it holds not less than 90% of its net assets in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies;

(ii) its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its net assets

Net assets, for the purpose of this proviso, would mean total assets excluding –

- cash and bank balances;
- investment in money market instruments and money market mutual funds
- advance payments of taxes; and
- deferred tax payment.

(iii) it does not trade in shares, bonds, debentures, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;

(iv) it does not carry on any other financial activity referred to in section 45-I(c) and 45-I(f) of the Reserve Bank of India Act, 1934 except:

a) investment in

i. bank deposits,

ii. money market instruments, including money market mutual funds,

iii. government securities, and

iv. bonds or debentures issued by group companies;

b) granting of loans to group companies; and

c) issuing guarantees on behalf of group companies.

Asset Finance Company (AFC)

AFC would be defined as any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines. Financing of physical assets may be by way of loans, lease or hire purchase transactions.

Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60% of its total assets and total income respectively.

Mutual Benefit Financial Company (MBFC)

Mutual Benefit Financial Company means a company which is a financial institution notified by the Central Government under section 620A of the Companies Act, 1956.

The above-mentioned types of NBFCs may be further classified into:

- NBFCs accepting public deposit (NBFCs-D) and
- NBFCs not accepting/holding public deposit (NBFCs-ND).

Operating leasing entities

Operating leasing companies do not come under the RBI definition of NBFCs since operating lease is not "equipment leasing" business as defined by the RBI. Only financial leasing is included in the RBI definition.

Further classification of NBFCs-ND based on the size of its Asset

NBFCs-ND may also be classified into (i) Systematic Investment and (ii) Non-Systematic Investment NBFCs based on the size of its asset.

NBFCs are typically into funding of:

- Construction equipment
- Commercial vehicles and cars
- Gold loans
- Microfinance
- Consumer durables and two wheelers
- Loan against shares, etc.

List of major products offered by NBFCs in India:

- Funding of commercial vehicles
- Funding of infrastructure assets
- Retail financing
- Loan against shares
- Funding of plant and machinery

Small and Medium Enterprises Financing

- Financing of specialised equipment
- Operating leases of cars, etc .

Types of instrument generally executed:

- Loans
- Hire purchase
- Financial lease
- Operating lease

Collateral definition and due diligence

The loan is granted against pledge of securities to the NBFC. More and more NBFCs are offering this option now and also expanding the financial assets that can be used as for a LAS option.

NBFCs usually define securities that can be pledged against the loan. These securities are very liquid, from high quality companies, and highly valued securities. The amount depends on valuation of securities, margin allowed by the NBFC, and past credit history.

The amount of loan is about 50% to 70% of the value of the securities pledged with the NBFC. Hence, if your stock portfolio for these securities is ₹ 10 lakh, you can get a loan of ₹ 5 lakh to ₹ 7 lakh against the stock portfolio.

The advantage of loan against securities is that you will be charged interest only on the amount you withdraw from the account and for the span of time the fund is utilised. The other advantage is that you require no personal guarantor for loan against securities.

Future prospects of NBFC sector

Summary

NBFCs have been playing a very important role both from the macro economic perspective and the structure of the Indian financial system. NBFCs are the perfect or even better alternatives to the conventional Banks for meeting various financial requirements of a business enterprise. They offer quick and efficient services without making one to go through the complex rigmarole of conventional banking formalities.

However to survive and to constantly grow, NBFCs have to focus on their core strengths while improving on weaknesses. They will have to be very dynamic and constantly endeavour to search for new products and services in order to survive in this ever competitive financial market.

RBI has been reviewing the existing NBFC guidelines and has proposed certain changes in the guidelines which could prove to have a significant impact on the NBFC space.