Non-Banking Financial Companies

forthcoming in

The Oxford Companion to Economics in India, K. Basu, editor

New Delhi: Oxford University Press

A Non-Banking Financial Company (NBFC) is a company incorporated under the Companies Act, 1956 and conducting financial business as its principal business. In contrast, companies incorporated under the same Act but conducting other than financial business as their principal business are known as non-banking non-financial companies. NBFCs are different from banks in that an NBFC cannot accept demand deposits, issue checks to customers, or insure deposits through the Deposit Insurance and Credit Guarantee Corporation (DICGC).

In India, the non-banking financial sector comprises a multiplicity of institutions, which are defined under Section 45 I(a) of the Reserve Bank of India Act, 1934. These are equipment-leasing companies (EL), hire purchase companies (HP), investment companies, loan companies (LCs), mutual benefit financial companies (MBFC), miscellaneous non-banking companies (MNBC), housing finance companies (HFC), insurance companies (IC), stock broking companies (SBC), and merchant banking companies (MBC). A non-banking company which conducts primarily financial business and belongs to none of these categories, is called a residuary non-banking company (RNBC). An overview of NBFCs together with relevant supervising bodies is given in Figure 1. Since banking, insurance, and stock markets are covered elsewhere in this Companion, HFCs, ICs, SBCs and MBCs will not be addressed in further detail here.

[Figure 1 about here]

While most institutions of India's non-banking financial sector are also found in other countries' financial systems, two of them, MBFCs and MNBCs, better known as Nidhis and Chit Fund Companies, respectively, are genuinely Indian institutions and rarely found outside South Asia. Inside India, they are most popular in Tamil Nadu and Kerala, from where they have originated. A Nidhi does business only with its equity share holders. Much like a cooperative bank, a Nidhi accepts deposits and makes loans, which are mostly secured by jewelry. A chit fund, in Kerala also known as kuri, is a particular form of a rotating savings and credit association (ROSCA), which is most easily explained by means of an example. Twenty people, say, agree to contribute a fixed amount, say Rs 1,000, every month. So the group pools in Rs 20,000 each month, the prize money. Every month an auction is held. In each auction, the bidder who offers the highest discount is given the prize money minus the discount. For example, when a member bids Rs 4,000, she will be paid Rs. 16,000. The discount of 4,000 is equally shared by all members. In this example, each member thus earns a dividend of Rs. 200. The winner of an auction continues to pay the monthly contribution but is not eligible to bid in subsequent auctions. According to this system, after 20 months each member has received the prize exactly once, at which point the chit fund comes to an end. A MNBC or Chit Fund Company acts as commercial organizer of Chit Funds.

In 1999, RBI mandated net owned funds (NOF) of at least Rs. two crore for registration of a new NBFC. Companies that were already in business in 1999, had to prove net owned funds of at least Rs. 25 lakh to register. Companies which failed to meet this requirement by 2003 have to phase out their business. This led to numerous mergers of existing NBFCs and a considerable reduction in the number of NBFCs since the late 1990's after the sector had seen thriving growth throughout the 1980's and early 1990's. To illustrate, the number of companies monitored by RBI increased from 7,063 in 1981 to 51,929 in 1996. At the same time the share of non-bank deposits tripled. In 2003, the number of NBFCs monitored by RBI had come down to 13,849, of which 710 were authorized to accept public deposits. Between 1998 and 2003, the ratio of public deposits with NBFCs to commercial banks came down from 3.4 to 1.5 percent.

A profile (as of 2003) of deposit-taking activities within the NBFC sector is given in Table 1. Among the 710 registered and 165 unregistered deposit-taking NBFCs, the majority operated as Hire Purchase Companies. The bulk of deposits was held by residuary non-banking companies. It should be noted, however, that these numbers understate the importance of NBFCs for savings mobilization for at least two reasons. First, financial intermediation in chit funds takes place instantly and members' contributions do not appear as deposits on Chit Fund Companies' balance sheets. For 2004, the turnover in registered chit funds is estimated at Rs. 20,000 crore. Second, deposits in Nidhis by Nidhi members do not count as public deposits. Since the Department of Company Affairs (DCA), to which MBFCs report, does not publish statistics on Nidhi operations, however, numbers on the volume of deposits in Nidhis are not available. The number of Nidhis was at 244 in 2004 and, according to conservative estimates, Nidhi companies had lendings of about Rs. 1,500 crore in 2001.

[Table 1 about here]

Selected items of NBFCs' (excluding RNBCs) balance sheets are displayed in Table 2. The majority of liabilities of these NBFCs are borrowings from various sources, whereas public deposits contribute less than 20%. The majority of assets are loans and inter-corporate deposits, and hire purchase assets, which mostly consist of retail funding of cars, commercial vehicles and consumer durables. While NBFCs excluding RNBCs have a deposit to net owned funds ratio of 1.2, the five RNBCs which report to RBI are much more leveraged with a deposit to net owned funds ratio of 18.6. The RNBC sector is dominated by two companies, which, in 2003, held more than 99.9% of RNBC deposits. While they offer a variety of financial products including insurance, their main business is to accept term deposits, which are invested into mainly government-issued securities.

[Table 2 about here]

Are NBFCs essential to a country's financial system or, put differently, could their functions not also be performed by banks? In this connection, several arguments can be made. First, NBFCs provide services not well suited for banks. Banks primarily provide payment services and liquidity. Since banks have to maintain the value of deposits, they tend to have mostly debt-type, as opposed to equity-type, items on both side of their balance sheet. In contrast, NBFCs can finance riskier borrowers and intermediate equity claims. They thus offer a wider range of risks to investors, which encourages investment and savings, and creates a market for risks. Second, NBFCs unbundle services that are bundled within a universal bank, and thus foster competition, which benefits customers. Third, through specialization, NBFCs can gain informational advantages over banks in their narrowly-defined fields of operation. Fourth, NBFCs diversify the financial sector, which may alleviate a systemic crisis.

Are the functions performed by NBFCs important for economic growth? Recent research with cross-country data sets has established that development of the financial sector has the potential to accelerate economic growth. However, no research on the particular role of NBFCs in this process has yet been undertaken. Nevertheless, international comparisons show that economies with lower per capita income tend to have a smaller range of equity-type claims and a smaller market share of NBFCs relative to banks.

An important and widely-discussed issue in the context of financial institutions is regulation. NBFCs are particularly important for facilitating storage of value and intermediation of risk. Moreover, like other financial institutions, they are sensitive to runs and herding behaviour. If the financial sector does not work smoothly, high transaction costs, lack of confidence and short-sightedness of economic actors, as well as a culture of corruption may result. The objectives of financial sector regulation are protection against systemic risks (like depositor runs), consumer protection, efficiency enhancement, and social objectives.

Regulation may be structured either institutional or functional. Under the former, each financial institution has its own regulatory agency, e.g. one for each category of NBFC. Under the latter, there are separate agencies for each function of an NBFC, e.g. one for deposit-taking activities, one for lending, one for market-conduct etc. India's legislators have chosen a mix between these two models. As illustrated in Figure 1, RBI regulates ELs, HPs, Investment Companies, LCs and RNBCs. Similarly, HFCs, ICs, SBCs and MBCs report to the National Housing Bank, the Insurance Regulation and Development Agency (IRDA), and the Stock and Exchange Board of India (SEBI), respectively. All these are instances of institutional regulation. In contrast, Nidhis report to the Department of Company Affairs (DCA) and Chit Fund Companies to the State Registrar of Chit Funds for their general operations, as well as to RBI for their deposit-taking activities, an instance of functional regulation.

To achieve the objectives of efficiency enhancement and protection against systemic risks, regulation has to be neutral. This means that institutions providing the same or similar services should be subject to identical regulatory requirements. Regulatory neutrality fosters efficiency-enhancing competition between institutions as each service will be provided by the institution which can provide it at the lowest cost. Deviations from regulatory neutrality, on the other hand, likely cause efficiency losses. Suppose that two institutions can provide a particular service at the same cost under regulatory neutrality but that, for no apparent reason, one of the two institutions is regulated less strictly. If regulatory requirements are costly to firms, that institution obtains a regulatory comparative advantage and will drive the more regulated one out of the market, an example of regulatory arbitrage. Moreover, if differences in regulatory requirements are big, less regulated institutions may drive out more efficient ones. In this worst case, the outcome will be both inefficient and fragile, as institutions which meet the lowest among all regulatory standards dominate the market.

Much of the history of NBFCs in India over the last fifty years can serve as a case study of non-neutral regulation and consequent regulatory arbitrage. Before 1997, RBI's supervision of NBFCs was limited to prescription of prudential norms and thus the structure of NBFCs' assets. No requirements were in place regarding minimum capital, amount and term structure of deposits, and interest rates on deposits and loans. At the same time the banking sector was heavily regulated through excessive statutory liquidity requirements, directed lending initiatives, and interest rate caps. NBFCs, which were not subject to any of these rules, thus enjoyed a substantial regulatory comparative advantage for several bank-type activities, most notably lending and deposit taking. Consequently, between 1981 and 1996, the number of NBFCs grew more than seven-fold and the share of non-bank deposits increased from 3.1 to 10.6 percent. Several companies were extremely leveraged and deposits-to-NOF ratios in excess of 40 not uncommon. Numerous bankruptcies of NBFCs in the early 1990's prompted RBI to take action. The measures sanctioned in 1997, most notably minimum NOF and a maximum deposits-to-NOF ratio of 1.5 and 4 (depending on the company's rating), brought NBFC standards closer to those of the banking sector. Subsequently the number of registered NBFCs shrank by seventy percent between 1997 and 2003. Nevertheless, NBFCs continue to enjoy regulatory privileges. As of 2003, they can pay 11% on deposits while the ceiling rate for banks is at 6.75%.

The 1997 provisions were not applied uniformly across NBFCs. In particular, Nidhis as well as RNBCs were exempt from maximum deposits-to-NOF ratios and, partly, from interest rate ceilings. Consequently, against the trend of a shrinking NBFC sector, the number of Nidhis increased from 192 in 1996 to 244 in 2005 with instances where deposits amounted to eighty times NOF. At the same time, insolvencies of major Nidhi companies made it to national news. It was only in April 2004 that DCA ruled Nidhis to gradually reduce the deposits-to-NOF ratio to twenty. The two main players in the RNBC sector have grown even more dramatically in response to the 1997 RBI initiative. As a share in total public deposits with NBFCs, deposits with RNBCs skyrocketed from less than ten to seventy-five percent between 1997 and 2003. The deposits-to-NOF ratio in the RNBC sector was at 116 in 2002 and improved to nineteen in 2003 through a massive injection of capital. As one of the two large RNBCs continues to have weak financials, RBI considers to mandate a cap of sixteen, although no action has been taken by 2005.

As it stands, substantial deviations from regulatory neutrality and resulting inefficiencies continue to be common features of the NBFC sector. While the regulatory measures implemented over the last ten years are steps into the right direction, regulators still have to go long ways to create an environment in which banking and non-banking financial institutions compete on even grounds.

References

Carmichael, Jeffrey and Michael Pomerleano, 2002. The Development and Regulation of Non-bank Financial Institutions. Washington, DC: The World Bank.

Reserve Bank of India, 2004. Report on Trend and Progress of Banking in India 2002-03, Mumbai.

	Number of Reporting Companies	Public Deposits
Equipment Leasing (EL)	58	511
Hire Purchase (HP)	439	3,539
Investment and Loan (IL)	173	329
RNBC	5	15,065
MNBC and MBFC	200	656
Total	875	20,100

Table 1. Profile of Public Deposits in the NBFC Sector as at End-March 2003, Amounts in Rs. Crore, Source: Report on Trend and Progress of Banking in India 2002-03.

Selected Assets		Selected Liabilities		
Equipment Leasing	2,011	Borrowings (by source)	Central and State Governments	1,570
Hire Purchase	13,031		Foreign Sources	694
Investments	4,338		Banks and Financial Institutions	8,959
Loans and Inter-corporate Deposits	13,296		Inter-corporate	2,074
Bills	450		Issue of Convertible or Secured Debentures	5,352
		Public Deposits		5,053
		Net Owned Funds		4,141

Table 2. Selected Assets and Liabilities of 870 NBFCs (excluding 5 RNBCs) as at End-March 2003, Amounts in Rs. Crore, Source: Report on Trend and Progress of Banking in India 2002-03.

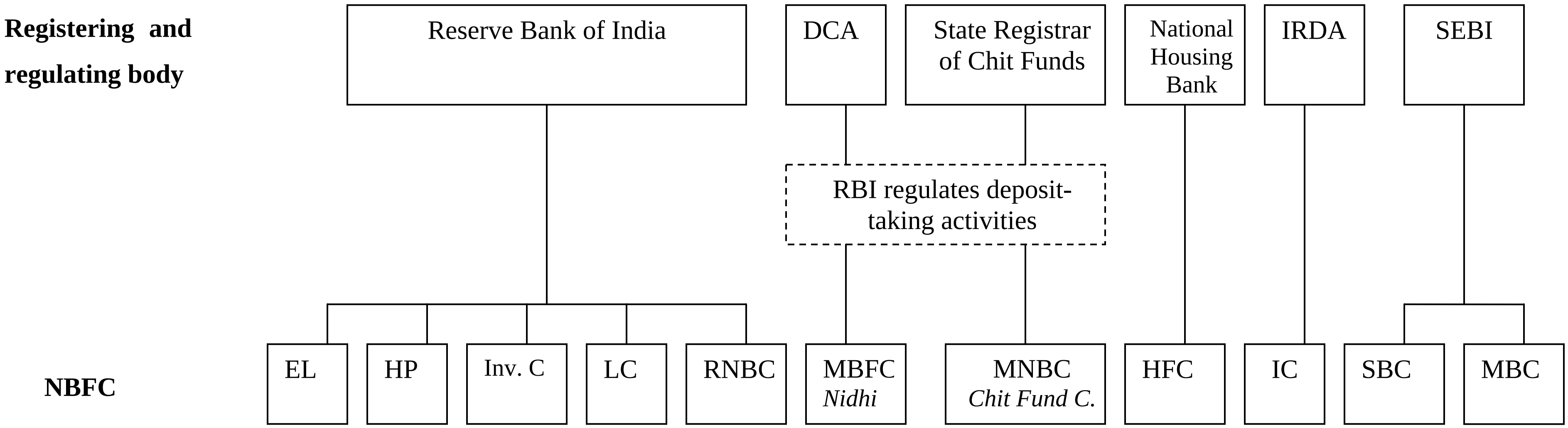

Figure 1. NBFCs and Supervising Bodies.