

Non-Banking Financial Companies in India

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Introduction

- Non-Banking Financial Companies (NBFCs) are financial institutions that provide banking-like services but do not hold a banking license.
- They are governed by the **Reserve Bank of India (RBI)** under the provisions of the RBI Act, 1934.
- NBFCs play a crucial role in the Indian financial system by offering credit to sectors underserved by traditional banks.

Features of NBFCs

- **Non-Deposit Holding:** Unlike banks, most NBFCs do not accept demand deposits (e.g., savings or current accounts).
- **Credit Focus:** They provide loans, hire-purchase financing, leasing, and other financial products.
- **Specialized Services:** NBFCs cater to niche markets such as microfinance, vehicle loans, housing finance, and infrastructure development.
- **Diverse Clients:** NBFCs often serve rural and semi-urban areas, SMEs, and individuals who lack formal credit access.

Types of NBFCs

- **Asset Finance Companies (AFCs):** Provide financing for physical assets like vehicles and machinery.
- **Loan Companies:** Focus on loans and advances to individuals or businesses.
- **Investment Companies:** Deal with securities investments.
- **Infrastructure Finance Companies (IFCs):** Offer credit for infrastructure projects.
- **Microfinance Institutions (MFIs):** Provide small loans to low-income groups.
- **Housing Finance Companies (HFCs):** Specialize in housing loans.

Role of NBFCs

- **Financial Inclusion:** NBFCs bridge the credit gap in rural and unbanked areas.
- **Economic Growth:** They finance key sectors like MSMEs, transport, and infrastructure.
- **Risk Diversification:** By targeting niche markets, NBFCs diversify risks in the financial system.
- **Job Creation:** NBFC activities stimulate economic growth, leading to employment generation.

News Summary

- NBFCs are grappling with challenges due to rising interest rates, regulatory changes, and limited funding avenues.
- **Sector Overview:**
 - NBFCs account for significant credit growth, particularly in rural and semi-urban areas, due to their wider reach and faster loan disbursements compared to banks.
 - **Assets under management (AUM) in the NBFC sector are projected to surpass ₹50 lakh crore in FY25**, up from ₹47 lakh crore in March 2024.
- **Regulatory Interventions:**
 - The **Reserve Bank of India (RBI)** has increased the risk weights for loans to NBFCs, raising borrowing costs and reducing bank funding.
 - Emphasis on compliance, risk management, and grievance redressal has added operational pressure on NBFCs.
 - Larger NBFCs are being discouraged from lending to smaller NBFCs and fintech firms to mitigate systemic risks.
- **Funding Challenges:**
 - **Bank funding to NBFCs has declined from 22% to 15% over the past year.**

- Smaller NBFCs and those with lower credit ratings face greater difficulty due to rising borrowing costs and fewer funding options.
 - NBFCs are exploring alternative sources like non-convertible debentures (NCDs), commercial papers, securitization, and external commercial borrowings, but limited liquidity in India's shallow bond market remains a challenge.
 - **Role of Co-Lending:**
 - Co-lending partnerships with banks can help NBFCs reduce costs and improve credit access for the underserved sectors, including agriculture and micro-enterprises.
 - **Impact on Priority Sector Lending (PSL):**
 - NBFCs play a critical role in priority sector lending, especially in agriculture and microfinance.
 - However, rising credit costs are expected to impact their operations, with **credit costs projected to increase from 2.6% in 2024 to 4% in 2025.**
 - **Potential Solutions:**
 - Development of a vibrant bond market could ease funding challenges and attract more investors, reducing reliance on banks and external markets.
 - Strengthened co-lending frameworks can create mutually beneficial models for NBFCs and banks.
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Q1. What is Repo Rate?

The repo rate is the interest rate at which the Reserve Bank of India (RBI) lends money to commercial banks and financial institutions.

Q2. What do you mean by Demand Deposit?

A demand deposit is a bank account that allows the account holder to withdraw funds at any time without giving the bank notice. Demand deposits are also known as checkbook money. Demand deposits are highly liquid and are often used for daily transactions like paying bills, making purchases, and withdrawing cash. They are different from term deposits, which lock money away for a set period of time.

News: NBFCs face funding challenges as RBI insists on risk management

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